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CAA's FINAL PROPOSALS FOR THE HEATHROW H7 PRICE CONTROL (CAP2365A)

Legal Annex to Heathrow's submissions

A. Introduction and Summary

1. This document sets out certain legal points which are relevant to Heathrow's response to the Civil Aviation Authority's (the "CAA") Final Proposals on the H7 price control[1] (the "Consultation" or the "Final Proposals").

2. Section B of this document sets out the applicable legal framework (including the appeals framework):

   a. the CAA is a creature of statute: its role starts and ends with its statutory duties[2];

   b. it is subject to an appeals regime which will correct material errors; and

   c. it must also carry out its functions in accordance with the rules of public law.

3. Section C of this document explains how the Final Proposals take the wrong approach and therefore fail to give effect to the CAA's statutory duties and public law standards of decision making. Section D focuses specifically on how the Final Proposals fail to properly address one of the most important aspects of the CAA's statutory framework, namely actual competitive conditions in the relevant markets.

4. The rest of this Annex applies these high level points to key aspects of the Consultation. Note that this document does not attempt to reiterate all of the points made in the main body of the response document. Many of those points constitute appealable errors in their own right and the fact that they are not rehearsed here should not be taken to indicate that Heathrow considers otherwise. Rather, this Annex sets out the main applicable legal principles and explains how they apply to certain aspects of the CAA's Final Proposals. We have provided cross references between this Annex and other Chapters of the Heathrow response. These are intended to assist the CAA but are not intended to be comprehensive and should not be taken as such.

5. In summary, the Consultation fails, in numerous respects, to give proper effect to the requirements of the CAA12 and/or the requirements of public law. Should the CAA fail to address these errors prior to making its final decision, the decision is likely to be vulnerable to appeal.

6. As some of the most notable examples:

   a. In important respects, the Final Proposals are deficient because they are focused on the interests of airlines, rather than the interests of consumers, contrary to the CAA's primary statutory duty. The CAA's Final Proposals take airlines' interests as representative of consumers' interests. This is legally indefensible: for example, the Final Proposals fail to assess whether airlines will pass onto consumers the savings from stripping back investment at Heathrow. As a result, the Final Proposals fail to properly promote economy and efficiency, and the outcomes of the Final Proposals are wrong. For example, the proposals disallow efficient investment which would benefit consumers in the long term; and they fail

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1 CAA CAP2365, Economic regulation of Heathrow Airport: H7 Final Proposals, 28 June 2022.

2 Primarily, in this context, duties arising under the Civil Aviation Act 2012 ("**CAA12**").

to allow Heathrow to meet the needs of the growing number of passengers who require special assistance.

b. The Final Proposals are rife with inconsistencies, contrary to the requirement of regulatory consistency in s.1(4) CAA12. The reasoning behind the Final Proposals involves "cherry picking" approaches for particular parts of the price control, but in doing so has rendered the price control incoherent as a whole. For example, (i) the Final Proposals arbitrarily switch between the notional and the actual company, and between different metrics, when assessing financeability; (ii) they focus on one financeability metric (to the exclusion of other metrics) when determining how far the TRS reduces risk but focus on a different metric (to the exclusion of other metrics) when determining whether a further RAB adjustment is required; and (iii) they use a high-case scenario traffic forecast throughout the Final Proposals, except for the TRS where they use a central traffic forecast. There are also inconsistencies between the outcomes the CAA expects of Heathrow and the cost allowances, which preclude Heathrow from making the expenditure necessary to achieve those outcomes. These same inconsistencies also render the Final Proposals unreasonable and at times irrational in the public law sense.

c. The reasoning in the Final Proposals, and the models which sit behind those proposals, contain a significant number of assumptions or findings of fact which appear to have no supporting evidence, contrary to basic principles of public law as well as the CAA's duties under s.1 CAA12. For example, the approach to estimating the asset beta involves numerous layers of assumptions that appear plucked from thin air, despite the very significant extent to which these assumptions impact Heathrow's allowed returns; and the passenger forecast model in the Final Proposals assumes Heathrow's share of the London market is the same as it was 20 years ago, neglecting more recent relevant evidence.

d. Relatedly, there are various aspects of the Final Proposals where the CAA has simply not explained its approach or its objectives in enough detail to allow consultees to intelligently respond, contrary to generally accepted public law principles of fair consultation. Important changes (such as changes to the methodology for calculating Heathrow's returns) are obscure and are not described in the Consultation; proposals such as sharing the revenue from the Terminal Drop Off Charge ("TDOC") are introduced with no justification; and the Consultation merely explains that the CAA has produced a passenger forecast which combines various pieces of evidence, but does not explain how those various pieces of evidence have been reconciled or weighed. The capex incentives proposals also lack any justification: the proposals would harm consumers by delaying capex projects, however the Consultation neither explains what problem the proposals are intended to solve, nor what consumer benefits would outweigh the harm that the proposals impose on consumers. The Consultation does not comply with basic principles of public law, nor does it comply with the CAA's statutory duty to have regard to the need for regulation to be targeted and proportionate.

e. The Final Proposals are based on numerous mistakes of fact. These vitiate the CAA's conclusions, because those conclusions are made on an incorrect premise. As examples: in assessing financeability, the Final Proposals take the wrong level of gearing as the starting point, which ignores amounts Heathrow has actually spent; the Final Proposals miscalculate the degree of revenue protection the TRS provides; and the Final Proposals wrongly assume the effects of the pandemic are over when calculating the asset beta. Case law is clear that a decision which depends on a mistake of fact, or which improperly designs a mechanism so that it does not deliver the result the regulator intended, is liable to be overturned on appeal.

f. The Final Proposals fail to discharge the CAA's basic public law duties to have regard to all relevant evidence, to all relevant considerations and to consultation responses. The proposals disregard Heathrow's evidence without justification, and in several cases does so where there is no countervailing evidence. For example, the proposals' passenger forecasts ignore the maximum number of air traffic movements Heathrow is legally allowed; the proposals disregard Heathrow's evidence about the regulatory risk associated with the TRS recovery mechanism; and the proposals summarily dismiss all of Heathrow's evidence (including an entire consultant report) about a further RAB adjustment without proper justification. These are serious procedural errors in themselves, which moreover have resulted in the CAA's decision being substantively flawed.

g. Finally, the Final Proposals fail to have regard to actual competitive conditions, including the possibility of Heathrow's level of market power varying between markets or market segments – contrary to the CAA's public law duties and the requirements of s1(2) and 1(4) CAA12. The Final Proposals have therefore failed to discharge the CAA's duties to ensure any new regulatory restrictions are necessary, justified and proportionate, and to ensure any new restrictions do not distort competition or hinder investment and innovation which would benefit consumers.

B. Legal framework

B1. *The CAA's statutory duties*

7. The CAA's duties for the purposes of H7 are set out in Chapter 1 of the CAA12.

8. Section 1(1) of the CAA12 sets out the CAA's primary duty to carry out its functions in a manner which will further the interests of users of air transport services regarding the:

    - range;
    - availability;
    - continuity;
    - cost; and
    - quality

    of airport operation services. The CAA's duty under section 1(1) governs all of the CAA's functions under Chapter 1.

9. Section 69 of the CAA12 provides that a "user", in relation to an air transport service, means a person who (i) is a passenger carried by the service, or (ii) has a right in property carried by the service. In this annex, when we refer to "consumers" we generally refer to both passengers and those with a property interest in cargo.

10. Paragraph 203 of the Explanatory Notes to the CAA12 clarifies, as is apparent on the face of the CAA12, that the definition of users of air transport services for the purposes of Section 69 of the CAA12 does not include airlines, pilots, or other members of crew.

11. Where appropriate, in accordance with Section 1(2) of the CAA12, the CAA must carry out its functions in a manner which it considers will promote competition in the provision of airport operation services.

12. In performing its duties under both of the above subsections, the CAA must have regard to the factors set out in Section 1(3) of the CAA12, which include most pertinently[3]:

    a. the need to secure that each holder of a licence under this Chapter is able to finance its provision of air operation services in the area for which the licence is granted ("the financeability duty");

    b. the need to secure that reasonable demands for airport operation services are met;

    c. the need to promote economy and efficiency on the part of each licence holder 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

[3] Other factors, less relevant here, are: any relevant guidance issued to the CAA by the Secretary of State; and any international obligation of the UK notified to the CAA by the Secretary of State.

the airport to which the licence relates, facilities used in connection with that airport ("associated facilities") and aircrafts using that airport; and

e. the principles in subsection 4.

13. The principles in subsection 4 are that –

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.

14. It is well understood that a requirement to act in the interests of consumers (in this case, passengers and cargo owners) goes well beyond low prices. This is, of course, set out on the face of the CAA12. Further, excessively low prices are damaging for consumers because (among other things) they discourage investment and competition. This orthodoxy was noted by the Competition Commission in an appeal from a price control decision by Ofcom:

> *"charge controls which, in practice, fail to enable the recovery of efficiently incurred costs may have an adverse impact on investment, which would be detrimental to consumers generally"*[4].

15. The important implication of this point is that the financeability duty is not something which can be considered in isolation. A price control which fails to secure adequate investment will be detrimental to consumers generally. Not only is the financeability duty engaged; the general duty to further the interest of users of air transport services– the CAA's principal duty under the Act – is also engaged directly.

B2. *The CAA's powers to set and modify Heathrow's licence conditions under the CAA12*

16. Section 18 of the CAA12 states that a licence may include –

a) such conditions as the CAA considers necessary or expedient having regard to the risk that the licence holder may engage in conduct that amounts to an abuse of substantial market power; and

b) such other conditions as the CAA considers necessary or expedient having regard to its duties under section 1 (its overriding duty to consumers).

17. Therefore, while Section 18 of the CAA12 does not necessarily compel the CAA to include any particular conditions, it does oblige the CAA to take proper account of the specified considerations when deciding whether or not to include a particular condition. For example – it must consider whether a putative licence condition may be in the interests of consumers, or whether it will further the financing objectives in accordance with section 1(3)(a) of the CAA12.

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[4] Hutchison 3G UK Limited v Office of Communications Case 1083/3/3/07; British Telecommunications plc v Office of Communications Case 1085/3/3/07 – the CC here noting Ofcom's position and practice.

18. Section 22(1)(a) of the CAA12 gives the CAA the power to modify Heathrow's licence conditions.

B3. *Public Law Standards*

19. In the exercise of its specific statutory duties to consult, the CAA is subject to general public law standards of adequate consultation:

    a. There are four basic requirements of legally adequate consultation (from *R v North and East Devon Health Authority, ex p Coughlan* [2001] QB 213 at §108 per Lord Woolf MR):

    > *"To be proper, consultation must be undertaken at a time when proposals are still at a formative stage; it must include sufficient reasons for particular proposals to allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and the product of consultation must be conscientiously taken into account when the ultimate decision is taken".*

    These criteria were expressly endorsed by the Supreme Court in *R (Moseley) v Haringey London Borough Council* [2014] UKSC 56 [2014] 1 WLR 3947 at §25, describing them as "*a prescription for fairness*". The governing principle is fairness: see *R (Keep the Horton General) v Oxfordshire Clinical Commissioning Group* [2019] EWCA Civ 646 at §18 and §66.

    b. Consultees' comments on a relevant aspect must not be excluded from conscientious consideration and consultees must not be denied an opportunity to present their case on an option: see for example *R (Parents for Legal Action Ltd) v Northumberland County Council* [2006] EWHC 1081 (Admin) at §36 and *R (Medway Council) v Secretary of State for Transport* [2002] EWHC 2516 (Admin) at §32 (consultees denied their only real opportunity to present their case on an option).

20. General public law also places the following duties on the CAA:

    a. The CAA has a duty of enquiry, i.e. "the duty … which falls upon a decision-maker to 'take reasonable steps to acquaint himself with the relevant information, in order to enable him to answer the question which he has to answer": see R (Campaign Against Arms Trade) v Secretary of State for International Trade [2019] EWCA Civ 1020 at §58.

    b. The CAA must have regard not only to the considerations specifically required in the CAA 2012, but also **any** considerations that are obviously material to its decision: see *re Findlay* [1985] 1 AC 318 HL per Lord Scarman at §333 and §334. It must also disregard irrelevant considerations: see *Associated Provincial Picture Houses Ltd v Wednesbury Corp* [1948] 1 KB 223, CA at §228 per Lord Greene MR.

    c. The CAA must respect any legitimate expectations which it has engendered, unless the overriding interest justifying the change of policy outweighs the requirements of fairness: see *R v North and East Devon Health Authority, ex p. Coughlan* [2001] QB 213 at §58.

21. Any findings of fact made by the CAA which underpin its decision are specifically subject to a right of appeal (see further below). However, for the avoidance of doubt the CAA is also subject to a general public law requirement that its decisions be based on evidence, and a duty to have regard

to all evidence that is potentially probative on the issues before it: see *R v Deputy Industrial Injuries Commissioner, ex p Moore* [1965] 1 QB 456, CA at §488 per Diplock LJ.

22. Recent case law shows that errors of fact are capable of rendering decisions by economic regulators unlawful – see *R (British Gas Trading Limited) v Gas and Electricity Markets Authority* [2019] EWHC 3048.

B4. *Appeals and the standard of review*

23. As a relevant licence holder under the CAA12, Heathrow has a route of appeal to the Competition and Markets Authority ("CMA") against a decision by the CAA to modify a licence under Section 22 of the CAA12. Section 26 states that the CMA may allow an appeal on one of the relevant appeal grounds:

    a. that the decision was based on an error of fact;

    b. that the decision was wrong in law; and

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

24. On appeal, the CMA is required to consider the merits of appeal by reference to the specific grounds of appeal outlined above.[5]

25. Errors of law do not allow for any margin of appreciation or "discretion" on appeal:

> *"in the context of challenges relying on an alleged error of law, … there [is] no role for 'regulatory judgement or discretion on the question of what is the correct construction of legislation' and also that 'on that question, the concept of reasonable judgement, as embodied in the Wednesbury test, has no part to play"*.[6]

26. The same is true of findings of fact:

> *"the [appeals body] has a clear jurisdiction in respect of factual errors, and we will exercise that jurisdiction where we conclude that GEMA has based its decision on a plain error of fact"*.[7]

27. Errors in the exercise of discretion do allow some room for judgment; but that room is not, by any means, unbounded. In a recent appeal under a closely comparable regime, the CMA considered this question. For example, the CMA found that whilst expert regulators should be afforded a margin of appreciation, it is not unbounded and depends on whether the error alleged is:

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5 This is the approach that the CMA took in the recent RII02 Energy Licence Modification Appeals ("ELMA"), see paras 3.20–3.32 of Cadent Gas Ltd, National Grid Gas PLC, National Grid Electricity PLC, Northern Gas Networks Ltd, Southern Gas Networks PLC and Scotland Gas Networks PLC, Scottish Hydro Electric Transmission PLC, SP Transmission PLC, Wales and West Utilities LTD v Gas and Electricity Markets Authority, 28 October 2021.

6 ELMA para 3.70, referring to the position in *SSE Generation Limited v GEMA and National Grid Electricity System Operator Limited and Centrica plc/British Gas Trading Limited*, Decision, 30 March 2021, at para 5.17.

7 ELMA para 3.69, citing E.ON at para 5.16; quoting the dicta of the Court of Appeal to this effect in *T-Mobile v Ofcom* [2008] EWCA Civ 1373.

a. merely alleging that the regulators weighting of factors or other exercise of judgement is wrong;[8] or

b. exercising discretion when making adjustments to costs, in which case the CMA has found that there has to be:

> *"a limit to the discretion of regulators to make adjustments to the costs assumed in setting the price control where the consultation process has failed to demonstrate evidence in support of those adjustments. The exercise of regulatory discretion remains bounded and subject to legal principles"*.[9]

28. There are numerous examples of decisions which fall within the scope of regulatory discretion but where the bounds of that discretion have been breached. Most typically – though not always – these are decisions where numbers are involved. So, for example, Ofcom was found to have erred in the exercise of its judgement in settling forecast volumes for BT's local loop unbundling price control (analogous to forecast passenger volumes in this price control).[10]

8 CMA: RIIO2 ELMA Final Determination, 28 October 2021, paras 3.65–3.68 which referred to *Virgin Media Limited v Ofcom* [2020] CAT 5 at para 57 and SONI at para 3.35.

9 CMA: *Northern Powergrid v the Gas and Electricity Markets Authority Final determination*, 29 September 2015, para 4.142.

10 *TalkTalk Telecom Group plc and British Sky Broadcasting Limited v Ofcom*; LLU and WLR appeals, 2013, Competition Commission Case 1193/3/3/12; note that this should not be taken to imply that there cannot be errors of fact, including precedent fact, in volume decisions.

C. The Final Proposals fail to give effect to the CAA's statutory duties and public law standards of decision making

C1. *Failure to promote the interests of consumers*

29. As is evident from the discussion above, the CAA's primary duty is to further the interest of consumers. This means that consumers' interests should be at the centre of the CAA's policies and decision-making. The broad approach taken by the CAA – in particular, its focus on outcomes-based regulation and on quality of service – is in several respects consistent with this duty. However, in other important respects, the Final Proposals are deficient because they exclusively focus on the interests of airlines, which the CAA treats, uncritically, as a proxy for consumers' interests.[11]

30. For example:

    a. the Final Proposals do not use any primary consumer research or consideration of consumer views or their long-term interests to inform the outcome of the H7 review. As we note below, the CAA does not appear to have tested its outcome-based regulation proposals with actual consumers: instead, it relies entirely on the results of engagement between Heathrow and airlines.

    b. Heathrow has previously explained to the CAA that airlines are increasingly and explicitly focused on short-term profitability. If this is true, it follows that airlines may be reluctant to allow capital expenditure, even if long-term interests of consumers would support new investment. By adopting the interests of airlines as if they were the consumers' interests, the Final Proposals fail to properly discharge the CAA's primary statutory duty and arrive at the wrong result. For example, the Final Proposals take a blanket approach of only allowing expenditure on investment which pays back within H7. That position may well suit airlines. However, the Final Proposals do not properly consider the effect of this lack of investment on consumers. It is easy to envisage that depriving consumers of long-term investments may drive up prices and lower quality in the long run. However, the CAA's focus on airlines' interests precludes consideration of these plainly relevant issues.

    c. The Final Proposals remove Heathrow's opex and capex allowance to invest in delivering for passengers who need additional assistance and support. Again, this may not be an area in which airlines have much commercial interest. However, the Final Proposals simply say that the CAA has "considered the interests of passengers in the round" and that Heathrow "has not justified the need for additional opex" (para 4.74) – implying that existing outcomes are satisfactory, and ignoring Heathrow's evidence of consumer engagement and the responsiveness of Heathrow's proposals to consumers.

[11] If the CAA wanted to adopt airlines' interests as a proxy, it would need to explain its approach; invite consultees to comment on it; and comply with the duty to make reasonable inquiries in accordance with *R (Campaign Against Arms Trade) v Secretary of State for International Trade* [2019] EWCA Civ 1020 at §58. The CAA has taken none of these steps.

31. The CAA has also failed to meet its obligation under s.1(2) CAA 12 to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services in that it has failed to consider whether lower charges for airlines will, in fact, be passed through to consumers. Rather, the CAA adopts the assumption that there is perfect competition down the entire value chain. However, the CAA has no evidence to suggest that this is the case; nor has it made any inquiries or undertaken any analysis to determine the circumstances in which, and the extent to which, lower prices for airlines will in fact benefit consumers. To do so, the CAA would need to undertake a proper market analysis of competition which the airlines using Heathrow face (including with each other and with airlines which do not use Heathrow).

32. The failure to undertake this assessment undermines all the judgements the CAA makes about trading off potential investments in order to lower prices for consumers – because the CAA has no idea whether those lower prices will actually be enjoyed by consumers, or whether they will simply result in higher profitability for airlines, which will ultimately only benefit airlines' shareholders. As a result, the Final Proposals risk curtailing investment which may be in consumers' interests, for no relevant demonstrable benefit, which may in turn lead to higher charges and/or lower quality of service for future consumers.

C2. *Failure to promote economy and efficiency*

33. The Final Proposals' approach of assuming perfect pass-through also fails to comply with the CAA's duty to promote economy and efficiency. If the CAA overestimates the savings that consumers would enjoy if Heathrow's investment was reduced, then it follows that the CAA's assessment of whether those investments are efficient and represent value for money will be flawed. Accordingly, the CAA will be likely to disallow investments which are in consumers' interests.

34. In section J below, we refer to a further way in which the CAA has failed to promote economy and efficiency: by failing to properly consider the conditions for competition between Heathrow and its competitors. As we explain in that section, the CAA's failure to undertake this further analysis means it cannot lawfully be satisfied that the constraints imposed on Heathrow are appropriate: in fact, they may simply dampen incentives for investment and innovation, which would fail to further consumers' interests. In this way, the CAA is also failing to comply with its primary statutory duty.

C3. *Failure to ensure financeability*

35. As noted above, the CAA has a statutory duty to have regard to financeability. Fundamentally, securing financeability requires the CAA to set an appropriate level of return that is reflective of market conditions and the level of risk being taken by investors, so that Heathrow can support the operation of the airport and make investments which further consumers' interests. As we have noted above, it is well understood – and was expressly accepted by the Competition Commission – that a price control which fails to secure financeability would adversely impact investment, to the long-term detriment of consumers.

36. Because financeability is an assessment which must take into account all the elements of the price control as a whole – including the overall level of risk and the overall returns Heathrow's investors can expect to achieve, and that efficient, value-for-money investment is in consumers' interests – it is essential the CAA adopts a consistent set of principles and assumptions throughout the price control to properly discharge its statutory duty. The CAA has failed to do this.

37. To take one example, the CAA correctly decides to assess financeability using the notional company as a starting point[12]: that means Heathrow faces the costs or enjoys the benefit of its own financing decisions, to the extent they diverge from those of the notional company, giving it incentives to adopt the most efficient financing structure. The CAA of course must not lead to Heathrow actually becoming unfinanceable, and to that extent the CAA must have regard to Heathrow's actual financial situation: the CAA12 requires the CAA to have regard to financeability for "*each holder* of a licence". But Heathrow's actual costs must be a cross-check, not the starting point.

38. Contrary to this established approach, the Final Proposals switch between the notional and actual companies when assessing financeability in an unprincipled and inconsistent way, contrary to good regulatory practice, the need for consistency, and the CAA's duty to have regard to efficiency. At various points, the Final Proposals use Heathrow's actual position as the starting position, rather than a "cross-check", regardless of the position of the notional company. As examples:

    a. The CAA has correctly specified a target gearing of 60%, but then has moved away from a notional approach in its specification of the target credit rating and the appropriate financial ratios. Instead, it has based its approach on aspects of the actual company;[13]

    b. The CAA repeatedly states that the notional company would issue debt with a 20-year tenor. This is linked to the average useful asset life of 20 years, and the view that a notional company would match its assets and liabilities. But in the Final Proposals, the CAA reduces the debt tenor to align more closely with Heathrow's actual position; and

    c. The CAA's decision not to allow a further RAB adjustment is based on an assessment that the *actual company* has survived, regardless of the position of the notional company.

39. The CAA's approach to financeability is therefore subject to numerous errors of law. The CAA fails to have regard to regulatory consistency. Its approach does not fulfil the requirement of being properly justified and proportionate. It is irrational – in the sense that it is not internally consistent. And it fails to properly further the interests of consumers, because it arbitrarily deprives Heathrow of incentives to adopt an efficient financing structure.

40. The CAA's financeability assessment is also vitiated by errors of fact. For example, the Final Proposals take the wrong opening level of gearing: expansion spending is not applied until the end

[12] Final Proposals, section 2 paras 13.2 – 13.3
[13] See Heathrow's Response, Chapter 12, para 12.1.6

of 2021, regardless of when it was actually incurred. This understates Heathrow's opening level of debt in the H7 price control, artificially subduing its debt levels and interest costs. It is also contrary to the principle of regulatory consistency – since costs have been added to the RAB as they were incurred consistently over the Regulatory Accounts for 2017, 2018, 2019, and 2020.

41. The Final Proposals also failed to properly assess financeability, by selectively adopting different financeability metrics at different points in the analysis. For example, the Final Proposals use total cashflow metrics to work out how far the TRS reduces Heathrow's risk, ignoring other relevant financeability metrics which show the TRS would have no, or very little, effect. The Final Proposals also use Heathrow's notional company's gearing ratio as the sole financeability criterion in assessing the need for a further RAB adjustment, despite evidence that a further adjustment would have a significant impact on other metrics like cash flow.

42. Finally, as we note above, financeability must provide an adequate reward to investors for the risks of investing in Heathrow. In turn, this requires the CAA to properly understand the degree of risk which investors have to accept. However, there are various respects in which the CAA has clearly failed to properly comprehend these risks. As we note in section F below, for example, the TRS does not absolve Heathrow's investors of risk to nearly the extent the CAA assumes. It follows that the CAA cannot have properly and lawfully fulfilled its statutory duty to have regard to Heathrow's financeability.

C4. *Failure to abide by public law standards of decision making*

43. As will be evident from the detailed discussion below, the CAA has failed to properly consult on a number of critical elements in the Final Proposals. In many cases, it has failed to properly explain its approach and the objectives it was attempting to achieve, so that stakeholders would be in a position to provide intelligent comment. In other cases, the CAA's proposals are impossibly vague or ranges provided are so broad that they do not give consultees a real understanding of the CAA's proposals and thinking.

44. The following are examples where the CAA has failed to fulfil these requirements:

    a. The Final Proposals have an amended methodology for calculating the required return to Heathrow, so that it no longer uses the average RAB, as has been accepted practice in previous price controls, but instead discounts the end of year RAB using the WACC and uses this figure to calculate the required return. This change is not highlighted or described anywhere in the CAA's Final Proposal consultation documents, and was only identified by Heathrow through an in-depth analysis of the CAA's figures; it is unlikely that any other stakeholder would have been in a position to identify the change. It is inexplicable that the CAA would make such a change without any explanation or justification.

    b. The CAA has failed to provide any proper justification, reasoning or supporting evidence for its proposal to introduce a revenue sharing mechanism for TDOC revenues, or for how

the mechanism has been designed. Because of the lack of justification, Heathrow cannot intelligently respond to this aspect of the consultation.

c. The Final Proposals do not explain the proposed change of price index for the price control from RPI to CPI, despite RPI having been consistently used in Heathrow's past price controls. The consultation documents do not give any meaningful consideration to the respective merits of using RPI and CPI. Consultees have been given insufficient understanding to properly understand the CAA's thinking and the objective it is seeking when deciding between the two measures, so as to provide intelligent input.

d. The Final Proposals change the way in which inflation is taken into account in the calculation determining the annual maximum allowable yield. Instead of using historic inflation, the CAA is now proposing to use a forecast of inflation for the year ahead. This, again, is a change from precedent and the reason for the proposal has not been explained.

e. The CAA has introduced a K-factor correction mechanism for 2020 and 2021 without prior consultation, after having removed the K-factor from 2023 charges. Again, the CAA has provided no justification for this change.

D. The Final Proposals fail to consider actual competitive conditions

45. The CAA has failed to investigate or consider actual competitive conditions when settling its proposals. This includes a failure to consider and investigate the extent to which competitive conditions may have changed as a result of COVID and the extent to which they may have changed since the CAA made the market power determination ("MPD").

46. Market definition and market power analysis are, of course, crucial in any MPD exercise. But the state of competition is also a central plank in the exercise of deciding on the appropriate remedy to any market power. It is not enough for the Consultation to assume a uniform level of market power based on a MPD made eight years ago.

47. At least three direct statutory requirements compel the CAA to consider the current state of competition:

    a. Section 19(2) of the CAA12 stipulates an airport operator's licence should include such price control conditions as considered necessary, 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 relation to airport operation services;

    b. Section 1(2) of the CAA12 requires the CAA to seek to achieve its principal objective by the promotion of competition where possible; and

    c. Section 1(4) of the CAA12 requires that regulatory activities are proportionate and targeted only at cases where action is needed.

48. None of these can possibly be achieved without a proper understanding of the state of competition; neither can they be achieved by licence conditions which assume that competition is homogenous and unchanged since 2014.

49. In addition, the proposals in the Consultation – and the CAA's duties themselves - must be considered in the light of the purpose of economic regulation, which is, so far as possible, to mimic the effects of competitive markets. This is recognised in the explanatory notes to the CAA12, at page 191:

> *"the ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market"*

50. Moreover, as set out at B3 above, the CAA's public law duties require it to take account of all obviously material considerations, of which the state of competition is one.

51. The statute and general public law therefore require the CAA to take account of the state of competition, and the extent of any market power, in settling a package of remedies and in setting remedies such as price control conditions; and in considering the purpose of economic regulation when setting the detail of the regulatory settlement. The CAA should have regard, for example, to recent threats from airlines to cut flights from Heathrow and increase operations at other (London) airports if airport charges were to increase, and what this implies for the CAA's regulatory approach.

52. Accordingly, the CAA should give proper consideration to the current competitive state before deciding to impose new price control conditions and in designing appropriate interventions. Yet, the CAA in the Final Proposals simply observes that Heathrow and affected airlines have not requested that the CAA conduct a further market power determination[14]

53. However, that misses the point: it is not simply a binary issue of whether Heathrow has market power in some market or market segment or whether the threshold for the application of the CAA's powers is met. It is a question of whether the CAA has an up to date understanding of all of the relevant markets, including any competitive forces at play, in order that its interventions are targeted, proportionate, and consistent with the CAA's duties to achieve its principal objective by promoting competition where that is possible.

54. Given that the CAA's market power determination and analysis was undertaken in 2014, the CAA cannot simply continue to rely on the 2014 decision as accurately reflecting current market conditions, given the changes in the market.

55. In relation to the relevant product market(s), the CAA has simply assumed that homogenous conditions apply across market segments. In doing so, the CAA has failed to recognise the varying characteristics between, for example, airport services for cargo and passenger transport, respectively, as well as different categories of passenger transport such as long-haul and short-haul flights.

56. In the CAA's Market Power Test Guidance[15], the CAA recognises that the relevant productmarket "comprises all those products and/or services that are regarded as interchangeable or substitutable for the focal product by the consumer by reason of those products' characteristics, their prices and their intended use"[16]. When considering a possible MPD for Stansted in 2014, the CAA chose to treat the airport operation services to cargo airlines as separate to services provided to passenger airlines.This is consistent with the practice of the European Commission, which has consistently distinguished between passenger and freight (cargo) transport. Cargo owners have a variety of choices – such as sea-based transport, land-based transport (truck and rail), and air-based transport – which in many cases will not be open to passengers. In fact, our understanding is that air transport is often significantly more expensive than alternatives, and airports have a very low market share of total cargo transport. And the rise of e-commerce and demand for expedited delivery options, may well have provided new opportunities for regional airport hubs to acquire significant market shares.

57. The European Commission has also consistently found passenger transport for long-haul flights to be in a separate market to passenger transport from short-haul flights. From a demandside, it is clear that consumers (and airlines) would not consider these services interchangeable. There are also supply-side differences in that different types of flights may have require different service conditions. For example, long-haul flights typically require longer runway, larger check-in areas,

14 Final Proposals, Summary at para 98

15 CAP1433.

16 CAP 1433, para 4.22. See also OFT403, section 3 and European Commission market definition notice(97/C 372 /03) section 7

and larger gate areas to accommodate for larger volumes of passengers[17]. Accordingly, treating these differentiated services as homogenous is a factual mistake.

58. In relation to the relevant geographic market, the CAA's Market Power Guidance notes that the relevant market "comprises the area in which the undertakings concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogeneous" (emphasis added), and that different geographic areas should be considered where the conditions are "appreciably different"[18]. Arguably, the conditions of competition between – at least – the London airports are 'sufficiently homogenous' for the CAA to take into consideration when contemplating the scope of therelevant geographic market, and whether there is merit in extending it to also include other airports (at least for certain airport operation services).

59. It could be expected that the CAA's assessment of the competition constraints for defining the relevant scope of the geographic market(s) includes an analysis of airlines' ability to switch from Heathrow to another airport (such as Gatwick or Stansted), as well the potential for passengers to interchangeably use such other airport – either because of preferred location, services, prices and/or loyalty to a certain airline. In relation to international transfer customers Heathrow also faces competition from non-UK airports.

60. The CAA has failed to properly consider the relevant market conditions and the competitive landscape which is erroneous given that the competitive conditions will impact the appropriate remedy. Where there are already competitive constraints limiting Heathrow's ability to raise prices and/or impose other conditions on airlines and which affect consumers or cargo owners, the CAA should consider whether the proposed additional restrictions are indeed necessary and justified – and whether existing restrictions instead may need to be withdrawn because they risk distorting the market and hindering investment and innovation.

61. Other regulators routinely assess the extent of market power – even where there are market power determinations in place – when settling remedies. For example, under the closest comparable statutory framework[19], Ofcom typically sets lighter-touch remedies in markets where competition – or the future possibility of competition – is greater. This is not only consistent with its statutory duties – which in this respect reflect Section 1 of the CAA12 – but it recognises that keeping regulation as proportionate and targeted as possible is essential to incentivise new investment and allow greater innovation.

62. For example, in its Wholesale Broadband Access market review, Ofcom defined three geographic markets and found market power in two of them. As the Court of Appeal laterexplained:

> *As to market 1, [Ofcom] said "there is limited prospect in the near term of any wholesale competition" (para 1.22). Therefore, it said it was imposing general access, non-discrimination and transparency obligations on BT, together with a requirement that*

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17 See e.g. the European Commission's decision in case COMP/M.5652 - GIP/ Gatwick Airport.

18 CAA's Market Power Guidance, para 4.24.

19 Communications Act 2003: it is similar in that it mandates the regulator to conduct a market power exercise; and if there is market power, enables it to impose remedies in the form of regulatory conditions.

> *charges should be based on the cost of provision. As to charges, it said that it had decided to impose a charge control "the details of which will be subject to separate consultation", to ensure that BT did not set excessive prices which would ultimately be passed on to consumers (para 1.23). As to market 2, it said that there would also be general access, non-discrimination and transparency obligations, but no charge control.*[20]

63. This is not an unusual case; it is standard practice for economic regulators in the UK to examine the necessity for new regulation carefully; ensure regulation is targeted and not redundant; and to deregulate wherever competitive conditions allow. The above example was selected merely because the Court of Appeal provided a neat explanation of the different approaches. There are many other examples, including the deregulation of retail calls and of wholesale broadband access.

64. It is also not unusual for different remedies to be applied within a single economic market even where there is market power – for example, Ofcom frequently specifies price regulation for a single "anchor product" in an SMP market, while allowing pricing freedom in other markets.

65. It is straightforward to see how a proper assessment of competition could have led the CAA to a different result in designing the price control. As one example, the Final Proposals continue the position whereby Heathrow's charges for cargo capacity fall under the general price control, with charges for freight-only services capped at the level of charges for passenger flights, and cargo charges on passenger flights contributing to the overall revenue cap. Regulation of Heathrow's cargo capacity can be expected to have discouraged investment by Heathrow in growing the cargo business, and contributed to the airport focusing solely on passengers rather than the needs of cargo owners, We understand in recent years this has made cargo owners concerned at issues such as airfield access bottlenecks; limited cargo handling capacity; and road congestion at Heathrow. This is unsurprising since – without airline support – the price control would not sustain a business plan for investment in alternative and improved cargo handling facilities at Heathrow. This outcome is not consistent with the CAA's duties under the CAA12 , since cargo owners and passengers' interests are both treated equally as the interests of consumers.

66. There are likely to be many similar areas where a proper understanding of competition in the markets in which Heathrow is active would reveal that the CAA's existing and any new proposed regulatory restrictions may be having negative effects, and are inconsistent with the CAA's primary duty under the CAA12. However, having failing to conduct any proper assessment of competition (and/or of the conditions which would prevail in a competitive market) – contrary to its statutory duties – the CAA is remaining wilfully blind to these possibilities.

67. It is not for Heathrow to perform this detailed competition-based analysis of particular types of airport operation services in order to inform the CAA's remedies setting exercise. It is a statutory and common law obligation which sits squarely on the regulator. The regulator has been equipped

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[20] *TalkTalk Telecom Group plc v Ofcom* [2013] EWCA Civ 1318; the matters under challenge in the appealare not directly relevant to the point at issue here.

by Parliament with information gathering powers and substantial resource in order for it to carry out this function.

68. However, there are examples of cases where the Consultation's blindness to considerations of competition have given rise to clear errors – for example, the CAA's stipulation that capex for certain of Heathrow's commercial operations must pay back "in period" – see Chapter 7 of the Heathrow response.

69. Given:

    a. the CAA's statutory requirement to mandate only licence conditions which are required to address Heathrow' actual level of market power; and

    b. the statutory requirement that intervention be proportionate; and

    c. the standard practice from the most closely comparable statutory framework; and

    d. the fact that it has been eight years since the MPD; and

    e. The fact that COVID has intervened since then, along with a large number of other potentially relevant market developments such as the continued growth of other airports and the rise of e-commerce (in relation to cargo); then

    the CAA's blanket approach to Heathrow's 'market power' is a serious legal error.

E. Legal errors in respect of outcomes based regulation

70. Heathrow broadly endorses the CAA's ambition to move to Outcomes Based Regulation (OBR). However, there are specific errors in the CAA's proposal for OBR which require to be corrected in the final decision. These are errors of fact and/or discretion and/or breach the CAA's specific statutory duties and would constitute appealable errors if not corrected:

a. The CAA makes errors of fact (i) in assuming that there is no sufficiently detailed definition of the measure of Heathrow's Carbon Footprint[21] when in fact, a detailed measure exists [22]and (ii) in finding that a combined measure for Stand Facilities had not been agreed between Heathrow and the airlines, when in fact such a measure was agreed through Constructive Engagement in 2020[23].

b. The CAA's inclusion of Control Post 16 (CP16) within the OBR framework is premised upon an error of fact, in as much as it is based upon the CAA's understanding that Heathrow's proposal to remove it was based upon "low usage" that "reflected the specific circumstances of the pandemic". In fact, only one control post is required on the east side of the airport and CP12 was constructed to replace CP16. Moreover, inclusion of CP16 would require Heathrow to open both control posts for the required hours and would be inefficient, contrary to the CAA's duty under s.1(3)(c) CAA12.

c. The CAA is proposing service targets that are inconsistent with the opex and capex investment allowances that it is proposing, in particular with respect to cleanliness, wayfinding, PRM/PRS targets, departure punctuality targets, immigration waiting times, check in availability, and overall customer satisfaction and customer effort.[24]This is contrary to the principle of regulatory consistency in s.1(4) CAA12, and is in any event irrational and/or an obvious error of discretion.

d. The CAA's decision to continue with a knife-edge approach to incentives, rather than an incentive structure focussing on consumer preferences and with a sliding scale mechanism, is disproportionate and contrary to the CAA's primary duty under s.1(1) CAA 12. A sliding scale mechanism would be superior and incentivise Heathrow to meet real consumer preferences.

e. The CAA's incentive weightings are flawed, insofar as the CAA has failed to enquire and/or to have regard to current consumer preferences.[25] This applies in particular to weightings that have been retained from Q6, such as availability of lifts, escalators and travelators, and to security queue times.

f. The CAA's decision to maintain a measure for ease of understanding Covid 19 safety information throughout the H7 period fails to have regard to the need to ensure regulatory

[21] see Final Proposals, Section 2, para 3.76
[22] see Heathrow's Response Chapter 4 paras 4.4.2-4.4.5
[23] see Heathrow's Response Chapter 4 paras 4.4.24.
[24] see Heathrow's Response Chapter 4 paras 4.5.3-4.5.7
[25] see Heathrow's Response Chapter 4 paras 4.6.4-4.6.12

action is targeted only at cases where it is needed. This information would in any event be captured under measures of general safety information and such a specific measure is unlikely to be necessary through the H7 period.

g. The CAA's proposed mid-period review undermines incentives by creating uncertainty for Heathrow. As such it not only fails to pursue but positively undermines the CAA's primary duty to promote the interests of consumers, in particular as regards the promotion of economy and efficiency. Moreover, it is disproportionate in failing to pursue any legitimate aim, and fails to target regulatory activities only at cases in which action is needed.

71. In addition, the CAA has failed to discharge its public law duty of enquiry insofar as it has not tested the OBR Proposals using primary consumer research, but instead relies on engagement between Heathrow and airlines: we explain this point in more detail in section C1 above. OBR should properly be designed so as to "further interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services", as required by s.1(1) CAA12. Such users do not include the airlines and there are important respects in which the interests of airlines and of consumers are likely to differ. In order to properly carry out that duty, the CAA should make enquiries directly as to the priorities and preferences of those users.

F. Legal errors in respect of key building blocks

F1. *Passenger forecasts*

72. Since the Initial Proposals, the CAA has amended its methodology to place less weight on creating a forecast based on the Heathrow models. Instead the CAA says it will "*consider a range of traffic forecasts, alongside other relevant information and evidence, including inputs from stakeholder during engagement, macroeconomic forecasts, the evolution of actual passenger data and assessment of the current challenges facing the industry*"[26]. These other forecasts, information and evidence are not explicitly combined or weighed with Heathrow's forecasts in any model (or at least not in any model that Heathrow has seen) but are said to be factored into a putative exercise of judgement. Similarly, the CAA has provided no meaningful explanation of how it has estimated the impact of carbon prices, and how they will impact passenger numbers, or the underlying assumptions used for those estimates.

73. This approach is unlawful in various respects:

    a. First, it fails to respect the legal requirements of adequate consultation set out in *Coughlan*. The Final Proposals do not explain how these other sources of information and evidence have been factored into the CAA's forecasts: consultees are expected to accept that these simply go into a 'black box' of regulatory judgement, despite the fact that passenger forecasts are by their nature quantitative and despite the fact that the CAA must have formed views about the relative credibility and weighting to be given each source of evidence. Moreover, by changing its proposal without providing sufficient information on how the CAA has weighed different sources of evidence and why, the CAA prevents intelligent engagement between Heathrow and the CAA on this new approach. This lack of explanation means that the proposal does not provide sufficient reasons for those consulted to give intelligent consideration and an intelligent response.

    b. Secondly, the methodology is so opaque that it fails to respect the principle of transparency in s.1(4) CAA 2012.[27] The CAA's apparent justification in relation to passenger numbers overall is that Heathrow has not shared its own model. this incorrect as a matter of fact because, as noted below, Heathrow is content with its models being shared in a confidentiality ring in line with regulatory best practice (a point we address below).But even if that were not the case, much of the additional information needed to provide transparency could be shared without sharing the confidential data or intellectual property within the models. The CAA does not appear to have even considered which data might be sharable, contrary to its public law duties.

    c. Thirdly, insofar as it is possible to discern the CAA's actual methodology and to infer the reasoning behind it, the CAA's forecasts for 2022 and the 2023-2025 period are vitiated by errors of substance. As regards the forecasts for 2022, for example, reliance on bookings

[26] Final Proposals, Section 1, paragraph 1.17.
[27] see Heathrow Response Chapter 2 pages 29-33

data as a lower bound fails to take account of an obviously relevant consideration, namely the fact that bookings data can overstate passenger numbers.[28] It follows that using bookings data as the lower bound without taking its unreliability into account is irrational and unlawful. In relying so heavily on an average of supposed lower and upper bounds, the CAA's approach to forecasting for 2022 also fails to have regard to relevant evidence as to the key drivers for passenger numbers.

74. The CAA's forecasts also appear to fail to take account of obviously relevant considerations in the following respects:

    a. The CAA wrongly fails to take account of the risks and problems that are being and will be faced by Heathrow (and airlines) in ramping up capacity after Covid.[29]

    b. In setting its forecast the CAA does not specifically consider the impact of the net zero agenda and carbon pricing across the H7 period.[30]

    c. The CAA wrongly fails to take account of the legal limit on Air Traffic Movements ("ATMs") at Heathrow. Heathrow is legally limited to 480,000 ATMs per annum, which allows for a maximum of around 476,500 passenger ATMs, when cargo movements are taken into account. This legal limit, together with physical capacity constraints, means that although Heathrow may have days when it has much less than the average number of flights it will not have days which significantly outperform the average. Hence the distribution of daily passenger ATMs is skewed, such that the mean average is lower than the mode. This asymmetric distribution is therefore a feature of Heathrow's passenger forecast models and is an obviously relevant consideration. The CAA explicitly and wrongly leaves this negative skew out of account.[31]:

75. The CAA's forecasts are also *Wednesbury* irrational, in that they could only be met with more ATMs than Heathrow can legally or practically fly.[32]

76. The CAA has also made an error of discretion insofar as it decides to place less weight on Heathrow's forecasting model on the basis that Heathrow "*has refused to make its passenger forecast models openly and transparently available*"[33] . As Heathrow explains in its submission, this misrepresents Heathrow's position and implies that Heathrow had no good reason for failing to disclose the models. In fact, the models contain commercially sensitive information – such as airline booking data – which the CAA ought to understand it is inappropriate to share freely with competing airlines. Furthermore, Heathrow has repeatedly expressed its willingness to share the model with airlines' independent advisers in a confidentiality ring: which is exactly the level of scrutiny that regulators like Ofgem and appeals bodies like the CMA have been content to allow for their own models. In placing less weight on evidence for these reasons, the CAA is operating under

[28] see Heathrow's Response, Chapter 2 at paras 1.4.13-14.20
[29] see Heathrow's Response, Chapter 2
[30] see Heathrow's response Chapter 2 for further details on this error
[31] see Heathrow's response Chapter 2
[32] Heathrow's Response, Chapter 2
[33] Final Proposals, section 1, para 1.15

a mistake of fact, and it is acting unreasonably because the CAA has been free to review and critique the model itself: under public law, it is the CAA's responsibility to take the model (being the product of consultation) into account, it cannot disregard or devalue evidence merely because it wants to delegate the task of scrutinising Heathrow's model to other consultees. Furthermore, the CAA is acting irrationally and inconsistently, since it has repeatedly praised Heathrow's model in the past, yet provides no reason or evidence for now departing from that judgement and treating the model with scepticism.

77. Finally, we note that significant assumptions in the CAA's approach appear to lack any evidentiary basis and are contrary to the evidence which is available. As examples, the CAA continues to assume that Heathrow's share of the London market is the same as it was 20 years ago, ignoring more recent evidence. Similarly, the CAA's assumption of a 10% decrease in business class travel appears to be entirely arbitrary, and the underlying consultant report provides no basis for such an assumption. In these cases, the CAA has both failed to properly consult (because it has not disclosed its thinking in a manner which enables intelligent comment), is proposing to make decisions without supporting evidence, ignores evidence which is clearly relevant, and is proposing to make a decision which is so unreasonable as to be unlawful.

F2. *Capital Expenditure ("Capex")*

78. In setting the Capital Expenditure allowance, the CAA has failed properly to pursue its statutory duties, in particular the duty to further the interests of users (including future users) of air transport services regarding the range, availability, continuity, cost and quality and the duty to promote efficiency. Moreover, it has failed to respect public law standards of decision making and has made appealable errors of both fact and discretion:

    a. Investment in commercial revenues: The CAA's decision only to allow for commercial investment which will pay back during the H7 period fails properly to pursue the CAA's objective of furthering the interests of users of air transport services. The statutory duty properly encompasses the interests not only of current users (i.e. during the term of the H7 control) but also future users. Further applying a hard cut-off is arbitrary and distortive and prioritises the short term charge over longer term affordability without justification. Moreover, the CAA has erred in only allowing a £157m allowance for investments that pay back within the regulatory period (£389m lower than in Heathrow's plan). This fails to fulfil the CAA's duty to both current and future consumers. Conversely, given the CAA's decision in respect of investment in commercial revenues, the CAA has also made an error in failing to take account of that lower proposed level of investment in commercial projects when calculating H7 commercial revenue forecasts. Heathrow's forecasts would have been lower had a lower level of investment been assumed.

    b. Efficient airport: The CAA has failed to fulfil its duties to current and future users of air transport services, and to promote efficiency, by only allowing for a fraction of Heathrow's proposed investment in the Efficient Airport programme (£48m out of £347m). This will severely limit Heathrow's ability to drive operating efficiencies in H7, as well as to deliver

automation and optimisation projects that will be valued by both airlines and consumers. In addition, the allowance given by the CAA is inconsistent with other aspects of the H7 decision as well as its regulatory policy more generally, contrary to the principle of consistency in s.1(4) CAA12. In particular: (i) the CAA's failure to include PRS investments as part of the Efficient Airport Programme is at odds with its ongoing requests for more personalised assistance services across the airport, and (ii) the CAA is not allowing spend for investments needed to deliver on its OBR targets including spend for passengers requiring support, digital wayfinding, baggage improvement initiatives, airfield projects contributing to punctuality, passenger experience improvements, T4 automated check in and per passenger security queue measurement.

c. Errors of fact: the CAA has made simple errors of fact in rejecting certain capex allowances. For example, the CAA alleges the requested allowance for T3 and T4 Ramp-Up projects and for the Pier Service Project were not approved by airlines. However, we are advised that is untrue: these projects were approved by airlines. As another example, the CAA alleges the outputs of the T3 and T4 ramp up projects can be delivered without capex. However, this is also wrong. As set out in Heathrow's submission, the projects are entirely focussed on critical infrastructure and systems maintenance and upgrades, which by their nature require capital expenditure. A decision which continues to be based on these errors of fact would in our view be clearly susceptible to successful appeal.

F3. *Capex Incentives*

79. The CAA's Final Proposals on capex incentives are legally severely flawed.

80. Breach of CAA's primary duty: First, and fundamentally, the proposals are contrary to the CAA's primary duty under s.1(1) CAA12 to further the interests of users of air transport services in relation to the range, availability, continuity, cost and quality of airport operation services. This is because they are liable to increase both the cost to Heathrow of delivering capex projects, and the time required to complete them: the CAA's proposals would unnecessarily delay consumers' enjoyment of the benefits of capex projects. But the CAA has identified no countervailing gain to consumers to justify imposing this detriment on them[34]. For example, we understand that compared with the current Q6 arrangements, the staff requirements required to monitor the governance arrangements will increase significantly. Moreover, the implications of Delivery Obligations are such that they will have to be agreed before the final investment decision (as opposed to the present situation where Trigger Obligations may often be finalised after investment decision) and this will increase delays. More generally, moving to an ex ante framework will significantly increase risk to Heathrow, through exposing it to a greater risk of forecast error, and therefore increase the cost to customers.[35] These costs, risks and time delays could only be justified by the CAA if they were outweighed by some stronger benefit to consumers. However, as we explain below, the CAA has not even identified a problem its proposals are supposed to

[34] see Heathrow's Response, Chapter 8 paras 8.4.3-8.4.39
[35] see Heathrow's Response, Chapter 8 para 8.2.6

address, much less shown that the benefits to consumers outweigh the detriment. This represents a significant dereliction of the CAA's legal duties.

81. Proportionality/Targeted Action: The CAA is required by s.1(4) CAA12 to have regard to the need to ensure that its regulation is proportionate and targeted only at cases where action is needed. The proposals fail these tests.

a. Proportionality requires (i) that the measure must pursue a legitimate aim; (ii) that the measure is suitable to achieve that aim, i.e., that it is well-designed to achieve it; (iii) that the measure is necessary, in the sense that no less intrusive or restrictive measure can achieve the aim; and (iv) that it appropriately balances competing interests: see *Vodafone et al v Ofcom & Hutchison 3G* [2008] CAT 22 §51; *Royal Mail v Ofcom* [2019] CAT 27 §693; and *R (on the application of FEDESA) v MAFF et al* [1991] 1 CMLR 507 [532] Judgment §13 (ECJ). Proportionality therefore presupposes both that there is a need for action and this is reinforced by the requirement to target regulatory action only at cases where action is needed. Moreover where it is proposed to change the status quo, it is fundamental to a proportionality assessment (a) that there should be some defect in the present scheme of regulation that requires to be addressed; and (b) that the proposed new scheme should better achieve the underlying aims.

b. The difficulty that the CAA faces in this regard is that there is a lack of evidence that there is any significant problem with the present capex incentive arrangements. The CAA's final proposals provide no evidence of capital inefficiency of existing arrangements[36]. The CAA's attempt to change the capex incentive scheme therefore fails the proportionality test at the first hurdle: reform does not pursue any identified legitimate aim. Nor has the CAA evidenced that a cap on capex is required. Furthermore, Heathrow is already subject to a number of licence conditions and requirements which secure efficiency – for example, a licence condition to conduct its relevant business and activities to "secure the economical and efficient … operation and maintenance; and … timely and appropriate enhancement and development of the Airport" (Licence Condition B3) and the CAA has not provided a proper explanation of why this condition is inadequate to achieve any objective of ensuring Heathrow's capex is efficient.

c. Moreover, the CAA's proposals give rise to a real risk of double or even triple jeopardy, with the possibility of Heathrow being penalised for an overrun not only via Delivery Obligations, but also by OBR metrics and the ex ante incentive rate on cost overruns.[37] This is manifestly disproportionate in that it goes further than is necessary to achieve the legitimate aim of incentivising efficiency and does not fairly balance the legitimate interests of Heathrow and airport users or airlines.

[36] see Heathrow's Response, Chapter 8 paras 8.5.4-8.5.12
[37] see Heathrow's Response, Chapter 8, paras 8.5.18-8.5.36

d. Further, requiring Delivery Obligations on all projects is not only unprecedented and contrary to best practice, but is also disproportionate and fails to target action appropriately as required by s.1(4) CAA12.

82. Regulatory consistency: The risk of double jeopardy referred to above also means that the proposals fail to comply with the CAA's duty of ensure its regulatory activities are consistent under s.1(4) CAA12.

83. Public law standards: The above flaws also constitute a failure to meet public law standards of decision making. In particular the CAA's decision to pursue a new capex incentive structure, in the absence of any evidence of inefficiencies arising from the previous structure is a breach of the CAA's duty of enquiry and a failure to have regard to an obviously material consideration.

84. Use of CPI: The CAA's use of CPI as the basis for ex-ante costing is also based on an (appealable) error of fact and/or fails to have regard to an obviously material consideration, in that it does not reflect how construction projects are contracted. Given the complexity and scope of construction contracts, inflation risks cannot easily be passed on to contractors, and Heathrow would normally retain some risk in cost and price. The use of CPI is inappropriate as contractors would use construction price inflation as their escalation assumption.[38]

F4. *Operating Expenditure ("Opex")*

85. As set out in Chapter 5 of Heathrow's response, the CAA's proposals in respect of Operating Expenditure are undermined by clear errors, each of which is an appealable error of fact and/or discretion, and/or fails to comply with accepted public law standards of decision making and/or fails to pursue the CAA's duties under s.1 CAA12:

a. Failure to consult/consider deliverability of H7 Operating Costs: The CAA has not provided sufficient information as to the evidence, cross checks and/or validation exercises that it has conducted to assure itself that the H7 Operating Costs are deliverable. To the extent that this material exists but has not been disclosed, there is a clear breach of the requirements of consultation. To the extent that the material has not been disclosed because it does not exist, there has been a failure to consider an obviously material consideration (namely the deliverability of the operating expenditure forecast and the links between that forecast and the capex allowance and service targets).

b. Flawed Efficiency Adjustments: The CAA errs in overestimating the adjustment required to ensure an efficient baseline for the H7 forecast. By applying a 1.4% reduction to 2019 outturn costs and a 1% ongoing efficiency assumption the CAA is incorrectly assuming that any increase in operating costs per passenger is the result of inefficiency and double counting the benefits of Heathrow's Cost of Change programme. This is counter to basic regulatory principles, and the regulatory framework set out in the CA Act, which obliges the CAA to have regard to Heathrow's actual level of efficient costs, rather than assuming

[38] see Heathrow's Response, Chapter 8 paras 8.5. 37-8.5.60

increases are inefficient without evidence. Moreover, CTA's analysis, on which the CAA rely, is subject to numerous errors. For example, without explanation, CTA simply assumes various figures used in Q6 are correct, rather than assessing the evidence; it appears to have removed energy costs from its ONS sample averages; and CTA has failed to weigh the different categories of ONS cost data by reference to Heathrow's actual cost base, leading to a result which is obviously wrong. The CTA analysis also fails to take into account the fixed nature of Heathrow's contracts for many operational costs, which means that any further savings would have to be found from limited areas of cost, which cannot realistically be reduced by the required amounts: see [ref]. Further, the efficiency target applied by CTA on the costs of the London Living Wage commitment does not have a sufficient evidential basis and fails to take account of the fact that any efficiencies accruing from the London Living Wage, in terms of lower levels of absenteeism and staff turnover, will primarily benefit Heathrow's suppliers rather than Heathrow directly.

c. Errors with respect to Input Price Inflation: The CAA have made a series of errors in respect of input price inflation which lead to an underestimate of the impact of increasing input prices over H7.

- UK unemployment is at a 50-year record low and Heathrow has described the aviation labour market as the most challenging ever faced in the UK. The CAA states that its advisers have taken account of labour market constraints and it acknowledges that "these constraints are expected to lead to higher average salaries for HAL and hence generate additional costs." However, the CAA's advisers only allow for lower than market rate salaries in 2022 and 2023 (they assume zero wage growth in 2020 and 2021), and fail to allow for the additional recruitment and training costs which arise from the current labour market conditions. This outcome is contrary to the stated intention of the CAA and its advisers to take market data into account; fails to have regard to relevant evidence produced by Heathrow; and fails to properly justify its decision and grapple with the market evidence which Heathrow has provided.
- Although the CAA's overall approach to forecasting energy prices is now correct, the forecast needs to be updated to use the latest available data. A failure to use the most current data, when that data is available, would be an appealable error: by ignoring more recent data, the CAA will be failing to have regard to relevant considerations; and by considering data which is out of date, the CAA will have regard to considerations which are irrelevant.
- The CAA errs in respect of insurance costs by having regard to airline insurance premiums, which are not relevant evidence. Airline insurance premiums are not properly comparable as they do not over the same risks in respect of property (which has risen in value) or cyber risks.

d. Covid and enhanced service overlays: The CAA have made an error of fact in assuming that obligations for hygiene and cleanliness will not continue beyond 2022. The CAA have made an error of fact in assuming that assets were out of service during 2020 and 2021; and in assuming inactivity during 2020/2021 will have extended asset life: since Heathrow is subject to asset availability targets, passenger sensitive assets will not have had increased downtime or reduced maintenance. Furthermore, the assumption that asset lives would – in any event – be extended by 6 months as a result has no basis in evidence and is supported by no reasoning.

86. The impact of these errors is that the CAA has not correctly identified the practical implications of the implied cost savings, which are not in the best interests of consumers, contrary to the CAA's primary statutory duty in the CA Act.

F5. *Other Regulated Charges*

87. Other Regulated Charges (ORCs) include services provided by Heathrow which can be charged on a unit basis to various users of the airport, such as airline handlers; catering teams; retailers; government agencies; hoteliers; and providers of surface transport. They include electricity, baggage, assistance for passengers with reduced mobility, waste and parking.

88. The CAA's Final Proposals would impose marginal cost pricing for airlines who pay ORCs. Non-airline users would continue to contribute to fixed costs as they do today. This requires a dual pricing framework, with the same users of a service paying a different amount depending on whether or not they are an airline.

89. In principle, Heathrow agrees that marginal pricing has a number of potential benefits. However, the CAA's decision to impose a dual pricing framework is legally flawed in a number of respects:

a. First, the CAA has failed to have regard to the need to ensure Heathrow can take reasonable measures to reduce, control and mitigate the environmental impacts of the airport as required by CAA12 section 1(3)(d). A key benefit of marginal cost pricing is its ability to give users of the airport the right incentives to make sustainable decisions. Under the CAA's proposal, non-airlines will have fewer incentives to minimise those costs which they are actually able to influence through their behaviour, compared to airlines. This may impact Heathrow's ability to grow sustainably, yet the CAA does not appear to have even considered the relevance of section 1(3)(d) in this context.

b. Secondly, and relatedly, the proposal is disproportionate. At paragraph 8.9 the Final Proposals accurately identify the legitimate objectives of applying marginal cost pricing to airlines, namely, allowing ORCs to focus on those costs that the airline can influence, simplifying the calculation of unit costs and making downturns in volume more manageable. Each of those objectives applies with equal force to non-airline users. Applying marginal cost pricing only to airlines and not to non-airlines is not well designed to meet the legitimate objectives that the CAA itself has identified, and is therefore disproportionate.

c. Thirdly, the CAA has not discharged its duty of enquiry, in that it has not sought information or otherwise properly enquired as to whether the proposal is technically feasible to implement in the timeframe proposed. In fact, we are advised that Heathrow does not currently have the technical capability to implement dual pricing and cannot guarantee it would be able to do so for the start of 2023. In failing to ascertain the feasibility of its proposals, the CAA has failed in its legal duty to make reasonable inquiries.

d. Fourthly, the approach will inevitably be arbitrary in practice, and breaches the CAA's duties to carry out its functions "in a manner which it considers will promote competition in the provision of airport operation services" under s.1(2) CAA12 and to carry out regulatory activities in a consistent way under s.1(4) CAA12. Instead, the CAA's proposal directly distorts fair competition and is inconsistent, because it imposes costs purely based on whether a service is provided by an airline or not – thereby artificially promoting certain business models (such as those in which services are provided directly by airlines rather than outsourced) over others. Supposedly 'non-airline' suppliers are, in fact, often closely related to airlines. This includes ground handling staff and caterers, for example. The CAA's proposed approach will mean – for example – that ground handlers working for an airline will have to pay one price for a service with the airline paying a different price. Given both parties are providing a service to the passenger, the CAA has not put forward any lawful justification for differentiating between them. Although the CAA may try to "fix" this problem by treating some suppliers as airlines, it is difficult to conclude that the CAA's proposal could involve anything other than arbitrary choices to advantage some business models over others. Fundamentally, an approach which artificially benefits certain business models over others undermines productive efficiency, and in turn both allocative and dynamic efficiency and thus will not further the interests of users of air transport services.[39]

F6. *Commercial revenues*

90. The CAA's proposals for commercial revenues contain a series of errors of fact, law or discretion, errors of regulatory approach and fails to comply with public law standards of decision-making in key respects. By way of examples:

a. TDOC: The CAA's forecast of TDOC revenues is vitiated by an error of fact and/or a failure to have regard to an obviously material consideration, in that it is inconsistent with upcoming changes to legislation. Over the period 2024-2026, the CAA forecasts TDOC revenues of around £135m. However, the Parking Code of Practice Act 2019 will be implemented in

[39] It is acknowledged that s.1(3)(c) only specifically requires the CAA to have regard to the need to promote economy and efficiency on the part of the holder of the airport operator licence. However, by undermining efficiency on the part of other undertakings that make significant contributions to the passenger's experience, it is clear that the CAA will be breaching its primary duty to further the interests of users of air transport services as regards the range, availability, continuity, cost and quality of airport operation services as requires by s.1(1).

2024, and means that Heathrow will not actually be able to generate revenues from TDOC. A proper forecast would be set to zero from 2024 onwards.

b. Short stay car parking: The CAA further makes an error of fact and/or fails to have regard to an obviously material consideration in failing to take account of the effect of the Private Parking Code of Practice ("PPCP") on short stay car parking. The PPCP mandates a 5-minute grace period for parking. Currently 18% of all MSCP stays are for less than 5 minutes, and almost half of all stays are for less than 15 minutes. By failing to take account of the grace period and expected significant behaviour change by customers the CAA has overstated revenue by around £33m.[40].

c. HEx and Piccadilly Line: The CAA's approach to forecasting HEx and Piccadilly Line revenues is based on a series of factual errors. In particular (a) CTA's forecasts of Piccadilly line revenue (on which the CAA relies) are driven by overall passenger numbers rather than by the number of passengers using the Piccadilly line (which actually drives Heathrow's revenue under the relevant agreement with TfL); (b) the CAA erroneously applies inflation to track access charges where the terms are contractually fixed in nominal terms; and (c) CTA applies an overlay based on CPI to previous forecasts HEx revenues to model the effect of holding fares flat, whereas the rail industry has historically used RPI to set fare increases. These factual errors result in the CAA overstating revenues by around £55m.

d. Property: The CAA's forecast of property revenues makes a factual error and/or fails to have regard to an obviously material consideration in that as it does not take into account important facts, such as that the former BMI hangar is vacant, and both the BMI hangar and the BA car crew park lease are not expected to be re-let. As a result the CAA overstates revenues by around £29m over H7.

e. Retail taxes and changing customer preferences: By adopting a top-down rather than bottom up approach to modelling retail revenues, the CAA fails to take into account obviously material aspects of the changing retail environment, namely including dynamic impacts arising from the withdrawal of airside tax-free retail and the VAT Retail Export Scheme (i.e. changes in customer and retailer behaviour) and changes to customer behaviour since the start of the pandemic.[41]

f. Q6 to H7 bridge overlay: CTA have omitted an overlay included by Heathrow to take account of changes in the retail environment over 2019-21, mostly due to the pandemic and retail tax changes. In so doing, they have made an error of fact in stating that the relevant changes were within Heathrow's control. They have also made an error of fact in alleging there is double-counting between the Q6 to H7 bridge overlay and the forward-looking tax overlay. For the reasons set out in Heathrow's submission, these capture different changes: the bridge overlay corrects for changes which have already happened, and the VAT overlay corrects for impacts which will materialise over time.

[40] see Heathrow Response, Chapter 6 paras 6.4.4 - 6.6.10
[41] See Heathrow's Response, Chapter 6, para 6.5.6

g. T4 Reopening Overlay: CTA (and hence the CAA) omitted an overlay, included by Heathrow, which would have taken account of the reduction in retail revenue during the ramp up phase of Terminal 4 reopening. In so doing, they have made an error of fact and/or have failed to have regard to an obviously material consideration, namely that shops will limit their offerings until passenger volumes rise.[42]

h. Management stretch: The CAA's application of 1% management stretch for commercial revenues fails to comply with the CAA's statutory duties or public law standards of decision making, in that it is a decision with no supporting evidence. As such it fails to comply with the principles of transparency, proportionality or accountability stated in s.1(4) CAA12, and there is no evidence that it pursues the interests of users of air transport services. Historic increases in commercial revenue have been based on specific investments and market developments, and cannot simply be assumed to continue on the basis of a concept of "management stretch". In addition the CAA's approach is flawed and disproportionate insofar as it applies the 1% management stretch to revenue forecasts which already take account of specific management actions that are intended to improve commercial revenues, such as the TDOC.[43]

i. Commercial capex: The legal issues with respect to the CAA's disallowance of large parts of Heathrow's commercial capex programme are set out at C2 above.

91. For the avoidance of doubt, Heathrow's position is also that the CAA is legally obliged by the principle of regulatory consistency and/or the general public law principle of legitimate expectations to remove costs and revenues associated with Pod parking from the commercial revenue forecasts. In its Q6 price control review, the CAA decided to disallow both historic and future capex associated with the Pod connection to T5 and further than that, the costs and revenues associated with it should be removed from the single till. There is no basis now to depart from that position.

[42] see Heathrow's Response, Chapter 6 paras 11.1.1-11.1.3
[43] see Heathrow's Response, Chapter 6 at 6.8

G. Legal errors in respect of uncertainty mechanisms

92. Throughout the Final Proposals, the CAA frequently refers to the traffic volume risk sharing mechanism (TRS) as a way in which risk for Heathrow's investors will be significantly reduced in H7. The price control – to a very large extent – relies on what the CAA considers to be the reduced risk arising from the TRS. For example, the CAA cites the TRS in justifying a large downwards adjustment to the asset beta[44], which in turn (it is said) greatly decreases Heathrow's WACC.

93. We set out our concerns with the general approach the CAA has taken to the WACC below. In this section, we outline our concerns with the CAA's assessment of how the TRS insulates Heathrow from risk, and the CAA's focus on how the TRS impacts total cash-flow at the expense of examining financeability comprehensively. In each of these cases, the CAA has made multiple legal errors.

94. First, the TRS does not in fact provide the degree of protection the CAA intends. The CAA states that it believes the TRS to ensure Heathrow is 91-94% protected from the impact on its EBTDA (earnings before taxation, depreciation and amortisation) when passenger volumes fall into the outer band of the TRS.[45] However, Heathrow's analysis shows this level of protection is not, in fact, provided,[46] because it fails to properly account for how incremental commercial revenues are disproportionately affected when passenger numbers drop. Instead, as set out in more detail in Heathrow's submission, the CAA has calibrated the sharing rate so that it only protects Heathrow to:

    a. 86% based on Heathrow's corrected forecasts of opex and commercial revenues; or

    b. 81% based on the CAA's own forecasts.

95. The TRS mechanism is therefore not in fact properly calibrated to achieve the outcome the CAA itself is targeting.

96. Where a regulator adopts a mechanism which improperly designed, so that it does not – as a matter of fact – achieve the result that the regulator aimed for, that will be a legal error susceptible to being overturned on appeal. This was demonstrated in British Gas's appeal of the RIIO-ED1 decision.[47] In that case, Ofgem had calibrated its 'information quality incentive' with the aim of ensuring that companies in the upper quartile of its efficiency benchmark would be rewarded. In fact, its calibration overcompensated so that additional companies beyond the upper quartile were rewarded unnecessarily, and the CMA therefore overturned the calibration on appeal. If the CAA fails to correct this error, it will similarly be susceptible to appeal, on the basis that the CMA has:

    a. Made a simple error of fact regarding the effect of the TRS;

[44] Final Proposals, Summary, para 63
[45] Final Proposals, section 1, para 2.44
[46] See Heathrow's Response Chapter 3, para 3.5.8
[47] British Gas Trading Limited v The Gas and Electricity Markets Authority, Final Determination, published 29 September 2015 at para 6.128

b. Made a decision which is wrong in law because it ignores relevant considerations, namely Heathrow's analysis about the actual effects of the CAA's decision; and

c. Made a decision which lacks proper justification and is therefore unreasonable and disproportionate.

97. Secondly, in assessing how the TRS reduces risk, the CAA's analysis focuses solely on total cash flows. Specifically, the CAA assumes the TRS reduces Heathrow's exposure to traffic risk by 50%, "*on the basis that the TRS sharing factors insulate HAL from approximately half of possible traffic-related cash-flow losses/gains under plausible (non-pandemic) traffic shock scenarios*" (Final Proposals para 9.158). However, the TRS mechanism does not materially reduce many of Heathrow's other financeability risks – in particular, Heathrow will retain significant liquidity risk; and the mechanism will do little to generate certainty for equity investors. If volumes decrease to the extent that the TRS kicks in, Heathrow would be allowed to recover part of its consequent losses over a 10-year period, through cash in H7 and through the RAB in H8. Cash recovery would not begin until two years after the passenger numbers decrease sufficiently to trigger the TRS, so a loss in 2022 would not even begin to be recovered until 2024. In the event of a prolonged downturn – such that passenger numbers were still reduced in year T+2 – some of that recovery would be delayed from year T+2 and only eventually be recovered through the K factor in year T+4.

98. While Heathrow and the CAA agree with this aspect of the TRS design, that does not entitle the CAA to assume the TRS simply "solves" all financeability concerns. Delaying and spreading recovery of losses still imposes significant short-term liquidity risk on Heathrow in the event of a material downturn in passenger numbers, for the reasons set out in Heathrow's submission.[48]Nor does it allow for collection of revenues within a timeframe consistent with rating agency requirements – for example, credit agencies look at whether Heathrow remains compliant with 3-year average performance against cash flow metrics; a 10-year recovery of losses would only partially assist with such an assessment. Consequently, the design of the TRS mechanism would not fully address credit rating agencies' concerns about traffic volumes.

99. The CAA's mechanistic approach of focusing solely on cash flows ignores most measures of financeability, and is obviously inadequate. It gives rise to numerous legal errors:

a. Because the CAA assumes the TRS halves systematic volume risk, there seems to be an implied assumption that a high proportion of volume risks are systematic, and would therefore flow through to the asset beta. However, this assumption is neither disclosed in the Final Proposals, nor is any reasoning – much less any evidence – set out for this assumption. The document therefore fails to meet the requirement of a proper and lawful consultation;

b. The CAA ignores considerations which are plainly relevant to the CAA's assessment of the degree of risk for which Heathrow's investors require fair compensation, and which are relevant to Heathrow's ability to retain its credit rating and therefore its financeability;

[48] See Heathrow's response, Chapter 3

c. The CAA fails to make reasonable inquiries regarding the extent of the residual risk to which Heathrow's investors are subjected, despite being put on notice by Heathrow that this risk remains and has not been taken into account; and

d. The CAA fails to properly discharge its statutory duties to have regard to financeability by failing to examine all relevant financeability credit metrics.

100. Thirdly, the 10-year time period over which Heathrow would recover losses imports significant regulatory risk into the TRS, because the CAA might in future change its mind or seek to amend aspects of the TRS before Heathrow is able to recover the extent of loss to which the TRS would entitle it. This is ironic, because the CAA says it recognised in the Initial Proposals "that investors may not price in the full value of cashflow protections [the TRS] offers, for example, because of uncertainty regarding the longevity of the mechanism".[49] Yet the CAA takes a new approach to estimating the impact of the TRS in the Final Proposals, and there is inexplicably no longer any indication that the CAA has taken regulatory risk into account under this new approach, much less any attempt to properly quantify that regulatory risk, by applying a specific discount factor to the impact of the TRS. In failing to have proper regard for regulatory risk – and failing to specifically estimate how this risk should impact the CAA's calculations – the CAA makes the same legal errors identified above: namely, failing to have regard to relevant considerations; failing to make reasonable enquiries; and not properly discharging its statutory duties.

101. The CAA in fact exacerbates the regulatory risk problem in the Final Proposals, by proposing not to fully implement the TRS through a licence condition. Instead, Heathrow's investors are expected to be content with the CAA issuing a policy document setting out the CAA's intended approach to recovery. This makes the degree of regulatory risk Heathrow's investors must bear significantly greater than Heathrow had anticipated prior to the Final Proposals, and far greater than the CAA has taken into account. A policy document does not have the same legal status, or provide the same certainty, as a licence condition. For example:

a. As the CAA must know, it would be a legal error for any public authority to slavishly follow a policy document without regard to the circumstances, effectively attempting to use an existing policy to "tie its hands" and fetter its own discretion. As Lord Reid stated in *British Oxygen Co Ltd v Minister of Technology* [1971] AC 610 at [625C], "anyone who has to exercise a statutory discretion must not "shut his ears to an application". Accordingly, if all the CAA has is a policy setting out how it intends to allow future recovery in H8, then the CAA is simply not in a position to give unequivocal assurances to Heathrow that the TRS will be applied in full.

b. To amend a licence, the CAA must follow the statutory procedure set out in s.22 CAA12. This guarantees up-front that Heathrow and airlines will be consulted, and that consumers and other interested parties will have an opportunity to review and comment on the proposed changes. While the CAA will be under a duty to comply with natural justice even while amending a policy, the CAA12 provides far greater certainty

[49] Final Proposals, section 3, para 9.33

by codifying what the CAA must do and setting out specific requirements for the consultation which may in some cases go beyond the common law requirement for natural justice.

c. If the CAA decided to amend licence conditions, Heathrow would have a right to seek an appeal of that decision on the merits. That right would not exist if the CAA was merely amending a policy document; Heathrow would be constrained to seeking judicial review. Heathrow could therefore only challenge a modification of the TRS on the basis that the CAA made a legal error, rather than on the basis that the CAA's decision was the wrong one, for example because it severely damaged investor confidence. This is of fundamental importance, because if the CAA's only accountability is judicial review, then the CAA is effectively granting itself far wider discretion to make changes to the TRS in future.

102. The greater certainty provided by a licence condition is, in fact, acknowledged by the CAA in the Final Proposals – the CAA explicitly says this:

> *"the TRS mechanism will be explicitly included in the licence which provides a level of regulatory certainty that investors have generally been comfortable with"*[50]

103. However, this statement is not true; only a tiny part of the recovery specified in the TRS policy will be covered by the licence condition. And any under-recovery due to reduced volumes in the final two years of the H7 period are not covered by the licence condition at all. This merely serves to highlight that the CAA has failed to recognise that much of the TRS will not in fact be set out in the licence and that the CAA is therefore overestimating the degree of certainty the TRS provides.

104. In addition to considering regulatory risk generally, the CAA therefore must also have regard to the new regulatory risks imposed by the CAA's proposal to implement parts of the TRS only through a policy document. If it fails to do so, the CAA will fail to have regard to plainly relevant considerations and fail to make reasonable enquiries about how its proposal could be understood by Heathrow's shareholders.

105. Fourthly, throughout the price control, the CAA has adopted a high-case scenario traffic forecast. Yet its proposed TRS mechanism is based on symmetrical risk-sharing from a central traffic forecast. This materially increases both the risk that Heathrow will not receive the revenues forecast by the CAA in the rest of the price control, and Heathrow's scope for outperformance. The miscalibration means that the CAA's decision is not internally consistent, and fails to meet the CAA's statutory duty to have regard to the need for regulatory consistency; is not properly justified; and is irrational because it adopts two inconsistent approaches. Furthermore, the failure to adopt a coherent set of modelling assumptions means that the CAA has failed to properly discharge its duty to have regard to Heathrow's financeability.

106. Legal errors in relation to uncertainty mechanisms are not limited to the TRS. As a further example, the CAA has proposed a revenue sharing mechanism for Terminal Drop Off Charge (TDOC) revenues. However, the CAA has provided no proper justification for this mechanism. Nor has it

[50] Final proposals, section 3, para 13.59

provided evidence or reasoning about how the mechanism has been calibrated. The CAA has also failed to justify its proposed 65% sharing rate. The lack of rationale or justifications makes it impossible for Heathrow to intelligently respond to this aspect of the consultation, and means that the CAA is failing to provide a proper consultation process in line with its legal duties. We do not currently see a way the CAA can legally correct this error without conducting another consultation process following the Final Proposals, in which the CAA will properly set out its objectives, assumptions and reasoning for how it has constructed the TDOC revenue-sharing mechanism.

H. Legal errors in respect of the lack of further RAB adjustment

107. The CAA's decision to apply an initial adjustment to the regulatory asset base (the "**RAB**") to reflect Heathrow's losses over the pandemic seems to us to be reasonable. However, the CAA's reasoning in April 2021 to justify limiting that adjustment to £300m – and its reasoning in refusing to make any further intervention now – are both subject to numerous legal errors.

H1. *Legal errors relating to the Interim Adjustment*

108. In April 2021,[51] the CAA decided to make an adjustment to Heathrow's RAB of £300m (in 2018 RPI prices) (the "**Interim Adjustment"**), far less than Heathrow's requested adjustment of £2.5 billion. Heathrow's requested adjustment was itself far lower than the roughly £4 billion of losses Heathrow sustained over the course of the pandemic.

109. The Interim Adjustment cannot be relied on in the Final Proposals for several reasons.

110. First, the decision was not properly justified. The CAA conceded that there were cases where the CAA had "not yet arrived at a final view on the evidence submitted" and instead the CAA stated that "a number of the most important issues that HAL has raised are best considered as part of the H7 price review".[52] For example, Heathrow had put forward important evidence – including based on cash flow metrics and other indicators – showing that £300m would be an insufficient adjustment to ensure that investors can recover their efficiently incurred capital. Consequently, the decision failed to have regard to all relevant considerations; lacked proper justification; and failed to properly fulfil the CAA's statutory duty to have regard to the need to ensure Heathrow remains financeable (CAA12t section 1(3)(a)).

111. Secondly, the decision was reached on the basis of a lack of proper consultation. The CAA did not consult on the criteria it ultimately applied: namely that Heathrow should be able to sustain a 70% notional gearing rate. The reasons for the CAA adopting that figure (which is inconsistent with the 60% notional gearing rate adopted by the CAA elsewhere) have still not been disclosed to Heathrow.

112. Thirdly, the CAA imposed an unlawful threshold when deciding whether to make the Interim Adjustment, and in that way failed to properly discharge with the CAA's statutory duties. Specifically, the CAA said only that "there is no **compelling** case for an immediate adjustment greater than the £300 million" (para 4.17, emphasis added) and that "the work we have undertaken does not currently provide a **clear case** for a [full] RAB adjustment"). However, the CAA12 and public law do not justify the CAA doing nothing unless there is a "compelling case" or a "clear case". Instead, the CAA has the simple task of fulfilling its statutory duty, which is to carry out its functions "in a manner which it considers will further the interests of users of air transport

[51] CAA, "Economic regulation of Heathrow Airport Limited: Response to its request for a covid-19 related RAB adjustment", 27 April 2021 (updated May 2021). https://publicapps.caa.co.uk/docs/33/HAL%20Economic%20Regulation%20Covid-19%20related%20RAB%20adjustment%20(CAP2140%20v2).pdf

[52] Interim Adjustment, para C3

services regarding the range, availability, continuity, cost and quality of airport operation service" (CAA12section 1(1)). That requires the CAA to review the evidence and determine which course of action will, on balance, further consumers' interests – for example by modelling the impacts on consumers of different levels of RAB adjustment. The CAA misapplies its duties where it imposes a higher threshold on acting.

113. Fourthly, at this stage in the H7 process, the assumptions on which the CAA calculated the Interim Adjustment have already been proven wrong. For example, the CAA assumed Heathrow would have 35 million passengers in 2021, but the actual number was 19.4 million. We are advised that the notional company's balance sheet in 2020, 2021, 2022 will not be financeable under the revised passenger forecast figures, and yet the CAA has nevertheless failed to conduct any analysis of how different levels of RAB adjustments would impact financeability metrics. Reliance on the analysis in the Interim Adjustment now would be a legal error: namely, taking into account an irrelevant consideration.

114. Fifthly, the CAA expressly confirmed to Heathrow that the CAA would fully consider the issues again for the start of H7.[53] On this basis, Heathrow chose not to seek judicial review of the Interim Adjustment, The CAA must now fulfil Heathrow's legitimate expectation by fully considering all the evidence.

115. When considering the issue of a further adjustment in the Final Proposals, the CAA therefore cannot lawfully take a "starting presumption" that the Interim Adjustment is the correct position. Nor can it piggy-back off the analysis undertaken for the Interim Adjustment without preparing a proper analysis of the benefits to consumers of alternative adjustment options now.

H2. *The reasoning in the Final Proposals*

116. However, the CAA now performs <u>less</u> analysis of the RAB adjustment options than it did when it made the Interim Adjustment. the Final Proposals do not even attempt to conduct any further or supplementary quantitative analysis of the RAB adjustment proposals beyond what was in the Interim Adjustment. Instead, the Final Proposals confirm the CAA's position of not moving from the Interim Adjustment, on the basis that:

    a. Heathrow had no legitimate expectation of regulatory intervention in the case of an exceptional traffic shock;[54]

    b. the CAA's decisions do not undermine the credibility of the regulatory regime ;[55] and

    c. a further adjustment is not necessary for investor confidence.[56]

117. These reasons cannot ground a lawful decision.

[53] CAA letter to Heathrow dated 11 May 2021.
[54] Final Proposals, section 3, para 10.29
[55] Final Proposals, section 3, para 10.36
[56] Final Proposals, section 3, para 10.43

118. First, it is evident from the CAA's reliance on qualitative judgements that the CAA continues to rely heavily on the analysis undertaken for the Interim Adjustment rather than conducting a new analysis. For the reasons set out in the previous section, that approach is not lawfully open to the CAA: the reasoning in the Interim Adjustment was unlawful; the facts underlying the Interim Adjustment analysis have changed; and Heathrow has a legitimate expectation that the CAA would review the entirety of the evidence.

119. Secondly, the CAA's reasons largely address the wrong question. The CAA's reasoning nearly entirely centres on the question of whether Heathrow is entitled to expect a RAB adjustment (we address this point below). However, the CAA has not, however, conducted any quantitative analysis on how different levels of RAB adjustment would impact Heathrow's financeability, investment and quality of service and are therefore in consumers' interests. The CAA's Final Proposals reasoning on financeability and investor confidence only refers back to the CAA's Initial Proposals:

> *"We have explained at Initial Proposals why we do not consider that allowing further recovery of historical losses would be in the interest of consumers."*[57]

120. Given the significant number of changes the CAA has made to many aspects of the price control package since the Initial Proposals – for example, the significant changes to the cost of capital –, any analysis undertaken in the Initial Proposals is also no longer a relevant consideration. In any event, the Initial Proposals essentially amount to a set of mostly qualitative assertions that:

    a. "we are not persuaded that it is necessary or appropriate to retrospectively correct for historical shocks";[58]

    b. A further RAB adjustment "would not contribute to a material additional reduction in the cost of equity when applied concurrently with the other steps we are taking in setting the H7 price control";[59] and

    c. A further RAB adjustment would not be necessary for investment or quality of service.[60]

121. The Final Proposals fail to engage with Heathrow's previous submissions in this respect. The assertions in both the Initial Proposals and the Final Proposals are dressed up as "regulatory judgements", but in fact they are matters which need to be informed by relevant evidence, analysis and reasoning. Despite Heathrow's earlier complaints, this work has still not been done.

122. Even in the one area where the Final Proposals do now include some quantitative analysis – namely, on financeability[61]– the analysis is still peppered with conclusions which lack any stated evidentiary backing or which are inconsistent with other parts of the proposals. For example, as we have noted above, the CAA's approach wrongly switches between Heathrow's actual performance

[57] Final Proposals, section 3, para 10.52
[58] Initial Proposals, section 2, para 6.30
[59] Initial Proposals, section 2, para 6.39
[60] Initial proposals, section 2, para 6.53
[61] Final Proposals, Exec Summary, para 78

and the performance of the notional company, contrary to the CAA's statutory and public law duties.

H3. *Failure to engage with relevant evidence*

123. In reaching its decision, the CAA has also failed even to acknowledge, and still less to assess, Heathrow's own quantitative evidence submitted after the Initial Proposals, such as its response to the Initial Proposals and a standalone submission dealing solely with the RAB adjustment, highlighting different quantification methods and their implications for Heathrow's financeability. The Final Proposals dismiss this material as having "little or no new evidence or arguments", without any further explanation or engagement. Similarly, the Final Proposals dismiss a report authored by KPMG and submitted by Heathrow, which refutes the CAA's qualitative assumptions on the appropriateness of the £300 million adjustment figure. The CAA's only substantive engagement with the KPMG report submitted by Heathrow is the following:

> *"By including historical periods in its analysis, HAL and KPMG are implicitly testing whether a creditor or investor with perfect foresight would, at a particular date in the recent past, have committed capital to the business knowing that a global pandemic was about to occur. It is not clear that this question is relevant to our statutory duties".*[62]

124. This is not a proper and lawful basis for disregarding the KPMG report.

a. The CAA cannot simply dismiss evidence which is prima facie directly relevant to the issue before the CAA without determining (on the basis of properly expressed reasons) either that the evidence is unreliable or that, on closer analysis, it is actually irrelevant. It is not sufficient in those circumstances for the CAA simply to conclude that it is not clear whether the material is relevant.

b. Secondly, the CAA's reasoning reflects a mechanistic view of financeability, which disregards relevant factors such as regulatory credibility and investor confidence. These are impacted by the CAA's past behaviour of keeping its promises, such as delivering a "fair bet", not just its future promises. These factors cannot simply be ignored on the assumption that investors will have no regard to the past; in doing so the Final Proposals fail to discharge the CAA's duty with respect to financeability.

c. Thirdly, even if the CAA had found that the KPMG report was not directed to the same question the CAA must answer, that would not justify the CAA immediately disregarding the evidence in its entirety. The KPMG report is not only focused on the past: for example, it concludes that "under both the CAA's high and low charge scenarios, Heathrow cannot expect to earn its H7 cost of equity, even before taking account the negative returns due to Covid-19" (emphasis added).

[62] Final Proposals, section 3, para 10.45

H4. *Failure to acknowledge legitimate expectations*

125. The Final Proposals conclude that Heathrow and its investors had no legitimate expectation of protection in the event of a calamity of the scale of Covid in Q6. The Final Proposals imply there is a difference between "business risks" – which in the CAA's view apparently includes any communicable diseases, no matter the scale, intensity or duration – and "catastrophic risk"[63] [FPs para 10.26]. The Final Proposals thereby imply that the only risks that would warrant regulatory intervention are those that would "render an airport inoperable for a sustained period" and that Covid is simply a "business risk" Heathrow was expected to bear.

126. However, in concluding that Heathrow has no legitimate expectations of protection, the Final Proposals only selectively acknowledge the CAA's past statements. For example, the Final Proposals ignore the following CAA statement:

> *"the ability of a licensing regime to revisit the price control if key assumptions, such as traffic, are significantly worse than the forecast, could be a credit strength."*[64]

127. The CAA has thereby signalled to investors that Heathrow can be considered lower-risk because the CAA could revisit the price control in the event of traffic being "significantly worse than the forecast".

128. The Final Proposals also fail to acknowledge that the structure of the regulatory regime could only have led investors to believe that Heathrow would be protected from extraordinary, unprecedented losses of customer volumes. The Final Proposals rely on this CAA statement (para 10.27):

> *"… the CAA may set the price control on the basis of a forecast level of shocks of 1% per annum. However, there could be a 10% chance that the out-turn level of shocks exceeds the forecast level by one percentage point or more. The risk that the out-turn 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"*[65] *(our emphasis).*

129. The problem with this statement is that Heathrow's "higher rate of return" did not compensate for catastrophic risks. The Q6 "shock factor" adjustment only compensated Heathrow for risks of -1.2%; the CAA did not even contemplate a drop in traffic of the size and duration that Heathrow has actually had to endure. Instead, as the CAA recognised:

> *"This -1.2% 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 volcanic ash".*[66]

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[63] Final Proposals, section 3, para 10.26
[64] CAA,CAP1151, paragraph I29
[65] CAA CAP1103: Q6 Final Proposals, 3 October 2013, para 3.14.
[66] CAA: CAP2265C para 7.5

130. In the CAA's own words, Covid's "*scale and duration has far exceeded any of the downside events that HAL had previously encountered*". Heathrow's investors were not compensated for taking on this risk in Q6 (which is why the CAA is proposing a different approach in H7). It is illogical that the CAA would expressly compensate Heathrow for the risk of lesser traffic risks, but leave investors uncompensated for taking on bigger traffic risks, especially when the CAA had said that the ability to reopen the price control was a credit strength. In its Initial Proposals, the CAA freely acknowledged that the "shock factor" in Q6 was never intended to account for pandemic magnitude events: "*We do not agree with the airlines that HAL is compensated in full for bearing demand risks through the allowed return*".

131. The CAA has provided no explanation of how, in light of the way the "shock factor" was calculated, investors could have plausibly concluded anything other than that:

    a. Any shocks of a far greater scale than Heathrow had experienced before would be treated as truly exceptional events; and

    b. they would have been protected from such unprecedented and exceptional events.

132. Finally, we note that the Final Proposals rely on a misleading quotes from a 2007 report from the Competition Commission, which rejected arguments from BAA that it should be protected against risks from "communicable diseases". The full quote is as follows:

> *"Whilst we accept that these were all significant events, we believe them to be business risks to which investors would expect an international airport to be exposed. Unlike these business risks, we consider catastrophic events to be* ***low frequency and high impact*** *in terms of rendering an airport inoperable for a sustained period. These events highlighted by BAA are* ***not infrequent (four in the last five years)*** *and* ***not high impact (as Oxera notes, these events have not threatened the overall activities or viability of BAA)****"*
>
> *(emphasis added).*[67]

133. The "communicable diseases" which were contemplated were those like SARS. SARS had an impact on traffic volumes of less than 1% - far less than various other events such as Operation Desert Storm (2.5%) or the volcanic ash of 2010 (2%).[68] Any one of these was an order of magnitude less damaging for Heathrow's business than Covid. The Commission cannot be read as excluding any and all "communicable diseases" from being "catastrophic events", regardless of their impact on Heathrow: rather, the Commission was only having regard to the diseases like SARS which had mildly impacted traffic volumes in the past.

134. When the full context of the report is considered, Covid in fact fulfils the criteria set out by the Commission for a catastrophic event: it was low frequency; high impact; rendered nearly all flights grounded for a sustained period; has resulted in a very slow recovery; and has fundamentally

[67] https://webarchive.nationalarchives.gov.uk/ukgwa/20140402235745mp_/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2007/fulltext/532af.pdf, para 141

[68] https://publicapps.caa.co.uk/docs/33/CAP%201103.pdf

threatened the viability of Heathrow, as already evidenced by the CAA's decision to grant an Interim Adjustment.

135. The Commission then went on to say that "cost of capital cannot capture the risks associated with truly catastrophic events" and that if a catastrophic event occurred, "we expect that the CAA would intervene." This evidences that the CAA would expect CAA intervention in the case of a catastrophic event on the scale of Covid-19. The CAA's own decision to grant a RAB adjustment illustrates that was indeed an event not factored into the Q6 cost of capital.

136. Consequently, the Final Proposals draw diametrically the wrong conclusion from the 2007 Commission report.

137. Even leaving aside the details of the price control structure, or specific quotes, the Final Proposals' attempt to recharacterise Covid as an everyday "business risk" is irrational and inconsistent with the CAA's approach even within the H7 price control consultation process. It is widely acknowledged and understood that Covid was an exceptional circumstance across the whole economy – with the travel sector more badly impacted than virtually any other economic sector. The CAA has repeatedly referred to Covid as "unprecedented" and as a set of "genuinely exceptional circumstances". The Final Proposals now attempt to characterise it as a "business risk" assigned to Heathrow, a conclusion which is inconsistent with the CAA's own views and is so outside the realm of common sense that it is, in public law terms, irrational.

138. In denying Heathrow's legitimate expectations, the CAA is acting irrationally; failing to take relevant considerations into account; and substantively failing to engage with Heathrow's legitimate expectations of recovery.

H5. *Relevance of expansion*

139. We also note that the CAA has – despite Heathrow raising this issue in submissions – still not assessed the relevance of the RAB adjustment on Heathrow's prospects for expansion. This comprises both a failure to consider relevant evidence, and a breach of the CAA's statutory duty to have regard to the interests of passengers. The CAA has long acknowledged that expansion has very significant benefits for consumers by promoting resilience, greater choice and improved competition between airlines, and there is significant evidence that those benefits remain important even post-Covid. Yet in the absence of a RAB adjustment, Heathrow's balance sheet will remain stretched, placing financial constraints on Heathrow's ability to deliver the expansion project.

H6. *Failure to have regard to the need to act consistently*

140. Finally, the Final Proposals fail to discharge the CAA's statutory duty to have regard to the need for consistency. For example, the Final Proposals state that "*the CMA was clear that it would not be appropriate for a regulator to seek to reverse, ex post, amounts previously added to the RAB*", yet its refusal to allow greater recovery of losses has exactly the same functional effect; as noted above, the Final Proposals and Interim Adjustment inconsistently switch between focusing on the

actual company rather than the notional company; and the CAA is now insisting on (its view of) the Q6 risk allocation despite concluding in its February 2021 consultation that to do so would "*represent too narrow a focus and so do not properly reflect our statutory duties in the exceptional circumstances of the covid-19 pandemic and the wide-ranging impacts associated with the present very difficult circumstances*."[69]

[69] CAA CAP2098: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment, 5 February 2021, paras 1.16 and 1.17.

I. Legal errors in respect of the WACC

141. The Final Proposals introduce significant changes to the cost of capital. These last-minute changes are compromised by significant and wide-ranging legal errors.

I1. *Asset beta*

142. The Final Proposal's assessment of the asset beta is legally indefensible. In contrast to its own established practice and the practice of other UK economic regulators, which focuses on reviewing up-to-date market data, the Final Proposals use an idiosyncratic twelve-step process to model the asset beta. This model involves (i) estimating Heathrow's pre-pandemic asset beta; (ii) assuming the current pandemic is over and then estimating the impact of future pandemics; and then (iii) adjusting for the impact of the TRS mechanism.

143. This approach requires a significant number of assumptions, many of which have been made – by the CAA's own admission – without any, or only with very poor quality, evidence. As examples, the Final Proposals assume:

    a. The current pandemic is over and has no impact in H7. This so defies common sense that it can only be characterised as irrational in the public law sense: there is significant evidence of new waves of Covid in the UK and the EU, and other parts of the world such as China continue to experience lockdowns. The CAA's advisers, Flint, acknowledge this assumption is not evidence-based. However, because they say no evidence is available, they simply assume Covid does not exist.

    b. Exactly 50% of traffic risk is mitigated by the TRS. The Final Proposals again concede that there is no real evidence for the assumption: "*We are cognisant that the adjustment for the TRS mechanism relies to a significant extent on judgement in several areas where there is limited evidence available with which to carry out a detailed quantification*".[70]

144. It is not open to the CAA to make assumptions without evidence. Even where a degree of regulatory judgement is necessary, that must be made by having regard to the available evidence – not by hazarding a guess. If a model's outputs are greatly impacted by assumptions for which little evidence is available, then the CAA must at least inquire carefully into sources of possible evidence to support or negate its approach.

145. However, compounding the first problem, the Final Proposals ignore the actual evidence which is available, such as actual market data points for the pre-pandemic beta. Yet in response to that evidence, the Final Proposals merely refer to an earlier CAA statement that "recent market data [cannot] be relied upon" in an unadjusted way. [71] Heathrow was not requesting that market data be adopted uncritically in the Final Proposals in an unadjusted way; it expected – and was entitled to expect – that the CAA would give the data some weight and grapple with its significance. Rather

[70] Final Proposals, section 3, para 9.160
[71] Final proposals, section 3, para 9.85

than doing this, the CAA appears to dismiss the data and prefers its convoluted modelling even though it fails to conform to observable real-world evidence.

146. The Final Proposals repeatedly dismiss other aspects of Heathrow's submissions in a summary way, too, rather than properly grappling with their arguments and evidence. For example, many of Heathrow's arguments about the asset beta are dismissed on the basis that Heathrow has the view that "a substantial increase in the asset beta is self-evident and obvious".[72] This is not a correct characterisation of Heathrow's arguments, which are supported by actual market data.

147. In failing to grapple with evidence that contradicts its assumptions, the Final Proposals proceed on the basis of mistakes of fact; does not appear to be genuinely consulting on its approach; and is ignoring relevant considerations.

148. We note that Heathrow is now providing further evidence regarding the asset beta in its submissions and attached reports. These, too, will need to be given proper consideration by the CAA if it is to make a lawful decision.

I2. *Cost of debt*

149. The CAA has also made serious errors in estimating the cost of debt. These include many of the same types of errors the CAA has adopted in estimating the cost of equity: for example, the CAA's approach to estimating the debt beta also relies heavily on unevidenced assumptions, for example about how the debt beta increases as gearing ratios increase. We focus on some illustrative examples of the specific errors found throughout this part of the Final Proposals in the paragraphs below.

Inflation

150. The CAA needs to make an assumption about inflation to convert its estimate of the cost of debt into real terms. The Final Proposals use:

    a. the OBR's RPI forecasts for 2022-25; and

    b. an RPI assumption of 2.9% for 2026 (being the government's 2% CPI target and a 0.9% wedge between RPI and CPI).

151. This approach is inconsistent with accepted regulatory practice and precedent – including the CAA's own decisions. Regulators and appeals bodies have consistently adopted longer-term forecasts than those proposed by the CMA, in order to avoid short-term swings in inflation expectations. For example:

    a. In the 2015 Bristol Water determination, the CMA said that "a stable approach to the cost of capital over regulatory periods is consistent with investors making long-term financing decisions. The notional real cost of debt should be generally expected to be more stable

[72] Final Proposals, section 3, para 9.84

and more reflective of a premium over the underlying real risk-free rate".[73] The CMA therefore adopted a term (5-10 years) which is significantly longer than what the CAA proposes here.

b. In the 2019 price control determinations, the CMA adopted an even longer-term view of inflation, by simply taking the Bank of England long-term target. The CMA said:

> *"it is typically assumed in the price control to be a symmetric risk and that the effect of inflation volatility should balance out over time. By setting the price control based around the Bank of England target, there is a built-in mean reversion, as the Bank has a duty to return CPIH inflation to 2% over time, and sets monetary policy to ensure this happens whenever inflation rises above this equilibrium level or falls below it. While rarely at exactly the 2% inflation target, historical evidence does suggest that UK inflation mean reverts to an average of 2% over time".*[74]

c. In the 2019 water price determinations, the CMA expressly said that "it would not be appropriate to base our real cost of capital estimates for the entire price control on what could prove to be temporarily distorted figures".[75] It said that consistently using a longer-term estimate is the fairest way to calculate the real cost of capital.[76]

d. The CAA itself has stated very clearly its position in its Q6 determination that rather than adopting a short or medium term assumption:

> *"Ideally the choice of inflation assumption needs to reflect the future inflation expectations at the same point in time as the market data on the bond and cover the period of time to that bond's maturity."*[77]

152. The CAA has adopted neither of the approaches the CMA adopted in 2015 or 2019, nor has it even adopted the approach it took in Q6; instead opting now for a period significantly shorter than either. In doing so, the CAA ignores the CMA's clear and well-reasoned warnings about adopting short-term inflation estimates, and the CAA's own thinking. In doing so, the CAA has not even acknowledged – much less justified – its departure from regulatory precedent set by the CMA or the CAA itself. This breaches the CAA's duty to have regard to relevant evidence, and the CAA's duties regarding regulatory consistency.

153. The CAA rejects a longer-term approach on the basis that Heathrow could be overcompensated if short-term inflation is higher than long-term inflation.[78] This is an unprincipled justification for its

[73] https://assets.publishing.service.gov.uk/media/56279924ed915d194b000001/Bristol_Water_plc_final_determination.pdf paras 10.62 and 10.63.

[74] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf para 9.32.

[75] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf para 9.35.

[76] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf Para 9.36.

[77] CAA (2014), Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences, CAP 1140 (emphasis added).

[78] Final Proposals, section 3, para 9.216

approach. However, the point of adopting a consistent approach across price control terms is to ensure that regulated firms have a "fair bet". There will be periods where short-term inflation exceeds long-term inflation, and periods where the opposite is true. As the CAA freely admits in relation to index-linked (rather than fixed-rate) debt, "we would expect that out-turn inflation will converge to inflation expectations in the longer-term".[79] The approach fails to discharge the CAA's duties regarding regulatory consistency, and is actively inconsistent with both its previous decisions and those of other regulators. By removing the "fair bet", it significantly raises investment risk, which in turn increases the cost of capital and is contrary to the long term interests of consumers, contrary to the CAA's primary statutory duty.

Debt tenor

154. The CAA has reduced the period over which the notional cost of embedded debt is estimated from 20 years to 13.5 years. The CAA's justification is that this "better reflects the issuance profile of HAL's Class A debt, which has been issued more recently on average than a 20-year profile would imply".[80]

155. However, the CAA has made a simple mistake of fact, because – as set out in the main body of Heathrow's response to the Final Proposals – the actual tenor of Heathrow's bonds issuance is far closer to 20 years than it is to 13.5 years (and for GBP bonds, is actually higher than 20 years). The *British Gas v GEMA*[81] case illustrates that regulators setting price controls must base their controls on the ascertainable facts, rather than unevidenced assertions. In failing to properly account for Heathrow's actual debt tenor, the CAA has failed to make reasonable inquiries; has made a fundamental mistake of fact; has failed to properly take Heathrow's own evidence into account; and has failed to properly discharge its statutory duties.

[79] Final Proposals, section 3, para 9.220
[80] Final Proposals, section 3, para 9.22, 9.262
[81] *British Gas Trading Limited v The Gas and Electricity Markets Authority Final determination. 29 September 2015*