

# Economic regulation of Heathrow Airport Limited from January 2020: notice of proposed licence modifications

CAP 1825



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## About this document

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This document gives formal notice under section 22(2) of the Civil Aviation Act 2012 (“CAA12”) of our proposal to modify Heathrow Airport Limited’s (“HAL”) economic licence to:

- extend the current price control by a two year interim period, up to 31 December 2021, taking account of the commercial arrangements between HAL and certain airlines for this period;
- include a new licence condition to promote economy and efficiency by HAL in the operation, maintenance and development of Heathrow airport; and
- make minor changes to update the price control arrangements, remove obsolete terms and make a change to HAL’s regulatory audit requirements to reflect current auditing guidelines.

This statutory consultation follows on from our consultation on interim price control arrangements in February 2019<sup>1</sup> and our consultation on the regulatory framework to support capacity expansion at Heathrow in March 2019.<sup>2</sup>

### Stakeholder views invited

We welcome views on all the issues raised in this document. Please e-mail responses to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by no later than 13 September 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information disclosure under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

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<sup>1</sup> Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements [www.caa.co.uk/CAP1769](http://www.caa.co.uk/CAP1769) (“the February 2019 Consultation”)

<sup>2</sup> Economic regulation of capacity expansion at Heathrow: policy update and consultation [www.caa.co.uk/CAP1782](http://www.caa.co.uk/CAP1782) (“the March 2019 Consultation”)

If you would like to discuss any aspect of this document, please contact Elly Shafran ([elly.shafran@caa.co.uk](mailto:elly.shafran@caa.co.uk)).

# Executive summary

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## Purpose of this document

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1. This document is a formal notice under section 22(2) of the Civil Aviation Act 2012 (“CAA12”) to modify the licence of HAL on 1 January 2020.
2. The proposed modifications reflect our intentions to:
  - further extend the current price control (the “Q6” price control) by two years, and to accept the commercial arrangements agreed with HAL and certain airlines at Heathrow for 2020 and 2021 as the basis for the interim price control, ahead of the next main price control for HAL (which is due to be implemented from the start of 2022);
  - introduce a new licence condition to promote economy and efficiency in the operation, maintenance and development of Heathrow by HAL. This licence modification would remain in place beyond the interim price control period noted above; and
  - make further minor changes to update the price control arrangements, remove obsolete terms and make a change to HAL’s regulatory audit requirements to reflect current auditing guidelines.

## Main issues raised in this consultation

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### Interim price control arrangements for 2020 and 2021

3. The Q6 price control on HAL's charges to airlines is due to expire on 31 December 2019. We consulted in April 2018<sup>3</sup> on a possible approach to extending the Q6 price control to 31 December 2021. We explained the advantages of this interim price control (“iH7”) include aligning the next main

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<sup>3</sup> Economic regulation of capacity expansion at Heathrow: policy update and consultation [www.caa.co.uk/CAP1782](http://www.caa.co.uk/CAP1782) (“the April 2019 Consultation”)

price control period ("H7") with the wider capacity expansion programme at Heathrow airport.

4. We suggested that the existing path for HAL's prices would continue at RPI-1.5% but that we would also reset some of the building block assumptions (passenger forecasts, costs and certain elements of the cost of capital) to take account of HAL's expected performance in 2020 and 2021. We said that the benefits of any expected outperformance would be shared with airlines and consumers in the longer term by making an adjustment to HAL's regulatory asset base (RAB).
5. There were then negotiations between HAL and certain airlines operating at Heathrow on commercial arrangements to cover 2020 and 2021 as a substitute for the interim price control arrangements described above. The commercial arrangements agreed between HAL and certain airlines are referred to in this consultation as the "commercial deal" or the "commercial arrangement" and provide for:
  - a 'fixed rebate' to all airlines currently operating from Heathrow totalling £260 million, split into two equal payments of £130 million to cover 2020 and 2021;<sup>4</sup>
  - a further volume rebate if the number of passengers rises above certain thresholds in 2020 and 2021;<sup>5</sup>
  - if passenger numbers were to turn out significantly lower than expected, the commercial arrangement also provides some downside protection for HAL (in these circumstances the fixed rebate to airlines would be reduced); and
  - default arrangements for any airlines that did not sign the commercial deal, so that those non-signatory airlines would receive an appropriate share of the fixed rebate but would not benefit from the volume rebate.
6. The commercial arrangement is conditional on the CAA setting an RPI-1.5% price path and retaining some existing price adjustment mechanisms including

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<sup>4</sup> Payment of the fixed rebate would be spread over a four year period, commencing after the rebate was accrued.

<sup>5</sup> The volume rebate would be paid in full the year after it is accrued.

those for the Service Quality Rebates and Bonus (SQRB) scheme and security expenditure. Any capital expenditure adjustments and regulatory depreciation would be based on the baseline capital expenditure assumptions as set out in the April 2018 Consultation.<sup>6</sup>

7. The February 2019 Consultation said that the CAA initially considered that an interim price control based on the commercial deal could have wider strategic benefits in terms of encouraging a more commercial relationship between HAL and airlines in the future, would allow stakeholders to focus on the important issues associated with capacity expansion, and would better align the next main price control with the timetable for the wider capacity expansion programme. We also noted that these advantages could outweigh any possible difficulties associated with concerns about the stringency of the proposed arrangements.
8. We received seven responses to our consultation which are available on our website.<sup>7</sup> HAL and airlines preferred the commercial deal to a price control with a RAB adjustment, but airlines, and groups representing airlines, raised a number of concerns around the process for establishing the commercial deal, whether there will be longer term benefits from the commercial arrangement and how the commercial deal should be reflected in HAL's licence. These matters are discussed further in chapter 1.
9. We understand from HAL that the commercial deal has now been agreed and signed by 46 airlines operating at Heathrow airport, whose operations cover around 89 per cent of the passengers using Heathrow.
10. On balance, stakeholders have not raised concerns that would cause us to change our position, which remains that an interim price control based on the commercial deal negotiated by HAL with airlines for 2020 and 2021 is in the interest of consumers. As a result, we propose to extend the existing Q6 price control to the end of 2021 on the basis of the commercial deal. A draft licence modification that reflects this proposal is set out in Appendix E.

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<sup>6</sup> CAP 1658. Appendix D Table D.4 [www.caa.co.uk/CAP1658](http://www.caa.co.uk/CAP1658) (also set out in Appendix B of this document).

<sup>7</sup> Heathrow Price control review H7, [Consultations and policy documents, CAP 1769](#)

## Promoting economy and efficiency

11. In March 2019, we consulted on whether a new condition in HAL's licence to promote economy and efficiency in the operation, maintenance and development by HAL of Heathrow airport would further the interests of consumers. We restated the position that we had explained in earlier consultations that HAL's licence does not currently drive efficiency across all its activities or provide an obligation against which the CAA can investigate inefficiency. In these circumstances, the new licence condition would be helpful in creating a rounded and proportionate set of regulatory obligations.
12. HAL and airlines' views varied on this issue. HAL opposed our proposal to introduce the new licence condition, largely on the basis of arguments that the introduction of such a condition was not necessary and had not been properly justified, but it also made suggestions on the drafting of the condition. Airlines and other stakeholders broadly supported such a condition alongside making suggestions on the drafting of the condition.
13. Stakeholders agreed that, if we were to introduce a new condition to promote economy and efficiency, it should cover only the activities of HAL at Heathrow, rather than having wider application to airlines or third parties such as Border Force.
14. Following a review of stakeholder responses, we intend to modify HAL's licence to include a condition to promote economy and efficiency from 1 January 2020 onwards. We consider that the new condition will be an important part of the overall regulatory framework, providing a further safeguard for consumers' interests, particularly if serious or systemic issues were to arise. A draft licence condition is set out in Appendix E.

## Our duties

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15. In developing this consultation, we have had full regard to our statutory duties under the CAA12, which are set out more fully in Appendix A.

## Structure of this document

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16. The structure of this consultation document is as follows:
- chapter 1 outlines our reasons for and the effects of the proposed modification to put in place interim price control arrangements for 2020 and 2021;
  - chapter 2 outlines our reasons for and the effects of the proposed modification to put in place an obligation on HAL to promote economy and efficiency from 2020;
  - Appendix A summarises our statutory duties;
  - Appendix B addresses the main points respondents made on how best to reflect the terms of the commercial deal in HAL's price control licence conditions, and sets out our preferred approach to these matters;
  - Appendix C explains the more general licence updates to reflect the extension of the price control and deals with respondents' views on these matters. It also explains the minor changes to update the price control arrangements, remove obsolete terms, and explains a change to HAL's regulatory audit requirements to reflect current auditing guidelines.
  - Appendix D addresses the main drafting comments respondents made on our March 2019 draft of the economy and efficiency condition; and
  - Appendix E sets out the proposed licence modifications for statutory consultation.

## Next steps

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- 3.1 We invite comments from stakeholders on the issues raised in this consultation document by 13 September 2019. We cannot commit to taking account of representations made after this date.
- 3.2 Having considered stakeholder views, we will decide what modifications, if any, to make to HAL's licence. If we decide to modify HAL's licence, we shall publish a notice of the modification in accordance with section 22(6) CAA12. If we decide

not to modify the licence we will publish a notice giving our reasons for not doing so in accordance with section 22(5) CAA12.

## Chapter 1

# Interim price control arrangements for HAL

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## Introduction

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- 1.1 We propose to modify HAL's licence to extend the current price control by two years, based on the commercial arrangements negotiated between HAL and airlines for 2020 and 2021. Our proposal is consistent with the approach set out in the February 2019 Consultation, which explained the advantages of a transitional arrangement to broadly align the next main price control with HAL's capacity expansion programme and proposed that the commercial deal negotiated between HAL and airlines should be the basis of the iH7 price control.
- 1.2 This chapter:
- provides a brief summary of what we said in the February 2019 Consultation;
  - sets out the main points raised by respondents to the February 2019 Consultation; and
  - addresses the points raised by respondents and it sets out and explains our broad approach to the interim price control arrangements.
- 1.3 Our approach to implementing these arrangements by modifications to HAL's licence is dealt with in Appendix B, with the licence drafting that forms the basis for the statutory consultation under CAA12 set out in Appendix E.

## The February 2019 Consultation

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### Our proposal to further extend the existing price control

- 1.4 We consulted in April 2018 and February 2019 on a proposal to extend the Q6 price control for two years until 31 December 2021.<sup>8,9</sup> We said that purpose of the iH7 price control would be to protect the interests of consumers by aligning the next main price control period with the wider capacity expansion programme at Heathrow airport. We said that this approach would give HAL more time to produce a high quality interim business plan, so that more robust information on the costs of capacity expansion can be considered during the next main price control review.

### Our proposal to accept the commercial deal for iH7

- 1.5 In February 2019, we consulted on a proposal that the two year commercial deal negotiated by HAL and airlines should be accepted by the CAA as the basis for the price control arrangements for 2020 and 2021. We said that the commercial deal reflected the potential wider strategic benefits for consumers, including:
- stakeholders will be able to focus on the challenges of capacity expansion, rather than on short term issues for establishing a detailed interim price control for 2020 and 2021;
  - facilitating airport and airlines to work together ahead of the next main H7 price control to deliver better outcomes for passengers, for example, reduced prices, improved service quality and the development of new services;
  - the potential for future commercial arrangements relating to capacity expansion to support traffic growth and the overall affordability and financeability of the capacity development at Heathrow; and
  - better arrangements for managing passenger traffic risks during 2020 and 2021.

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<sup>8</sup> See “the April 2018 Consultation” at [www.caa.co.uk/CAP1658](http://www.caa.co.uk/CAP1658)

<sup>9</sup> See “the February 2019 Consultation” at [www.caa.co.uk/CAP1769](http://www.caa.co.uk/CAP1769)

- 1.6 We also presented our assessment of the revenue that HAL is likely to generate from the commercial deal. Our analysis suggested that HAL would receive a lower revenue allowance under the commercial deal compared to a “headline” RPI-1.5% price path. It also indicated that the assumptions underlying the commercial deal were less stringent than the estimates of the underlying cost drivers for 2020 and 2021 which had been developed by CEPA as part of our early work on an interim price control.<sup>10</sup> However, we said that we expected that this difference would come down had we continued with our assessment of HAL’s cost drivers as part of the iH7 regulatory review process.
- 1.7 We acknowledged that the commercial deal means that airlines are likely to gain in the short term (the rebates paid by HAL during 2021 to 2025 has the effect that airlines will effectively pay a lower price than the “headline” RPI-1.5% price path), but that charges to airlines may be higher than they would otherwise have been in the longer term.
- 1.8 Overall, we considered that the wider strategic benefits outweighed the concerns around the form of the commercial deal (rebates being paid during 2021 to 2025, rather than a RAB adjustment over a longer period) and about the stringency for HAL of the targets included in the commercial deal.
- 1.9 We said that we would modify HAL's licence to ensure that the commercial deal integrates properly with existing regulatory arrangements at Heathrow. We invited early views on this in the February 2019 Consultation, but we said that we would engage on the specific licence modifications later in the year.
- 1.10 We also said that it is important for HAL to demonstrate that it continues to deliver service quality in the interests of passengers during 2020 and 2021, particularly given that the commercial deal incentivises passenger growth. A further extension of the Q6 price control for the period to 31 December 2021 delays the introduction of the outcome based regulation (OBR) framework, so we suggested that the interim price control period could offer the opportunity for HAL to begin to "shadow track" key parts of the future (OBR) framework that it is

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<sup>10</sup> See preliminary CEPA review of Heathrow Airport Limited’s (HAL’s) initial business plan submission for the Heathrow interim H7 price control (iH7) at [www.caa.co.uk/CAP1769A](http://www.caa.co.uk/CAP1769A)

currently developing for its H7 business plan. We said that tracking key indicators during 2020 and 2021 would not only have the benefit of piloting their suitability but could also provide evidence to help set incentive thresholds, bonus and penalty rates which would help improve the final OBR framework for the H7 price control.

## Stakeholder views

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- 1.11 HAL and the airlines that responded to the February 2019 Consultation preferred the commercial deal as the basis for the iH7 interim price control, compared to our earlier proposal for an interim price control with an adjustment to HAL's RAB to take account of the expected value of certain efficiency gains.
- 1.12 HAL said that it is a proportionate and targeted regulatory decision for the interim period which will allow stakeholders (HAL, airlines and the CAA) to focus on the capacity expansion programme and the next main H7 price control review. It also suggested that the commercial deal should incentivise airlines to increase passenger volumes for example, by optimising aircraft utilisation, which has the potential to unlock terminal capacity in the near term, ahead of the wider expansion programme. HAL said that the commercial deal is a step towards achieving future commercial arrangements and was in line with its ambition of working towards better commercial relationships with airlines.
- 1.13 Airlines said that they support the payment of rebates in the short term, rather than a RAB reduction in the longer term, saying that it would provide certainty to airlines and allow for the timely return to consumers of the benefit from outperformance by HAL. Airlines also broadly supported the arrangements for volume rebates<sup>11</sup> and agreed with HAL that this mechanism is likely to incentivise passenger growth.
- 1.14 Three airlines<sup>12</sup> expressed reservations around some of the assumptions supporting the commercial arrangement, including the lack of stretch in HAL's

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<sup>11</sup> The volume rebates are available to airlines that have signed the deal if the number of airlines passengers rise above certain thresholds in 2020 and 2021.

<sup>12</sup> This was a confidential joint response from three airlines.

- assumptions on passenger numbers. They also raised an issue around how the overall airport rebates and targets included in the deal are allocated to individual airlines operating at Heathrow, suggesting that certain long-haul carriers may be disadvantaged.
- 1.15 The Airlines Operators' Committee (AOC) and the London Airlines' Consultative Committee (LACC) raised concerns over our assessment of the commercial deal and said that limited evidence exists that the commercial deal would deliver longer term benefits to consumers. Concerns were also raised about our assessment of the revenue that HAL was likely to receive under the commercial deal, when compared to CEPA's preliminary estimates of HAL's underlying costs for 2020 and 2021. The AOC and LACC noted that commercial negotiations with companies that hold substantial monopoly power will not lead to genuinely competitive outcomes.
- 1.16 Airlines raised concerns over the process by which the commercial deal was negotiated, saying that HAL did not give them enough time properly to assess the baseline assumptions (including the forecasts of passenger numbers) that support the commercial arrangement. Airlines also said that most carriers had limited success in negotiating significant changes to the commercial terms that were initially proposed by HAL.
- 1.17 They also raised concerns that the CAA's April 2018 initial proposal for the interim price control was 'very weak', especially as a one year extension to the Q6 price control had already been implemented. They said that they were left with no alternative but to discuss and agree the commercial deal offered by HAL. Airlines said that they did not support future commercial arrangements at Heathrow airport because of concerns about HAL's market power and the lack of airline bargaining power (particularly for airlines with smaller scale operations at Heathrow airport). They noted that the commercial deal reflected a specific set of circumstances for 2020 and 2021 and the CAA's proposals to share efficiency saving through reductions in the RAB rather than rebates.
- 1.18 Airlines agreed that the SQRB mechanism should be retained for 2020 and 2021 but said that there are some areas of the scheme that should be reviewed to take account of the opportunities available to HAL to deliver higher levels of

service quality (including in relation to the Quality of Service Monitor and security queues). IAG also suggested that the CAA should complete a service quality audit to ensure that the SQRB scheme continues to be administered correctly ahead of the H7 price control.

- 1.19 Airlines did not support our proposal to shadow track key parts of the OBR framework during 2020 and 2021. They were concerned that this could lead to perverse incentives for HAL to underperform during the interim price control period if future targets are based on performance during 2020 and 2021. HAL agreed in principle that the interim price control period presented a good opportunity for shadow tracking but raised concerns that this could undermine work that they have started in this area.
- 1.20 HAL supported our proposal to introduce a new licence condition for the interim price control period to reflect the commercial deal and welcomed further engagement with stakeholders on this issue. Airlines argued for a "belt and braces" approach to enforcement to ensure that the rebates under the commercial deal are paid and suggested that the contractual rights offered under the commercial deal should be replicated in full in an obligation in HAL's licence. Further detail of stakeholder feedback on this issue is set out in Appendix B.

## Way forward

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### **Commercial arrangements between HAL and airlines for 2020 and 2021**

- 1.21 Having considered stakeholders' responses, we remain of the view that basing the interim price control on the commercial deal negotiated by HAL and airlines at Heathrow for 2020 and 2021 is in the interests of consumers. This is the first time that commercial arrangements have been negotiated to cover operations at Heathrow, so evidence of the wider benefits of such arrangements is limited at this stage. There remain advantages in encouraging HAL to adopt a more commercial relationship with airlines and accepting the commercial deal as the basis for the interim period will allow stakeholders to focus on dealing with the important issues around capacity expansion. Nonetheless, it is also clear that HAL has a significant amount of work to do if it is going to be able to build on the

- commercial deal and develop a more commercial relationship with airlines in the future.
- 1.22 Despite the reservations that they have expressed, airlines have indicated a strong preference for the commercial deal that they have negotiated with HAL for 2020 and 2021, compared to the price control that we would have otherwise set (with an adjustment to HAL's RAB rather than rebates). Airlines whose operations cover around 89 per cent of passengers at Heathrow have signed the commercial deal.
- 1.23 Accepting the commercial deal as the basis of the interim price control facilitates regulation being focused on areas where it is most needed, which is consistent with the principles of better regulation. It also enables us to have a greater focus on the important matters related to capacity expansion and the H7 price control review, which should allow us to better protect consumers in the medium and longer-term.
- 1.24 The volume rebate mechanism included in the commercial deal provides some additional benefits from passenger growth to those airlines that have signed it, while giving some protection to HAL if passenger volumes decrease in 2020 and/or 2021. In the longer term, consumers should benefit if HAL achieves greater efficiency savings than those underlying the commercial deal, as these can be shared with consumers at the next main price control review.
- 1.25 We acknowledge that some airlines have raised concerns about their relative treatment compared to other airlines under the commercial deal. We note that the price control framework for the economic regulation of HAL airport does not determine the treatment of individual airlines as it focuses on the average level of airport charges per passenger, rather than determining individual elements of HAL's charging arrangements. HAL will still be required to consider airport charges in accordance with the broader requirements of the price control, the Airport Charges Regulations 2011 and competition law.
- 1.26 We note that airlines that have not signed the commercial arrangement will benefit from the overall RPI-1.5% path of charges and the fixed rebates that HAL has offered to all airlines operating at Heathrow (regardless of whether they

have signed the commercial deal). We also note that much of the existing regulatory framework, for example around capital expenditure governance, HAL's RAB and the work to support capacity expansion, continues in place and should help protect the interests of consumers and airlines in the medium and longer term.

- 1.27 As noted above, airlines have raised concerns around HAL's approach to negotiating the commercial arrangement. We also recognise that future commercial arrangements at Heathrow have received limited support from airlines. HAL will need to consider carefully how to address these concerns if it is to build on the commercial arrangements in the future.

### **Reflecting the commercial deal in HAL's licence**

- 1.28 It will be important to adopt a proportionate approach to introducing the interim price control, with HAL's licence capturing those high-level features of the commercial deal (including the fixed rebates) that are available to all airlines operating at Heathrow. The proposed licence modification, and our reasons for and the effects of this proposal, are set out in Appendix B where we also assess the key issues raised by stakeholders on reflecting the commercial deal in HAL's licence and our views on these issues.

### **Delivering service quality during 2020 and 2021**

- 1.29 At this stage it would not be proportionate for us to review the existing SQRB targets, or to carry out a detailed audit of these arrangements, given the advantages of building on the successes of the SQRB and moving towards an approach to outcome-based regulation (OBR) for the H7 price control.
- 1.30 We remain of the view that HAL should continue to develop an evidence base during 2020 and 2021 to support its H7 proposals and that the period to 31 December 2021 presents a good opportunity for HAL to test aspects of the OBR framework, including shadow tracking to the extent that this is appropriate. Testing potential aspects of a new framework can give greater confidence about their introduction in H7. We will continue to engage with HAL on its development of OBR, including how it can test the framework before the H7 price control period.

- 1.31 Bearing the above in mind the existing SQRB mechanism will be retained for the period to 31 December 2021 which will incentivise HAL to continue to deliver quality services during 2020 and 2021.

### **Relationship between commercial deal and HAL's H7 price control**

- 1.32 The commercial deal provides rebates to airlines to be accrued during 2020 and 2021, but not actually paid in full to airlines until subsequent years in the H7 price control period.
- 1.33 Respondents agreed that the rebates payable in respect of the period to 31 December 2021 should not be treated as reductions in HAL's revenues, and so should not affect the setting of the H7 price control. We support this approach and do not intend to make any extra allowances when we set the price control for the H7 period because of these rebates. It would not be in the interest of consumers for the regulatory regime to allow HAL to recover revenues more than once in relation to services it provides. Nonetheless, in setting HAL's next main price control, we will consider both affordability and financeability and cannot rule out making adjustments to our projections of HAL's price control revenues to take account of financeability of the capacity expansion programme.

### **Price control arrangements beyond 2021**

- 1.34 We remain of the view that our regulatory framework should be broadly aligned with the wider capacity expansion programme. The February 2019 Consultation said that we intend to retain the option of putting in place further interim arrangements to cover 2022 if the capacity expansion programme is significantly delayed. We noted that these arrangements would involve resetting more of the key drivers of the price control revenue, including the reassessment of the cost of capital.
- 1.35 In July 2019 we issued a consultation on early costs that HAL expects to incur to support capacity expansion, and the timetable for developing the regulatory framework for HAL.<sup>13</sup> We highlighted that the wider timetable for capacity expansion is under a degree of pressure (which is not, in itself, surprising given

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<sup>13</sup> See the "July 2019 Consultation" at: [www.caa.co.uk/CAP1819](http://www.caa.co.uk/CAP1819)

the scale and complexity of the programme) and we are consulting on whether the regulatory timetable remains appropriate. Our current view is that there would be a number of advantages to retaining a target of 2021 for the main H7 price control proposals rather than delaying the regulatory timetable or introducing a further transitional period. This approach could involve the greater use of uncertainty mechanisms to deal with those elements of the programme which will be less certain.

- 1.36 Stakeholders with comments on these matters should respond to the July 2019 Consultation on early costs and the regulatory timetable by 22 August 2019.

## Views invited

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- 1.37 Views are invited from stakeholders on any of the issues raised in this chapter.

## Chapter 2

## Promoting economy and efficiency

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### Introduction

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- 2.1 The March 2019 Consultation<sup>14</sup> built on previous consultations since 2014 in considering whether a new condition in HAL’s licence to promote economy and efficiency by HAL (an “efficiency condition”) would further the interests of consumers. We stressed the importance of such a condition in filling a gap in the regulatory framework for HAL, in that it is not practicable or desirable to try and develop incentive arrangements to cover all aspects of its conduct.
- 2.2 This chapter:
- provides a brief summary of what we said in the March 2019 Consultation;
  - sets out the main points raised by respondents to the March 2019 Consultation on these matters; and
  - explains our decision to move forward with our proposals for an efficiency licence condition, with Appendix E setting out the licence drafting for statutory consultation.

### The March 2019 Consultation

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- 2.3 The March 2019 Consultation reiterated our position that HAL's licence does not explicitly drive efficiency across all its activities or provide a general obligation against which the CAA can investigate questions of inefficiency. It went on to make clear that we consider that neither other elements of the regulatory regime, nor pressure from airlines adequately compensate for this, and that *ex post* application of competition law does not sufficiently protect the interests of consumers.

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<sup>14</sup> See Economic regulation of capacity expansion at Heathrow: policy update and consultation [www.caa.co.uk/CAP1782](http://www.caa.co.uk/CAP1782) (“the March 2019 Consultation”)

- 2.4 In this light, we refined our approach to an efficiency condition to focus more clearly on how HAL conducts its business rather than precisely what it delivers. Consistent with our approach of not mandating either capacity expansion (which should be funded and incentivised through HAL's next main price control), or other particular investments (which should be decisions for HAL's management using established governance mechanisms), we said that an efficiency condition would complement, rather than replace, HAL's price control arrangements and facilitate oversight of the way that HAL runs its business generally to avoid regulatory "gaps".
- 2.5 While not being suitable for determining (or intended to cover) either:
- commercial disputes between HAL and the airlines it serves; or
  - insignificant matters,
- such a condition would give stakeholders (particularly airlines) the ability to raise concerns in "real time" rather than through slower issue-specific regulatory developments or having to wait until the conclusion of the next price control review.
- 2.6 Overall, we were minded to continue to develop an efficiency condition with a view to implementing a condition at the start of the 2020 and the interim price control period (which will run for two years before HAL's next main price control). We said that such a condition has the potential to be an important part of the overall regulatory framework, ensuring efficiency and economy in the provision of airport operation services ("AOS") and providing a further safeguard for users' interests, particularly if serious or systemic failings in HAL's conduct were to arise.

## Stakeholder views

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- 2.7 The stakeholders whose responses addressed the introduction of an efficiency condition broadly followed the approach that they had taken in response to previous consultations:
- HAL opposed its introduction, but nonetheless suggested specific drafting changes; and

- airlines, their representatives, and other stakeholders broadly supported an efficiency condition targeted at how, rather than what HAL delivers.
- 2.8 Stakeholders agreed that any such a condition, if introduced, should be clear in covering only the activities of HAL at Heathrow airport, rather than having wider application to airlines or third parties such as Border Force.
- 2.9 In opposing an efficiency condition, HAL continued to say that the CAA had failed to justify the introduction of an efficiency condition in line with its statutory duties. It suggested that the CAA had failed to demonstrate the weaknesses in its existing power with respect to ensuring economic and efficient delivery by HAL. It cited the CAA's "Section 16" reports as evidence that the CAA has been able to influence effective engagement and said that section 50 CAA12 provides the CAA with adequate tools to gather information. It also said that the CAA should carry out a full quantified impact assessment or cost benefit analysis before introducing any such condition.
- 2.10 Without prejudice to these comments, HAL expressed the view that the drafting of any condition should be clear and properly reflect the CAA's duties. In so doing, it agreed with the CAA's approach that the condition should focus on behaviour, not outputs and not mandate expansion or specify "areas of focus". It also took the view that the drafting of the condition should track more closely the wording of CAA12, and that certain terms used in the draft condition should either be defined or expanded on in order to clarify the condition. HAL made drafting comments on the condition in the March 2019 Consultation which are summarised and addressed in Appendix D.
- 2.11 HAL also took the view that it is not appropriate to include an efficiency condition in its licence at this stage, considering its implementation rushed, and seeing its entry into commercial agreements with airlines for the interim price control period as a change of circumstances which signals a more commercial relationship between HAL and airlines. In any event, the CAA should provide further assurances that its enforcement guidelines and prioritisation criteria that will apply to any enforcement action to make clear that the condition is not aimed at resolving commercial disputes or trivial matters.

2.12 Individual airlines commented that:

- HAL's market power makes it incumbent on HAL to demonstrate efficiency in all aspects of its business and in how it responds to its customers;
- airlines do not bring commercial pressure to bear on HAL as the capacity constraints at Heathrow means they have no countervailing buyer power;
- HAL's opposition to a condition, along with its lack of responsiveness to airlines, helped to show why an efficiency condition is needed;
- while HAL may not reasonably be expected to deliver all the desired outputs all the time, it should deliver all the desired outputs and outcomes most of the time and customers should not be expected to pay for undesired outputs or outcomes;
- "economy and efficiency" do not need to be defined in the condition as they are well understood;
- references to the requirements of present and future users and the need for HAL to be able to finance its activities should not lead to an increase in HAL's rate of return;
- any additional "perceived" risk for HAL would not necessarily be reflected in HAL's actual financing costs and an efficiency condition should increase investors' confidence that they will receive a fair return; and
- the CAA must be seen to act on the licence condition to ensure that HAL acts efficiently and in the interests of consumers.

2.13 Airline representatives remained more cautious, considering that a new condition should not replace effective and rigorous regulation that should focus on appropriate outcomes. They also considered that more stringent price control arrangements might help address some of the issues associated with the current regulatory framework.

2.14 The Arora Group ("Arora") supported the new condition but were disappointed that failure to engage with a competitor by HAL would not prima facie "engage" the condition, believing this will undermine the CAA's policy on alternative delivery arrangements. Arora also said that the CAA has an important role to

play in creating a level playing field. It took the view that increases in HAL's Category B and C costs is evidence of requirement for condition and that any competitor is at a disadvantage due to:

- the wealth of data and information from operating Heathrow that HAL holds; and
- HAL's costs are directly recoverable from airlines.

2.15 Arora welcomed the CAA's approach of referring to elements of its own duties in the condition as an aid to interpretation, but considered that the CAA should assess compliance in accordance with all its duties. It urged the CAA not to let the timetable for introducing the condition slip beyond the end of 2019.

2.16 Another respondent was generally supportive and thought that the obligations should be drafted clearly to hold HAL to account. This respondent was also concerned that the use of RAB based regulation may not provide sufficient incentive for HAL to develop cost effective expansion proposals. It cited HAL's costs for providing car parking as evidence that HAL may not be cost efficient. It also suggested that the condition should be drafted to require HAL to have full regard to the Airports' National Policy Statement ("NPS").

2.17 HAL, airlines and their representatives also requested that the CAA clarify how the condition will operate, including information gathering and resourcing of investigations. They also made comments on the drafting of the condition which are addressed in Appendix D.

## Way forward

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### The reasons for and effect of the proposed modification

2.18 We have set out in a series of consultations why we consider that modifying HAL's licence to include a new efficiency condition is justified. The reasons for the proposed condition and the effects of it have been set out in those previous consultations and are summarised below:

- An efficiency condition should address the fact that it is not practicable for price control incentives fully to capture all aspects of HAL's behaviour.

We consider that is the case because:

- we cannot be certain that incentives can be designed in such a way that they could be relied on, by themselves and without more, to drive economy, efficiency and timeliness in all aspects of HAL's existing business and in developing new capacity (especially given both the requirements for detailed information and foresight that the design of such incentives would require in the circumstances of a programme as complex and difficult as capacity expansion, and given the size and complexity of HAL's business);
- there is the risk that incentives may be gamed or may have unforeseen consequences; and
- we cannot be certain that *ex post* reviews (a form of incentive) would be fully effective in protecting consumers from the costs of inefficiency, not least because they are more suited to the disallowance of inefficient expenditure rather than dealing with other inefficiencies.

In addition, for the period of the interim price control at least, the incentive arrangements applicable to HAL are likely to be less effective, not least because of the time elapsed since the last full price control was set (the Q6 price control period commenced in 2014).

- The regulatory regime applicable to HAL does not contain a general obligation to promote economy and efficiency across the full range of HAL's activities.

Although HAL's licence does contain tightly focussed obligations on efficiency, in relation to the promotion of capital projects (Condition C3) and operational resilience (D2), neither CAA12 nor HAL's licence contains a general obligation to promote economy and efficiency across the full range of HAL's activities.

Furthermore, the use of competition law is not well suited to addressing efficiency issues (see further below).

- An efficiency condition should be included in HAL’s licence to be part of a suite of regulatory tools that, taken together, should promote and incentivise efficient behaviour by HAL in the interests of consumers.

Given:

- that the CAA must have regard to promoting economy and efficiency on the part of each holder of a licence;
- the absence of general obligations on HAL to operate efficiently; and
- the limitations of incentives set out above,

an efficiency condition should sit alongside incentives to prove a tool that would facilitate the CAA in having regard to the need to promote economy and efficiency on the part of HAL and satisfy its obligation to do so under CAA12.<sup>15</sup>

- An efficiency condition should provide clear expectations for the way HAL conducts its business, working alongside the price control, not in place of it.

As noted in above, the efficiency condition should complement, not replace the price control.

To provide clear expectations for HAL, the efficiency condition should also make appropriate reference to the reasonable demands for airport AOS and requiring HAL to consult appropriately to determine what these are in order to help it frame its conduct, as well as further tracking the requirements of section 1 CAA12.

- An efficiency condition should provide the CAA with the ability to address issues arising from HAL’s behaviour generally and in “real time”, without the need either to wait for the outcome of the next price control or the development of issue-specific licensing rules, to address particular and/ or unforeseen circumstances that may have arisen and are causing detriment to consumers.

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<sup>15</sup> As such, an efficiency condition should track the CAA’s duties in CAA12 as far as reasonably practicable so that the CAA has the tools to satisfy its duties.

As noted above, while *ex post* efficiency reviews may have a role to play in regulating HAL, these are more suited to disallowing costs than dealing with broader efficiency issues. Furthermore, given that efficiency reviews are conducted at the next price control review, they cannot provide timely protection for the interests of users and are not accompanied by the broader range of tools that investigations and enforcement action can bring.

At the same time:

- new licence conditions are slow to develop, given the need to identify the relevant issues, form an appropriate response and observe the required process under CAA12 to implement them; and
- competition law is not well suited to deal with questions of efficiency and would involve a lengthy process, making timely intervention to protect the interests of users difficult.

Finally, other actions such as terminating the price control to address efficiency issues are not appropriate as they are too intrusive, unlikely to be proportionate and would undermine investor confidence.

- An efficiency condition would frame early discussions between the CAA and HAL, potentially reducing the need for formal actions.

If an issue were to arise under the efficiency condition, our policy on enforcement is proportionate and may lead to a range of responses. Details of our approach to enforcement activity is set out in the CAA's Regulatory Enforcement Policy.<sup>16</sup>

- 2.19 Likewise, the implementation of an efficiency condition would avoid the CAA being left in a position where it lacks an appropriate tool to address significant issues raised by HAL's behaviour, or having to use another licence condition (even if one were available) which was not fit for purpose. As noted above, HAL has neither a general statutory obligation to conduct its activities efficiently, nor a general obligation under its licence to do so, the CAA does not have such tools at present to ensure that:

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<sup>16</sup> For the current CAA Regulatory Enforcement Policy, see: [www.caa.co.uk/CAP1326](http://www.caa.co.uk/CAP1326)

- it has oversight of the way it runs its business generally;
- it can consider efficiency issues that both bear on the price control and more widely; and
- there are no “gaps” in the oversight of HAL.

2.20 The CAA’s information gathering powers under competition law and section 50 CAA12 are not a substitute an efficiency condition and the CAA’s conduct of price control reviews are limited in time and, therefore, cannot deal with issues arising between price control reviews. Similarly, commercial pressure from airlines is not a full substitute for regulatory oversight, not least because HAL has substantial market power, there is an information imbalance between HAL and airlines, and airlines have neither the investigatory nor enforcement tools to address this.

2.21 In addition to the above factors, we have explained that other regulatory measures, such as incentives, while a primary tool of regulation, cannot:

- be "seamless" to cover all aspects of HAL's business or incentivise all aspects of HAL's conduct;
- be perfectly designed to incentivise efficient behaviour by HAL in all circumstances; or
- to the extent that they operate *ex post*, be used to address issues that arise which cause, or risk causing, detriment to consumers promptly and in "real time".

2.22 Having considered stakeholders’ responses, we consider that these arguments<sup>17</sup> justify the proposed modification and that an efficiency condition will help in addressing the risk that consumers may suffer detriment<sup>18</sup> as a result of the above factors and limitations of the current regulatory framework and that:

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<sup>17</sup> For more detail of stakeholders’ previous responses on the issues raised in this chapter and the CAA’s reasons justifying the proposed modification to insert an efficiency condition, see especially:

- chapter 2 and Appendix B of the October 2018 Consultation [www.caa.co.uk/CAP1722](http://www.caa.co.uk/CAP1722); and
- chapter 3 of the March 2019 Consultation [www.caa.co.uk/CAP1782](http://www.caa.co.uk/CAP1782).

<sup>18</sup> Such detriment could arise equally from under- or over- investment, operational behaviour or other inefficient

- as noted above, absent an efficiency condition, HAL is under no general obligation to act economically or efficiently, currently having only specific licence obligations that are limited in scope<sup>19</sup>, while HAL's obligations under competition law are not well suited to enabling the CAA to address inefficiency; and
- specific licence conditions to deal with particular problems are slow to develop.

2.23 Bearing the above in mind, we do not consider that the existing arrangements are sufficient to further the interests of consumers because the existing obligations on HAL do not provide a general rule to ensure that inefficient behaviour by HAL in relation to the operation, maintenance and/or development of Heathrow airport does not cause detriment to consumers.

2.24 Further we do not consider that the limited commercial pressure that airlines can bring to bear on HAL is sufficient to ensure HAL always acts efficiently in the interests of consumers. Indeed, our experience of Enhanced Engagement suggests that, while airlines do have some influence on the commercial behaviour of HAL, there are limits to that influence. The limitations on the commercial pressure that airlines can bring to bear on HAL is implicit in the substantial market power that HAL holds and which underpins the licensing of HAL. So, the proposed modification will have the effect of providing a suitable tool on which to take action in these circumstances.

2.25 HAL's comments in relation to:

- the impact of our Section 16 reports and the Enhanced Engagement process on its serve to reinforce our arguments, since the Section 16 and Enhanced Engagement processes have only enabled the CAA to influence, rather than require, desired behaviour by HAL;

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conduct by HAL.

<sup>19</sup> See, for example, Condition C3 (Procurement of capital projects) of HAL's licence.

- section 50 CAA12 are not relevant, since that provision provides only a tool for evidence gathering during an investigation, not a means for the CAA to either require action or address particular behaviour.

2.26 As for HAL's comments on the need for an *ex ante* quantitative impact analysis before the condition is implemented, we do not consider that this is either possible or appropriate, given the nature of the issues likely to be caught by an efficiency condition. In any event we do not consider that an efficiency condition will have significant adverse effects on HAL, or its ability to finance its activities, because:

- HAL's compliance costs appear likely to be low as compliance should be monitored through existing business assurance processes;
- there do not appear to be realistic or credible downsides for HAL's business of a requirement to operate economically and efficiency;
- investors should take reassurance that the regulatory regime promotes efficient behaviour by HAL; and
- HAL has provided no evidence that the presence of similar regulatory obligations in other regulatory regimes has made it more difficult for entities in those sectors to raise finance, or has made such finance more expensive.

2.27 At the same time, the benefits for consumers in terms of the ability of the CAA to address matters for the benefits of consumers and the more general impact such a condition may have in driving economy and efficiency on the part of HAL, while undoubtedly positive, are difficult reasonably to quantify as this would require the CAA to have foresight of the specific issues that might arise and be addressed under the condition. We also consider that there is no merit in arguments that an efficiency condition would deter efficient spending or behaviour as this is contrary to the clear requirements of the condition.

2.28 That said, as noted above, the CAA has conducted a qualitative assessment of whether an efficiency condition would be necessary or expedient to further the

CAA's duties under CAA12, including assessing whether the desired level of protection for consumers can be delivered through less restrictive measures.<sup>20</sup>

- 2.29 Having also analysed the responses to the March 2019 Consultation, the CAA considers that its proposal to modify HAL's licence to include an efficiency condition meets the tests set out in CAA12. Therefore, the CAA proposes to modify HAL's licence to include an efficiency condition, to be implemented from 1 January 2020. Issues relating to the application and implementation of the proposed condition are dealt with below and the form of the proposed condition is specified in Appendix E.

### Application of the condition

- 2.30 An efficiency condition in HAL's licence can, as a matter of law, place obligations only on HAL, not third parties, such as airlines. Further, the proposed drafting of the condition seeks only to create obligations on HAL. This is because it is drafted to read:

*“The Licensee shall conduct **its** business and **its** activities that relate to the provision of airport operation services at the Airport”* (emphasis added)

In each case, it is clear that “its” refers to “[t]he Licensee” and to no one else. As such, concerns that an efficiency condition might be used to expand the scope of economic regulation are unfounded. We consider that the drafting of the proposed condition, by referring to airport operation services reinforces this point. We do, however, propose to make a change to the drafting in the March 2019 Consultation to further clarify this point.<sup>21</sup>

- 2.31 We also consider that the condition should apply to how HAL conducts its activities, rather than specifying what it delivers (which would be better achieved through incentive arrangements) or attempting to mandate or incentivise capacity expansion. We will, however, address incentives for capacity expansion

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<sup>20</sup> See, in particular, Appendix B of the October 2018 Consultation. We consider that HAL's reference to the CAA's obligations not to impose or maintain undue burdens on HAL under section 72 of the Regulatory Enforcement and Sanctions Act 2008 as it raises the essentially the same question of “proportionality” as the CAA is required to address in satisfying its duties under section 1 CAA12.

<sup>21</sup> See Appendix D.

during HAL's next main price control review. To reflect this approach, we removed the references to capital expenditure and the NPS from previous drafts of the condition and are continuing with this approach.

- 2.32 By contrast, we consider that there remains merit in retaining specific reference to engagement with airlines and other stakeholders in the condition as a means of ensuring that HAL meets the reasonable demands for AOS and satisfies the interests of users. We consider that this is appropriate as a means of reflecting the need for the CAA to have regard to the reasonable demands for AOS and further the interests of users as set out in its duties under section 1 CAA12 since airlines will have significant insights into the needs of the passengers they serve. At the same time, we consider that this provides HAL with transparent guidance as to how it should go about achieving compliance with the condition.
- 2.33 While HAL commented that an efficiency condition should reflect the CAA's duties, we do not consider that its specific comments on the draft efficiency condition we published in the March 2019 Consultation were consistent with this approach. That said, we consider that the drafting of an efficiency condition can be enhanced and have set out the changes, together with the reasons for them in Appendix D and the form of the proposed condition is specified in Appendix E. With these changes, we consider that an efficiency condition would have the effect of enabling the CAA to hold HAL to a high, but achievable, standard, and is consistent with both the need to manage the risks arising from HAL's significant market power and appropriately reflecting the CAA's duties under CAA12.

### **Implementation issues**

- 2.34 While we welcome it, the entry into the commercial deal between HAL and airlines for the 2020 and 2021 interim price control period is not relevant to the issues underpinning our assessment of the need for an efficiency condition. This is because the deal focuses on airport charges, which would normally be dealt with under the price control, rather than HAL's wider behaviour.
- 2.35 As a result, we consider that it remains appropriate to modify HAL's licence to include an efficiency condition to have effect from 1 January 2020. This

approach is consistent with our view that an efficiency condition should be in addition to, not instead of, appropriate price control arrangements. As such, the efficiency condition would remain in HAL's licence beyond the end of the interim price control period.

2.36 Consistent with our view in the March 2019 Consultation, we do not consider that an efficiency condition provides a suitable context for the CAA to become involved in dealing with either:

- trivial matters; or
- commercial disputes between HAL and airlines.

2.37 By contrast, we consider that such a condition is more suited to addressing issues of similar seriousness as those which other sectoral regulators have addressed and/or may address using their equivalent powers. Examples of these include recent investigations by the ORR and Ofgem.<sup>22</sup> Nonetheless, questions as to what constitutes economy and efficiency in any particular case involving airport operation services will depend on the circumstances at hand, including what the reasonable demands for AOS are, and what the interests of users comprise, in the relevant context of Heathrow airport.

2.38 In areas where HAL is subject to specific regulatory incentives, we consider that an efficiency condition is unlikely to be relevant to assessment of HAL's behaviour provided that HAL's behaviour is reasonable in the context of the regulatory incentive in question. We would not expect to investigate HAL's behaviour in such an area under the efficiency condition unless it fell significantly short of the minimum parameters contemplated by the relevant incentive.

2.39 While airlines and others will be able to raise issues with the CAA relating to the efficiency condition, our approach to taking any action under an efficiency

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<sup>22</sup> See the recent investigations by:

- (i) ORR into Network Rail ([https://orr.gov.uk/\\_data/assets/pdf\\_file/0008/39842/provisional-order-published-2018-11-29.pdf](https://orr.gov.uk/_data/assets/pdf_file/0008/39842/provisional-order-published-2018-11-29.pdf)); and
- (ii) Ofgem into Cadent (<https://www.ofgem.gov.uk/publications-and-updates/investigation-cadent-gas-limited-and-its-compliance-its-obligations-under-its-gas-transporter-licence-standard-special-conditions-a40-a50-and-a55-and-consequence-section-9-gas-act-1986>)

condition would be guided by our duties under CAA12 as well as our prioritisation principles and enforcement guidelines from time to time in force.<sup>23</sup>

2.40 While the CAA will remain vigilant on compliance and will be open to evidence from stakeholders, stakeholders will need to bear in mind that the CAA will only commence an investigation in the light of credible evidence that we receive. In doing so, our general position will be that the CAA's focus in considering taking any steps in relation to an efficiency condition will be to concentrate on matters that seem likely to have a material adverse impact on users.

2.41 We also note that our development of an efficiency condition is separate from our policy in relation to the development of alternative delivery arrangements, albeit that it is possible that HAL's behaviour in relation to a competitor may raise issues under the condition in some circumstances. We will continue to consider any representations that we receive from the Arora Group in relation to its engagement with HAL (including any failure on the part of HAL to engage appropriately with Arora) in order to assess whether any issues arise where intervention by the CAA could further the interests of consumers.

## Views invited

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2.42 Views are invited from stakeholders on any of the issues raised in this chapter.

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<sup>23</sup> For the current CAA Prioritisation Principles, see: [www.caa.co.uk/CAP1233](http://www.caa.co.uk/CAP1233)

## Appendix A

## Our duties

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1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
2. CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
5. In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
  - the need to secure that each licensee is able to finance its licensed activities;
  - the need to secure that all reasonable demands for AOS are met;
  - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
  - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
  - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
  - the Better Regulation principles.

6. In relation to the capacity expansion at Heathrow, these duties relate to the CAA's functions concerning the activities of HAL as the operator at Heathrow.
7. CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.
8. We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

## Appendix B

## Proposed licence modifications for the interim price control arrangements

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1. To give effect to our proposed arrangements for the interim price control, several modifications to HAL's licence are required. These updates include:
  - new licence provisions to recognise the commercial arrangement for 2020 and 2021 (discussed in this appendix); and
  - more general licence updates to reflect the extension of the price control to 2021 (discussed in Appendix C).
2. Following our February 2019 Consultation, we engaged further with those stakeholders who had responded to that consultation on the ways we could reflect the commercial deal in HAL's licence for the interim control period. We shared a preliminary draft licence modification informally with them and we understand that this was discussed with the wider airline community through the LACC.
3. This appendix summarises our preliminary licence drafting to reflect the commercial deal in the licence, the key issues stakeholders raised as part of our informal engagement with them and also sets out our proposals for the way forward on these issues.
4. As noted in the executive summary the commercial deal is conditional on the CAA setting an RPI-1.5% price path and any adjustments for outturn capital expenditure being made against the capital expenditure estimates we published in the April 2018 Consultation. For the avoidance of doubt we have restated the assumptions made on capital expenditure and associated regulatory depreciation for 2020 and 2021 in this appendix.

## Recognising the commercial deal in HAL's licence

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### Our preliminary licence drafting

5. In our preliminary licence drafting our primary consideration was to ensure that HAL was under an obligation to make rebates to airlines equivalent to the total level of fixed rebate set out in the commercial deal.
6. We suggested that HAL should be required to place details of the fixed rebate into its Conditions of Use ("the CoU") for the benefit of non-signatories and that it should comply with them. We also suggested that the payment of the maximum amount of the fixed rebate (£130 million in respect of each of 2020 and 2021, subject to the terms set out in the commercial deal) should be required by the licence.
7. We did not propose to include in the licence those elements of the commercial deal that were specific to individual airlines that had signed the commercial deal. We considered that any disputes on these terms should be a matter for individual airlines to address using the rights arising under the contracts forming the commercial deal.
8. We also considered it was important to ensure that the modifications we make to HAL's licence to reflect the commercial deal are consistent with its wider price control licence condition, its responsibilities under the Airport Charges Regulations 2011 (2011 No.2491) and wider competition law.

### Stakeholder views

9. HAL supported our proposal to introduce a new licence condition for the interim price control period to reflect the commercial deal. It agreed that putting the full detail of the fixed rebates of the commercial deal in the CoU was a practical solution. However, HAL questioned why there should be a licence requirement for it to comply with the payment of the fixed rebate as it considered that any disputes with airlines that have signed the commercial deal could be resolved through the usual processes for resolving contractual disputes.

10. The AOC and LACC said that they do not consider the commercial arrangement is a normal commercial deal between competitive parties and as such these airline groups have requested the maximum level of protection for airlines. They say that this approach would be the only way to ensure consistent enforcement of the commercial deal and it avoids the risk of different airlines having to pursue costly and time consuming claims through the courts.
11. Airlines strongly disagreed with several elements of our preliminary draft licence modification. They said that they entered into the commercial deal with HAL in place of a more conventional price control extension, and they consider that it is not a normal commercial arrangement between competitive parties. In this context airlines expected the CAA to provide much greater regulatory protection than that set out in our preliminary draft modification and that the commercial deal should be primarily enforced through the licence.
12. Airlines suggested that the terms of the commercial deal should be set out in full in an appendix to the licence, as this would provide full regulatory protection. They wanted all features of the commercial deal (not limited to the fixed rebates) to be included to ensure that it is universally and consistently applied. They said that HAL's significant market power meant that the whole of the commercial deal should be reflected in the licence to provide airlines with appropriate regulatory protection.
13. The airlines strongly disagreed with including any reference to the commercial deal in HAL's CoU. They said that many of the airlines at Heathrow have not accepted the CoU and this may make taking legal action more difficult. They also said that, during the negotiations on the commercial deal, they had made it clear to HAL that they did not want any linkages between the commercial deal and the CoU.

### **CAA views**

14. We are seeking to take a proportionate approach to recognising the commercial deal through the licence and do not consider it is necessary to

reflect all of the detail of the commercial deal in HAL's licence in order to protect the interests of consumers.

15. We acknowledge that airlines had entered into the commercial deal in place of a more standard price control extension and that they had some reservations about how this would work. Nonetheless, HAL's price control conditions provide overall constraints on the revenue HAL can recover from airport charges and the circumstances of the commercial deal, and the interim price control, do not suggest a different or a more intrusive approach is warranted. We also note that where a company has chosen to enter into a contract, the primary enforcement mechanism for that contract would normally be through the courts. This approach is also consistent with our Regulatory Enforcement Policy.<sup>24</sup>
16. Bearing the above in mind we have included an obligation for HAL to pay up to the maximum amount of the fixed rebate (£130 million in each year, in accordance with the terms of the commercial deal including the assumptions on passenger numbers).<sup>25</sup> This hardwiring of the fixed rebate in the licence gives both regulatory and legal protection to all airlines for this element of the commercial deal.
17. We acknowledge the airlines' concerns about using the CoU to set out the relevant terms of the commercial deal. We had considered it a sensible option because it is an existing arrangement, is accessible to all airlines using the airport and is also where the airport charges are set out. However, the relevant terms of the commercial deal do not have to be set out here and we accept that HAL and the airlines should have the flexibility to agree an alternative, so long as this is accessible to all airlines using the airport. We have, therefore, revised the proposed licence condition to

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<sup>24</sup> For the current CAA Regulatory Enforcement Policy, see: [www.caa.co.uk/CAP1326](http://www.caa.co.uk/CAP1326)

<sup>25</sup> Recognising that the commercial arrangements allow for the fixed rebate to be reduced if passenger numbers were to turn out significantly lower than expected. £130 million per annum is the maximum amount of fixed rebate that will be paid to airlines in 2020 and 2021.

require HAL to set out the terms in “alternative arrangements” but have not specified what precise form these should take.

18. We do not consider that airlines’ concerns around the enforcement of their contractual rights under the commercial deal are well founded. Specifically, we consider that enforcement through the courts is a normal and valid route for commercial arrangements. We note that courts have rules on discovery of evidence which should address airlines’ concerns regarding HAL’s informational advantages. All airlines that have signed the commercial deal will have regulatory protection for the fixed rebate elements of the commercial deal and, if they choose, will have the option to seek redress through the courts. However, the approach we have taken to drafting the proposed modification to HAL’s licence would enable us, if there was evidence of inconsistent application of these terms, to investigate the position under the licence. This should provide a reasonable degree of protection for non-signatory airlines.
19. We note the airlines’ comments regarding renegotiation of the commercial deal but also note that the terms of the commercial deal itself allow for renegotiation. Renegotiation can only be carried out with the agreement of all parties so the licence drafting only replicates what the commercial deal allows but does not provide HAL with any additional leverage to force airlines to renegotiate. Rather, it preserves the flexibility for the airlines to renegotiate the commercial deal in the future, should they choose to do so. As a result, we have not made any further changes to the draft condition.

### **Way forward**

20. Having considered stakeholder comments, we propose to recognise the commercial deal in the licence, through condition C1 referring to the high-level features of the commercial deal (the fixed rebates) applicable to all airlines operating at Heathrow. The text of this condition is set out in Appendix E.
21. This approach offers protection for payment of the fixed rebates to those airlines operating at Heathrow that have not signed the commercial deal

and who otherwise would not have a direct means of enforcement, and for the overall level of fixed rebate payable. It also offers airlines a level of protection for payment of the fixed rebates, so that HAL does not discriminate between airlines that have signed the deal and those that have not signed.

22. We consider that this approach is appropriate as it offers a proportionate level of protection to airlines. It would not be appropriate to offer a greater level of regulatory intervention for the commercial arrangement compared to the formal price control, for which we set the maximum allowed revenue per passenger from airport charges.
23. The new licence condition will, therefore:
- acknowledge the existence of the commercial deal;
  - require HAL to put in place, and comply with appropriate arrangements to ensure that non-signatories will be dealt with in a non-discriminatory manner;
  - make it clear the commercial deal cannot lead to higher revenues than the Q6 price cap or absolve HAL of its obligations under the Airport Charges Regulations;
  - require HAL to pay up to a maximum of £130 million fixed rebates in respect of each of 2020 and 2021, spread across all airlines in accordance with the terms set out in the relevant arrangements; and
  - be flexible so that it does not prevent airlines and HAL renegotiating terms of the deal during 2020 and 2021, if all parties agree to do so.

## **Regulatory depreciation**

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24. The commercial deal specifies a price path and associated rebates. It states that “regulatory depreciation [is] based on the baseline capital expenditure assumptions in and underpinning CAP 1658 Appendix D Table D.4”. For the avoidance of doubt this table is reproduced in Table B.1.

Table B.1: CAA capital expenditure scenario for 2019 to 2021 (2014 prices). This is table D.4 from the April 2018 Consultation.

	2019	2020	2021
Expansion capex	167	167	485
Non-expansion	182	306	509
Maintenance	391	350	350
<b>Total</b>	<b>740</b>	<b>823</b>	<b>1,344</b>

25. The regulatory depreciation figures used in conjunction with baseline capital expenditure were not set out in the April 2018 Consultation (CAP 1658), but they were calculated in model scenarios for interim price control arrangements in the April 2018 Consultation. For clarity, we present the underlying regulatory depreciation figures below.
26. Regulatory depreciation is not used to calculate the charges for the period to 31 December 2021, but these figures will be needed to determine the opening RAB at the start of the H7 price control.

Table B.2: Regulatory depreciation underpinning CAP 1658 Table D.4

£m, 2016 prices	2020	2021
Depreciation	745	750

## Appendix C

## Other proposed updates to HAL's licence from 2020

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1. Several modifications to HAL's licence are necessary to give effect to the extension of the price control, including changing the relevant dates and allowing for the additional two years in the security factor and various tables. These changes are similar to changes we made for the earlier one-year extension to the price control (Q6+1).
2. We are also proposing to make some other changes to the licence to simplify some processes, to bring the licence up to date with current practices and to remove some obsolete terms and tables. These were summarised in the February 2019 Consultation.

### Details of the proposed updates to HAL's licence

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3. In the February 2019 Consultation we outlined further licence changes that would be required to reflect the 2020 and 2021 regulatory period, including changing dates and references to the number of years in the price control, adjusting the security S-factor "deadband" (the S-factor) and updating relevant tables in several conditions and in the Service Quality Rebates and Bonuses in the schedule to the licence ("the SQRB").
4. We also summarised certain other changes that we proposed to make to HAL's licence to address the following issues:
  - Condition C1 - changes to the way the Treasury Bill Discount Rate is published;
  - Condition D1 - simplification of the time periods in which modifications to the SQRB can be made;
  - Schedule to the licence - removing references to Terminal 1 from the SQRB; and

- Condition E1 – changes to the auditing requirements to reflect changes in auditing guidelines.
5. We also noted that a change in security requirements meant that the responsibility for hold baggage screening (“HBS”) had transferred from airlines to HAL. We said that, if this activity was going to be treated as an “other regulated charge” (“ORC”) under Condition C2, we may need to modify Condition C2 to include HBS as a specified activity.

### Stakeholder views

6. Stakeholders agreed to our proposed updates outlined above and agreed with most of our proposed changes to reflect the new 2020 and 2021 regulatory period. We are, therefore, proposing to make these modifications, as set out below.
7. Nonetheless, stakeholders provided comments on several specific issues:
- airlines challenged our proposal to uplift the S-factor by forecast inflation to £21 million for 2020 and 2021. They said that a longer control period presents more opportunity for new security initiatives to be implemented, so the deadband should be increased to reflect this. They proposed that it should be increased by £4.2 million each year so that the S-factor for the period to 31 December 2021 would be £28.4 million.
  - HAL proposed that the business rates revaluation term (“BR<sub>r</sub>”) that is currently included in its licence is no longer necessary. It suggested that the business rates revaluation took place in 2017 so less uncertainty exists around the level of business rates that HAL will pay during 2020 and 2021. HAL also said that the underlying economics of the commercial deal agreed with airlines already reflects an assumption of the business rates that Heathrow is likely to pay during 2020 and 2021.
  - Airlines and HAL had conflicting views on whether a licence modification would be required to include HBS as a specified activity in Condition C2. Airlines consider that HBS should be treated as a

change in security standards and the costs should be included under the price cap in Condition C1, thereby being subject to the S-factor. HAL said that it is only a change in responsibility and the standards are remaining the same and, therefore, the costs should be passed through directly to the airlines to retain the status quo.

### CAA views

8. The S-factor applies to up-front costs of additional security requirements and has been increased in line with inflation over successive price controls. In Q5, the S-Factor was £16.5 million and, for the additional year of Q5+1, was increased by five per cent RPI inflation to £17.3 million. It was then further increased by inflation in Q6, and again for Q6+1. Given that this is an interim price control arrangement it would appear disproportionate to trigger a review of these long standing arrangements and so we propose to take a consistent approach with that adopted at previous reviews and uplift the S-Factor by RPI (at March 2019) for 2020 and 2021 to £21 million.
9. We note that the business rate revaluation led to a reduction in costs for HAL and this should be reflected in the price control mechanism for the remainder of the Q6 price control. HAL has subsequently agreed the revaluation is not reflected in the commercial deal and the business rate factor should remain.
10. We understand that HAL and airlines are still discussing the treatment of the HBS activity and may refer the matter to the CAA for resolution. As no conclusion has been reached on this matter at present we have not proposed any modifications in relation to HBS in this statutory consultation.

### Way forward

11. We are proposing to modify Conditions A3.1(g), C1.2, C1.4, Table C1, Table C2, Table C3, Table C4, C1.11, C1.12, C1.16<sup>26</sup> (definitions), C2.5, C2.6, C4.1 and Table 9 in Schedule 1 to reflect our decision to extend the

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<sup>26</sup> Previously C.1.13 (definitions).

current price control by a further two years. These modifications will mean that the current price control will end on 31 December 2021 instead of 31 December 2019 but make no other amendment to the price control mechanism. These modifications will:

- change references to 'five Regulatory Years' to read 'seven Regulatory Years';
- change references to '2019' to read '2021';
- include additional references to 2020 and 2021; and/or
- extend Tables C3 and C4 to include the relevant formula for 2020 and 2021.

12. We are proposing to modify the S-Factor in Condition C1.4 to change all references to '£20 million' to read '£21 million'. We are proposing this modification to uplift the S-Factor by inflation for the additional two year extension. This will mean that HAL must bear the costs of changes to security standards up to a maximum of £21 million in this current price control. This modification requires additional modifications to Tables C1 and C2 to include the relevant formulae for 2020 and 2021.
13. The way the Treasury Bill Discount Rate is published has changed. This is used to calculate the specified rate in the passenger correction factor (k) in Condition C1.5. We are proposing to modify the definition of the specified rate in Condition C1.16<sup>27</sup> (Definitions) to reflect the method used up to 2017 and introduce a new definition to reflect the new method. This will ensure that the calculations can use the correct method.
14. In Condition D1 we are proposing to simplify the methodology for making "self-modifications" to the SQRB by allowing changes to be made at any time, rather than once every three months. This is because the three month restriction proved to be more restrictive and unnecessary. The self-modification mechanism still requires the agreement of HAL, the airlines

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<sup>27</sup> Previously C.1.13 (definitions).

and the CAA, but the modification allows greater flexibility to make changes when they are needed.

15. In the SQRB, we are proposing to remove references to Terminal 1 and replace Tables 1a to 1d with 'Not Used' as this terminal is now decommissioned, and these references and tables are now obsolete.

### **Audit requirements**

16. We are also proposing to modify the audit requirements for the regulatory accounts in Condition E1. The Institute of Chartered Accountants in England and Wales ("ICAEW") has issued revised guidance on the audit opinion for regulatory accounts. This means that auditors will no longer provide an opinion that the regulatory accounts fairly present the financial position and the financial performance of the Licensee.
17. In the February 2019 Consultation, we proposed replacing this requirement with new requirements to obtain a "prepared, in all material respects, in accordance with" opinion and for HAL to make reasonable endeavours to agree "Agreed-upon-Procedures" with us and its auditors, and for its auditors to report on their findings. This approach has been used in other regulated sectors, for example energy, and is designed to mitigate any loss of assurance from the change in guidance. Since the February 2019 Consultation, we have further refined the proposed modification to allow for any future changes to the ICAEW guidance, so that an audit opinion should now be worded in a form required by the relevant professional bodies and reference compliance with the licence. This will ensure that future changes to auditing guidance do not inadvertently place HAL in breach of its licence.

## Appendix D

# Efficiency condition: assessment of drafting comments

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## Introduction

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1. This appendix assesses the specific comments made by stakeholders in response to the drafting we published in the March 2019 Consultation.
2. It also sets out a revised draft of the efficiency condition, showing the changes from the draft set out in the March 2019 Consultation which we have made for this statutory consultation.

## Assessment of stakeholders' comments on Condition B3.1

3. Proposed text set out in the March 2019 Consultation:

*“B3.1 The Licensee shall conduct its business and its activities that relate to the provision of airport operation services at the Airport so as to secure the economical and efficient:*

*(a) operation and maintenance; and*

*(b) timely enhancement and development of the Airport.”*

Stakeholder comment	CAA response
<p><b>LACC:</b> the condition should make clear it only applies to goods and services provided by HAL.</p> <p><b>Virgin and IAG:</b> concerned that condition may extend scope of economic regulation.</p>	<p>As discussed in paragraph 2.30, obligations in HAL’s licence cannot apply to other parties, nor does the drafting do so. See also comments on condition B3.2 below.</p>

Stakeholder comment	CAA response
<p><b>HAL and LACC:</b> “economy and efficiency” should be defined</p> <p><b>IAG:</b> “economy and efficiency” are well understood concepts that do not require further definition, but it is not clear what the CAA means by economy and efficiency being situation specific.</p>	<p>One of our aims in drafting an efficiency condition is to ensure that the CAA’s duties in CAA12 are appropriately reflected in HAL’s licence so that the CAA has the tools to satisfy its duties. The terms “economy and efficiency” are well enough understood to inform compliance and are used, without further definition, in CAA12 and in other sectors. It is not appropriate to put a gloss on the wording of CAA12 which may lead to unforeseen consequences for the effectiveness of the condition. Indeed, the drafting of equivalent provisions in other sectors does not seek to create such definitions, and this approach does not appear to create difficulties.</p> <p>We have given further information on the manner in which we consider that this condition is likely to be applied in paragraph 2.36ff.</p>
<p><b>HAL:</b> requiring “timely” development is not appropriate as HAL’s decision making should not be unduly fettered and should allow for consideration of wider</p>	<p>We do not accept HAL’s suggestion that the concept of “timeliness” should be removed from the condition. Timeliness is not an absolute concept that requires delivery early: rather it means “coming at the right time” rather than “early” as HAL’s concern seems to suggest. As such, it allows HAL to consider precisely the issues that it considers relevant, while being more targeted at the temporal aspects of HAL’s behaviour (i.e. seeking to challenge delay) rather than a much broader concept of “appropriateness”. However, we consider that there may be merit in inserting the word “appropriate” and the dimensions of what is</p>

Stakeholder comment	CAA response
user requirements. It should be replaced by “appropriate”.	“appropriate” should be determined by the outcome of the obligations in Conditions B3.2 and B3.3 (including the demands of users, financeability, and all other relevant circumstances). See below and for further discussion of the drafting of the revised condition.
<b>LACC:</b> the word “effective” should be included in B3.1 to mitigate the risk that HAL efficiently procures something which does not deliver anything that anyone wants.	CAA12 does not refer to “effectiveness”: we do not consider that it is appropriate to put this gloss on the wording of CAA12. However, the effectiveness of HAL’s activities could be relevant to an assessment of whether HAL had acted in an economical and efficient manner, as it is unlikely that expenditure could be efficient if it did not deliver anything useful. This is backed by the reference to the needs of users: HAL may struggle to justify an approach that cannot benefit users.
<p><b>HAL:</b> the condition should be re-drafted as follows:</p> <p><i>“The Licensee shall conduct its provision of airport operation services subject to this Licence in the economical and efficient</i></p>	<p>HAL’s suggested reference to a “prudent market operator” is not needed or helpful here, as it attempts to put a gloss on the well-understood concepts of “economy” and “efficiency”. However, HAL would be free, in a particular case, to argue that an approach that mimicked such an approach was evidence that it had behaved in an economical and efficient manner.</p> <p>We do not consider that HAL’s suggested reference that it should comply with “the other requirements and terms of the Licence and the Act” is appropriate, as HAL must comply</p>

Stakeholder comment	CAA response
<p><i>manner of a prudent private market operator so as to secure the:</i></p> <p><i>(a) operation and maintenance; and</i></p> <p><i>(b) appropriate enhancement and development</i></p> <p><i>of the Airport in accordance with the other requirements and terms of the Licence and the Act. “</i></p>	<p>with these in any event. This also may undermine the overarching requirement for HAL to behave economically and efficiently, in its provision of AOS.</p>

## Assessment of stakeholders' comments on Condition B3.2

### 4. Proposed text set out in the March 2019 Consultation:

*“B3.2 In complying with Condition B3.1sh, the Licensee shall seek to secure that the reasonable demands of present and/or future users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services at the Airport are met. In so doing, the Licensee shall carry out appropriate engagement with users,*

*airlines and other stakeholders, including providing timely and accurate information to them, so that it can identify present and/or future users' reasonable demands."*

Stakeholder comment	CAA response
<p><b>HAL:</b> the reference to securing the reasonable demands of users is highly burdensome and could lead to inefficient and uneconomical behaviour. The objectively justified requirements of users should be used as the standard against which its decisions should be judged.</p> <p><b>LACC:</b> “reasonable demands” should be defined to require the CAA to use a more objective test</p>	<p>Condition B3.2 should be read in the context of condition B3.1, setting out steps that HAL should undertake as part of its compliance with condition B3.1, so these steps do not go beyond what is economical and efficient to identify the reasonable demands for AOS. This requirement is, therefore, not overly burdensome.</p> <p>In practice, the better the evidence that HAL has been able to obtain that a demand is reasonable, the greater the likelihood that it will be able to demonstrate that its own approach in response is reasonable. Even though some “demands” may be based on subjective views (for example in relation to the customer experience), redrafting the condition to move away from the language of CAA12 does not appear appropriate. Rather, HAL should be able to determine what the “reasonable demands” for AOS are from engagement (consultation) with stakeholders.</p>

Stakeholder comment	CAA response
<p><b>IAG:</b> Condition must make clear that it applies only to HAL by making clear it applies to service “<i>provided by the Licensee</i>”.</p>	<p>See paragraph 2.30. However, given airlines desire for additional clarity, we propose to adopt this change.</p>
<p><b>HAL:</b> recognises the rationale for stakeholder engagement to identify the requirements of users, but considers the draft goes too far in creating a blanket obligation: engagement should be with “users and/or providers of air transport services” to reflect the wide range of stakeholders and their circumstances.</p>	<p>We do not consider that it is appropriate to exclude all reference to “other stakeholders” since these could be transport authorities, local councils and local businesses affected by the airport’s operations to only to the extent that they are relevant to identifying reasonable demands for AOS. As such, this is not a “blanket” requirement and the wider engagement contemplated by the condition may enable HAL to point to a wider range of views in developing its plans than those of airlines.</p> <p>That said, we do not consider that consultation with parties that cannot offer insight into demand for AOS is required or beneficial, and hence we propose to change the drafting to refer to “relevant stakeholders” to address this.</p>
<p><b>HAL:</b> Financeability should be addressed directly in condition B3.2 as the reference in the CAA’s drafting for condition B3.3 (referring to</p>	<p>The obligation in CAA12 is to “have regard to” the ability of the licensee to be able to finance its activities at the airport: it is not an absolute obligation. As such, it is not appropriate for the CAA to apply a different standard than that</p>

Stakeholder comment	CAA response
<p>financeability as a matter to be taken into account, rather than a duty to be secured) is not sufficient. Ensuring financeability is essential to HAL being able to deliver for customers and the CAA should not require HAL to take actions that could reasonably adversely affect its ability to finance its activities.</p>	<p>required by its duties under CAA12. However, we propose to amend condition B3.3 to make clear that, in complying with the condition, HAL must take all relevant circumstances into account, including its ability to finance its activities (see below). Taken together, this revised wording of the licence condition, coupled with the duty that the CAA has under section 1 CAA 1 to have regard to HAL’s ability to carry out its activities (which applies equally to any investigatory or enforcement action the CAA might be minded to take), would be sufficient to protect HAL from being required to act unreasonably.</p>
<p><b>HAL:</b> the condition should be re-drafted as follows:</p> <p>“In complying with Condition B3.1, the Licensee shall:</p> <p>a) seek to take into account insofar as practicable the objectively justified requirements of present and/or future users of air transport services regarding the range, availability, continuity, cost and</p>	<p>The changes proposed by HAL generally shift away from the approach it advocates of tracking the wording of CAA12. Specifically, we do not agree with HAL’s suggestion that financeability should be a duty to be “secured” since such an approach would not be in line with the requirement in CAA12 that the ability of licensees to finance their activities be something to which the CAA must “have regard” in carrying out its functions.</p> <p>However, changes to require “consultation” rather than “engagement” and to limit this to “relevant” stakeholders (whose relevance would be determined by their ability to have input into the assessment of the reasonable demands of</p>

Stakeholder comment	CAA response
<p>quality of airport operation services at the Airport. In so doing, the Licensee shall appropriately consult with users and/or providers of air transport services; and</p> <p>b) not be required to take or omit any action that might reasonably be expected to adversely affect its ability to finance its activities under the Licence. “</p>	<p>users expressed in the purpose of the consultation required) would appear appropriate.</p>

### Assessment of stakeholders' comments on Condition B3.3

5. Proposed text set out in the March 2019 Consultation:

*“B.3.3 The Licensee shall fulfil its obligations under this condition to the greatest extent reasonably practicable, taking into account all relevant circumstances, including the need for it to finance its provision of airport operation services at the Airport.”*

Stakeholder comment	CAA response
<p><b>HAL:</b> The obligation requiring HAL to fulfil its obligations “to the greatest extent reasonably practicable” is too high and creates risk.</p>	<p>We propose revised drafting for Condition B3.3 to remove this wording to simplify the condition and avoid any possible mismatch between the obligations in conditions B3.1 and B3.3. The CAA’s aim is to hold HAL to a high, but achievable standard, which reflects HAL’s substantial market power and the CAA’s duties and consider that Condition B3.1 achieves this. The CAA has drafted specific references in the condition to reasonable demands for AOS and financeability to make clear that there are a range of factors that HAL will need to consider in complying with the condition. Requiring HAL to have regard to all relevant circumstances makes it clear that there will inevitably be trade-offs in the decisions it takes.</p>
<p><b>HAL:</b> The condition should set parameters of what “all relevant circumstances” should be that HAL should take account of in fulfilling its obligations under the condition</p>	<p>What will constitute “all <i>relevant</i> circumstances” could vary significantly depending on what issue was under consideration in the context of the licence condition. As such, it is not appropriate for CAA to seek to set out what these might be in advance, not least as such an approach might include or exclude a factor that might be relevant in a particular case. However, we propose redrafting the condition to clarify and simplify it.</p>

Stakeholder comment	CAA response
<p><b>HAL:</b> the condition should be re-drafted as follows:</p> <p><i>“In evaluating the objectively justified requirements of present and/or future users, the Licensee shall be entitled to take into account all available evidence and, where there are competing requirements, be entitled to assess the strength of such evidence as is provided to it (including, among other factors, the materiality of the costs at issue).”</i></p>	<p>We do not consider that it is appropriate to set out how HAL should assess any trade-offs it makes, but, as discussed above, propose redrafting the condition to clarify and simplify it.</p>

## Revised draft of the efficiency condition, showing the changes from the draft set out in the March 2019 Consultation

Changes to the draft set out in the March 2019 Consultation	Rationale for change
<p>B3.1 The Licensee shall conduct its business and its activities that relate to the provision of airport operation services at the Airport so as to secure the economical and efficient:</p> <p>(a) operation and maintenance; and</p> <p>(b) timely <u>and appropriate</u> enhancement and development of the Airport.</p>	<p>As noted above there are advantages in retaining “timely” in the licence drafting but also adding “appropriate”.</p>
<p>B3.2 In complying with Condition B3.1, the Licensee shall seek to secure that the reasonable demands of <u>present and/or future</u> users of air transport services regarding the</p>	<p>The words “provided by the licensee” suggested by IAG have been included further to clarify that the condition applies to HAL and not airlines.</p>

Changes to the draft set out in the March 2019 Consultation	Rationale for change
<p>range, availability, continuity, cost and quality of airport operation services <a href="#">provided by the Licensee</a> at the Airport are met. In so doing, the Licensee shall carry out appropriate <del>engagement</del> <a href="#">consultation</a> with users, airlines and other <a href="#">relevant</a> stakeholders, including providing timely and accurate information to them, <del>so that it can</del> <a href="#">so that they can assist the Licensee to</a> identify <a href="#">reasonable demands for airport operation services.</a> <del>reasonable demands.</del>”</p>	<p>The word “consultation” suggested by HAL in place of “engagement”. We consider that this is preferable as it implies a two-way process with stakeholders.</p> <p>Change to qualify consultation to be with “relevant” stakeholders acknowledges HAL’s position that blanket engagement with stakeholders is not be appropriate. It gives HAL the opportunity to target consultation to those stakeholders whose views might be relevant to identifying reasonable demands for AOS.</p> <p>Simplification of the drafting of the purpose of consultation tracks the wording of CAA12 more closely and helps to make clear both what the purpose of the consultation should be and, by implication, help HAL to identify the scope of “relevant stakeholders”.</p> <p>The reference to “present and/or future users” has been simplified as the CAA12 definition of “users” includes both present and future users and is incorporated into HAL’s licence by Condition A2.2.</p>

Changes to the draft set out in the March 2019 Consultation	Rationale for change
<p>B.3.3 <del>In complying with its</del> <del>The Licensee shall fulfil its</del> obligations under this condition, <del>the Licensee shall to the greatest extent reasonably practicable,</del> <del>take</del><u>ing</u> into account all relevant circumstances, including the need for it to finance its provision of airport operation services at the Airport.</p>	<p>The requirement to comply with the obligation in B3.1 “to the greatest extent practicable” has been deleted to</p> <ul style="list-style-type: none"> <li>(i) avoid a possible mismatch in the intensity of the obligations in this condition (i.e. “the licensee shall...” in B3.1 and “the licensee shall ... to the greatest extent practicable...” in B3.3); and</li> <li>(ii) clarify that HAL is <i>required</i> to take into account matters relating to its ability to finance its provision of AOS in complying with the condition.</li> </ul> <p>This change ensures the importance of financeability is made clear on the face of the licence, yet preserves the relative importance of other relevant factors (i.e. including the demands of users). As discussed in relation to Condition B3.2 above, we do not consider it appropriate to make financeability an absolute duty. However, it would be open to HAL to argue in a particular case, for example, that a particular user demand was not reasonable, because it was not financeable.</p>

## Appendix E

## Proposed licence modifications

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Our proposed licence modifications are set out below with the proposed changes marked against the current provisions of HAL's licence. Where a condition, or part of a condition, is not set out below, no modifications to it are proposed.

### Proposed modification to Part A3 Definitions:

Condition A3.1(g) shall be modified as follows:

A3.1 In this Licence:

- (g) the Regulatory Year means for each of the ~~five~~ seven years from 2015 to ~~2019~~2021, the twelve month period beginning on 1 January and ending on 31 December. These years shall also be considered to be the Licensee's financial year for the purposes of this Licence.

### Proposed modification to Part B: General Conditions

A new condition shall be inserted after condition B2 as follows:

#### B3 Promoting economy and efficiency

B3.1 The Licensee shall conduct its business and its activities that relate to the provision of airport operation services at the Airport so as to secure the economical and efficient:

- (a) operation and maintenance; and
- (a) timely and appropriate enhancement and development of the Airport.

B3.2 In complying with Condition B3.1, the Licensee shall seek to secure that the reasonable demands of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services provided by the Licensee at the Airport are met. In so doing, the Licensee shall carry out appropriate consultation with users, airlines and other relevant stakeholders, including providing timely and accurate information to them, so that they can assist the Licensee to identify reasonable demands for airport operation services.

B.3.3 In complying with its obligations under this condition, the Licensee shall take into account all relevant circumstances, including the need for it to finance its provision of airport operation services at the Airport.

### **Proposed modifications to Part C: The price control conditions**

Condition C1 shall be modified as follows:

#### **C1 Price Control**

C1.2 On each occasion on which the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in each of the five~~seven~~ subsequent relevant Regulatory Years starting on 1 January 2015 and ending on 31 December ~~2019~~2021, the Licensee shall fix those charges at the levels best calculated to secure that, in each relevant Regulatory Year, total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the amount set in accordance with the formula below:

$$M_t = (1 + RPI_{t-1} + X + B_{t-2})Y_{t-1} + \frac{D_t}{Q_t} - \frac{T_t}{Q_t} + \frac{A_t}{Q_t} + \frac{BR_t}{Q_t} - K_t$$

Where:

- $M_t$  is the maximum revenue yield per passenger using the Airport in Regulatory Year  $t$  expressed in pounds, where;
- $RPI_{t-1}$  is the percentage change (positive or negative) in the Office for National Statistics (ONS) CHAW Retail Price Index between April in year  $t-1$  and the immediately preceding April;
- $X = -1.5\%$ ;
- $B_{t-2}$  is the bonus factor in Regulatory Year  $t$ , based on the Licensee's performance in  $t-2$ , as defined in condition C1.8;
- $Y_{t-1}$  is the revenue yield per passenger in Regulatory Period or Regulatory Year  $t-1$  defined in condition C1.3;
- $D_t$  is the cumulative development capex adjustment in Regulatory Year  $t$  defined in condition C1.9;
- $T_t$  is the capital 'trigger' factor in Regulatory Year  $t$  defined in condition C1.7;
- $Q_t$  is passengers using the Airport in Regulatory Year  $t$ ;
- $A_t$  is the cost pass-through for runway expansion in Regulatory Year  $t$  defined in condition C1.12;

- $BR_t$  is the business rate revaluation factor in Regulatory Year  $t$  defined in condition C1.11; and
- $K_t$  is the per passenger correction factor in Regulatory Year  $t$  defined in condition C1.5.

$Y_{t-1}$ : average revenue yield per passenger

C1.3  $Y_{t-1}$  is the average revenue yield per passenger in Regulatory Period or Regulatory Year  $t-1$  calculated in accordance with the following formula:

$$Y_{t-1} = Y_{t-2}(1 + RPI_{t-2} + X) + S_{t-1}$$

Where:

- $Y_{2014} = £22.261 + S_{2014}$
- $RPI_{t-2}$  is the percentage change (positive or negative) in the Retail Price Index between that published with respect to April in Regulatory Period or Regulatory Year  $t-2$  and that published with respect to the immediately preceding April;
- $X = -1.5\%$
- $S_{t-1}$  is the allowable security cost per passenger defined in condition C1.4.

$S_{t-1}$ : allowable security cost per passenger

C1.4  $S_{t-1}$  is the allowable security cost per passenger in Regulatory Period or Regulatory Year  $t-1$  arising as a result of changes to security standards. Additional costs from changes in security standards are considered as positive values. Reductions in cost from changes in security standards are considered as negative values. This mechanism only applies when the expected cumulative cost associated with changes to security standards are:

- (a) above a cumulative ~~£2021,000,000~~ "deadband" figure; or
- (b) below a cumulative - ~~£2021,000,000~~ "deadband" figure

$S_{t-1}$  is calculated in accordance with the following formulae expressed in pounds:

For each relevant Regulatory Period or Regulatory Year  $t-1$ , in the case that EC is a positive value, with reference to the absolute value of EC:

If:  $|EC_{t-1}| > \del{£2021,000,000}; and$

$|EC_{t-2}| > \del{£2021,000,000}$

Then:  $S_{t-1} = 0.9C_{t-1}$

Or if:  $|EC_{t-1}| > \text{£}2021,000,000$ ; and

$|EC_{t-2}| < \text{£}2021,000,000$

Then:  $S_{t-1} = 0.9 \frac{(EC_{t-1} - \text{£}201,000,000)}{(t^*)Q_{t-1}}$

Or if:  $|EC_{t-1}| < \text{£}2021,000,000$ ; and

$|EC_{t-2}| > \text{£}2021,000,000$

Then:  $S_{t-1} = -0.9 \frac{(EC_{t-2} - \text{£}201,000,000)}{(t^*)Q_{t-1}}$

Otherwise:  $S_{t-1} = 0$

For each relevant Regulatory Period or Regulatory Year t-1, if EC is a negative number, with reference to the absolute value of EC:

If:  $|EC_{t-1}| > \text{£}2021,000,000$ ; and

$|EC_{t-2}| > \text{£}2021,000,000$

Then:  $S_{t-1} = 0.9C_{t-1}$

Or if:  $|EC_{t-1}| > \text{£}2021,000,000$ ; and

$|EC_{t-2}| < \text{£}2021,000,000$

Then:  $S_{t-1} = 0.9 \frac{(EC_{t-1} + \text{£}201,000,000)}{(t^*)Q_{t-1}}$

Or if:  $|EC_{t-1}| < \text{£}2021,000,000$ ; and

$|EC_{t-2}| > \text{£}2021,000,000$

Then:  $S_{t-1} = -0.9 \frac{(EC_{t-2} + \text{£}201,000,000)}{(t^*)Q_{t-1}}$

Otherwise:  $S_{t-1} = 0$

Where:

- $Q_{t-1}$  is passengers using the Airport in Regulatory Period or Regulatory Year t-1.
- $t^*$  is a time variable, which is defined for each Regulatory Period or Regulatory Year in table C.1 below:

**Table C.1: Time variable**

Period t =	$t^*$ =
9mo. 2014	<del>69</del> 93/9
2015	<del>5</del> 7
2016	<del>4</del> 6
2017	<del>3</del> 5
2018	<del>2</del> 4
<u>2019</u>	<u>3</u>
<u>2020</u>	<u>2</u>

- $C_{t-1}$  is the total allowable security claim per passenger using the Airport in Regulatory Period or Regulatory Year t-1 (whether of a positive or negative value) expressed in pounds relative to security costs per passenger in the previous period;
- $EC_t$  is the expected cumulative security claim over the relevant Regulatory Period and ~~five~~ seven Regulatory Years starting on 1 April 2014, in period t, which shall be calculated in accordance with table C.2 below:

**Table C.2: Calculation of annualised allowable security costs**

Period t =	2013	9mo. 2014	2015	2016	2017	2018	2019	2020
Changes in 2014	0	<del>7.66</del> 10.33 * C <sub>2014</sub> * Q <sub>2014</sub>	10.33 * C <sub>2014</sub> * Q <sub>2014</sub>	10.33 * C <sub>2014</sub> * Q <sub>2014</sub>				
Changes in 2015	0	0	<del>57</del> * C <sub>2015</sub> * Q <sub>2015</sub>	7 * C <sub>2015</sub> * Q <sub>2015</sub>	7 * C <sub>2015</sub> * Q <sub>2015</sub>			
Changes in 2016	0	0	0	<del>46</del> * C <sub>2016</sub> * Q <sub>2016</sub>	<del>46</del> * C <sub>2016</sub> * Q <sub>2016</sub>	<del>46</del> * C <sub>2016</sub> * Q <sub>2016</sub>	6 * C <sub>2016</sub> * Q <sub>2016</sub>	6 * C <sub>2016</sub> * Q <sub>2016</sub>
Changes in 2017	0	0	0	0	<del>35</del> * C <sub>2017</sub> * Q <sub>2017</sub>	<del>35</del> * C <sub>2017</sub> * Q <sub>2017</sub>	5 * C <sub>2017</sub> * Q <sub>2017</sub>	5 * C <sub>2017</sub> * Q <sub>2017</sub>
Changes in 2018	0	0	0	0	0	<del>24</del> * C <sub>2018</sub> * Q <sub>2018</sub>	4 * C <sub>2018</sub> * Q <sub>2018</sub>	4 * C <sub>2018</sub> * Q <sub>2018</sub>
<u>Changes in 2019</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	3 * C <sub>2019</sub> * Q <sub>2019</sub>	3 * C <sub>2019</sub> * Q <sub>2019</sub>
<u>Changes in 2020</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	2 * C <sub>2020</sub> * Q <sub>2020</sub>
EC <sub>t</sub> =	Sum rows	Sum rows	Sum rows	Sum rows	Sum rows	Sum rows	Sum rows	Sum rows

Where:

- $C_t$  is the total allowable security claim per passenger using the Airport in Regulatory Period or Regulatory Year  $t$  (whether of a positive or negative value) expressed in pounds, relative to security costs per passenger in the previous period; and
- $Q_t$  is the actual number of passengers using the Airport in Regulatory Period or Regulatory Year  $t$ .

$K_t$ : per passenger correction factor

C1.5  $K_t$  is the per passenger correction factor (whether positive or negative value) to be made in Regulatory Period or Regulatory Year  $t$ , which is calculated as follows:

Where:  $t = 2015$  or  $2016$

$$K_t = \frac{R_{t-2} - (Q_{t-2}M_{t-2})}{Q_t} \left(1 + \frac{I_{t-2}}{100}\right)^{21/12}$$

Where:  $t \neq 2015$  or  $2016$

$$K_t = \frac{R_{t-2} - (Q_{t-2}M_{t-2})}{Q_t} \left(1 + \frac{I_{t-2}}{100}\right)^2$$

Where:

- $R_{t-2}$  is total revenue from airport charges in respect of relevant air transport services levied at the Airport in Regulatory Period or Regulatory Year  $t-2$  expressed in pounds;
- $Q_t$  is passengers using the Airport in Regulatory Period or Regulatory Year  $t$ ;
- $M_{t-2}$  is the maximum revenue yield per passenger using the Airport in Regulatory Period or Regulatory Year  $t-2$ ;
- $I_{t-2}$  is the appropriate interest rate for Regulatory Period or Regulatory Year  $t-2$ , which is equal to:
  - the specified rate plus 3% where  $K_t$  is positive; or
  - the specified rate where  $K_t$  is negative. In both cases  $K_t$  takes no account of  $I_t$  for this purpose.

- C1.6 In relation to the Regulatory Period and the Regulatory Year 2015, the values of  $R_{t-2}$ ,  $Q_{t-2}$ ,  $M_{t-2}$  and  $I_{t-2}$  shall be calculated by reference to the conditions as to airport charges imposed in relation to the Airport under the Airports Act 1986 in force at 31 March 2014. In the case of the Regulatory Period,  $t-2$  refers to the 12-month period from 1 April 2012 to 31 March 2013.

$T_t$ : trigger factor

- C1.7  $T_t$  is the trigger factor, which is a reduction in the maximum revenue yield per passenger occurring when the Licensee has not achieved specific capital investment milestones associated with relevant projects. The factor shall be calculated as follows:

$$T_t = \sum_i TM_{it} TF_{it}$$

Where:

For any specific trigger  $i$ , in Regulatory Period or Regulatory Year  $t$ :

- $TF_{it}$  is the number of months between the milestone month and the earlier of; the project completion date or the end of Regulatory Period or Regulatory Year  $t$ , up to a maximum of 12. In 2014  $TF_{it}$  is restricted to a maximum of 9.
- $TM_{it}$  is the trigger payment associated with each trigger in Regulatory Period or Regulatory Year  $t$ ;

Where :  $TM_{it} = MTP_i \frac{P_{t-1}}{222.80}$

- $MTP_i$  is the monthly trigger payment which is defined for each relevant project; and
- $P_{t-1}$  is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year  $t-1$ ;
- The triggers, milestone month and monthly trigger payments are defined in the Q6 Capital Investment Triggers Handbook and may be modified in accordance with the modification processes set out in that handbook.

$B_{t-2}$ : bonus factor

- C1.8  $B_{t-2}$  is the bonus factor based on performance achieved in respect of specified elements  $k$  of the Licensee's service quality rebates and bonuses scheme (SQRB) as defined in Condition D1. The bonus factor shall be calculated in accordance with Schedule 1 of this Licence.

*D<sub>t</sub>: cumulative development capex adjustment*

- C1.9  $D_t$  is the cumulative development capex adjustment, which adjusts the maximum revenue yield per passenger in Regulatory Period or Regulatory Year  $t$  to account for cumulative changes in the revenue requirement associated with development capex projects.  $D_t$  shall be calculated in accordance with table C.3 below.

**Table C.3: Development capex adjustment**

Additional revenue requirement for projects in	Year t =							
	9mo. 2014	2015	2016	2017	2018	2019	<u>2020</u>	<u>2021</u>
2014	$0.5 \times d_{2014}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-5}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-6}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-7}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-8}} \times d_{2014}$
2015	0	$0.5 \times d_{2015}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-5}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-6}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-7}} \times d_{2015}$
2016	0	0	$0.5 \times d_{2016}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2016}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2016}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2016}$	$\frac{P_{t-1}}{P_{t-5}} \times d_{2016}$	$\frac{P_{t-1}}{P_{t-6}} \times d_{2016}$
2017	0	0	0	$0.5 \times d_{2017}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2017}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2017}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2017}$	$\frac{P_{t-1}}{P_{t-5}} \times d_{2017}$
2018	0	0	0	0	$0.5 \times d_{2018}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2018}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2018}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2018}$
2019	0	0	0	0	0	$0.5 \times d_{2019}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2019}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2019}$
<u>2020</u>	0	0	0	0	0	0	$0.5 \times d_{2020}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2020}$
<u>2021</u>	0	0	0	0	0	0	0	$0.5 \times d_{2021}$
	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$

Where:

- W is the Weighted Average Cost of Capital which shall have a value of 5.35%;
- $d_t$  is the annual development capex adjustment in Regulatory Period or Regulatory Year t defined in condition C1.10; and
- $P_{t-1}$  is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year t-1.

$d_t$ : annual development capex adjustment

C1.10 The annual development capex adjustment in Regulatory Period or Regulatory Year t is an amount equal to the net difference between the development capex allowance included in the Q6 settlement and the total capex associated with new core capex projects in Regulatory Period or Regulatory Year t, to be calculated as follows:

$$d_t = O_t - \left( V_t * \frac{P_{t-1}}{222.80} \right)$$

Where:

- $O_t$  is the total capex in Regulatory Period or Regulatory Year t associated with all development capex projects that have transitioned to core capex project status after the Q6 settlement either during or before Regulatory Period or Regulatory Year t, which includes the capital spend incurred during the development stages of projects, irrespective of whether projects have transitioned from development to core as determined through the governance arrangements.
- $V_t$  is the development capex allowance in Regulatory Period or Regulatory Year t; and
- $P_{t-1}$  is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year t-1.

$BR_t$ : business rate revaluation factor

C1.11  $BR_t$  is the business rate revaluation factor in Regulatory Period or Regulatory Year t, calculated in accordance with the following formulae.

If:  $t = 2018$ ;

Then:  $BR_t = 0.8[(Z_{2017}) * (1 + RPI_{t-1}) + Z_{2018}]$

If:  $t = 2019$ ;

*Then:*  $BR_t = 0.8 * Z_{2019}$

*If:*  $t = 2020;$

*Then:*  $BR_t = 0.8 * Z_{2020}$

*If:*  $t = 2021;$

*Then:*  $BR_t = 0.8 * Z_{2021}$

*If:*

*Otherwise:*  $BR_t = 0$

*Where:*

- $RPI_{t-1}$  is the percentage change (positive or negative) in the ONS CHAW Retail Price Index between April in Regulatory Period or Regulatory Year t-1 and the immediately preceding April.
- $Z_t$  is the business rate forecast variance in Regulatory Period or Regulatory Year t, calculated in accordance with table C.4 below:

**Table C.4: Business rate forecast variance**

Period t =	$Z_t =$
9mo. 2014	0
2015	0
2016	0
2017	$(U_t - £136,900,000) * \frac{P_{t-1}}{222.80}$
2018	$(U_t - £136,800,000) * \frac{P_{t-1}}{222.80}$
2019	$(U_t - £136,800,000) * \frac{P_{t-1}}{222.80}$
<u>2020</u>	$(U_t - £136,800,000) * \frac{P_{t-1}}{222.80}$
<u>2021</u>	$(U_t - £136,800,000) * \frac{P_{t-1}}{222.80}$

*Where:*

- $U_t$  is the regulatory allowance for business rates (that is £136,900,000 in 2017, £136,800,000 in 2018 to 2021 and ~~£136,800,000 in 2019~~) multiplied by the revaluation impact.

- $P_{t-1}$  is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year  $t-1$ .

$A_t$ : *pass-through of Category B costs (planning costs) for runway expansion*

C1.12  $A_t$  is the cost pass-through adjustment of up to £10 million in each Regulatory Year to allow for the recovery of the reasonable costs (capital, operating and financing) of applying for planning permission for a third runway and associated infrastructure (Category B costs) since the Government announcement of its decision on 25 October 2016 to support the development of a third runway at the Airport. These Category B costs must, in the CAA's view, have been efficiently incurred. This adjustment shall have regard to any policy guidance that may be issued by the CAA, following consultation, in relation to the recovery of these Category B costs.

If:  $t = 2016, 2017, 2018, \text{ or } 2019, \text{ 2020 or 2021}$

Then:  $A_t = \text{eligible and efficient Category B costs up to } \pounds 10,000,000$

Otherwise:  $A_t = 0$

### Commercial arrangements for the 2020 and 2021 price control extension

C1.13 Nothing in this Part C shall prevent the Licensee from entering into any commercial agreement.

C1.14 Where the Licensee enters into any commercial agreement, the Licensee shall:

- provide for, and comply with, alternative arrangements to ensure that, in relation to the definition and payment of fixed rebates, the Licensee does not unduly discriminate between airlines that are party to any such commercial agreement and airlines that are not party to a commercial agreement and shall make such arrangements available to all airlines using the Airport;
- save to the extent that any commercial agreements entered into prior to 1 January 2020 have been varied by agreement between the Licensee and airlines, and such variations have been provided for in the alternative arrangements required by condition C1.14(a), pay any fixed rebate in accordance with the terms of the commercial agreements and those alternative arrangements of up to a total of £130 million in respect of each of 2020 and 2021.

C1.15 The Licensee's ability to enter into agreements or other arrangements in relation to any aspect of airport charges described in Condition C1.13 and

[the obligations of the Licensee set out in condition C1.14 are without prejudice to Licensee's obligations under conditions C.1.1 and C1.2, and the Airport Charges Regulations 2011 \(2011 No.2491\).](#)

## Definitions<sup>28</sup>

C.1.136 In this Condition C.1:

- (a) **allowable security claim per passenger** means the annual equivalent of the increase or decrease in security costs at the Airport in the relevant Regulatory Period or Regulatory Year which arise as a result of a change in required security standards at the Airport, as certified by the CAA, divided by the number of passengers using the Airport in that Regulatory Period or Regulatory Year;
- (b) **average revenue yield per passenger** means the revenue from airport charges levied in respect of relevant air transport services in the relevant Regulatory Period or Regulatory Year, before any deduction of rebates under the Service Quality Rebates and Bonuses Scheme, divided by the total number of passengers using the Airport in the relevant Regulatory Period or Regulatory Year;
- (c) **business rate cost** is the tax paid by the Licensee associated with the Airport's land and property assets, as determined by the Valuation Office Agency;
- (d) [commercial agreement](#) means [any agreements or other arrangements \(as varied from time to time\) entered into between the Licensee and airlines in relation to any aspect of the airport charges that the Licensee levies in respect of relevant air transport services for 2020 and 2021, including \(but not limited to\) the payment of rebates to airlines in respect of those charges;](#)
- (e) **core capex project** is any project that has passed Gateway 3, being taken forward for implementation in accordance with the governance arrangements;
- (f) **development capex allowance** is a capex allowance included in the Q6 RAB based on the sum of development capex project P80 cost estimates as set out in the governance arrangements;
- (g) **development capex project** is any project under development that has not passed Gateway 3 in accordance with the governance arrangements, but for which an allowance has been included in the

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<sup>28</sup> The individual definitions have been renumbered from (d) onwards to account for new items being included under C1.16.

development capex allowance;

- (h) [fixed rebate shall bear the same meaning it has in any commercial agreement entered into by the Licensee;](#)
- (i) **Gateway 3** has the meaning set out in the governance arrangements;
- (j) **the governance arrangements** means the arrangements set out in the Q6 Capital Efficiency Handbook published by the Licensee by 1 October 2014 as agreed by the CAA, [and updated in April 2015;](#)
- (k) **passenger using the Airport** means a terminal passenger joining or leaving an aircraft at the Airport. A passenger who changes from one aircraft to another, carrying the same flight number is treated as a terminal passenger, as is an interlining passenger;
- (l) **project completion date** is the date when in the judgement of the CAA the Licensee has achieved the trigger criteria as defined for each project through the governance arrangements;
- (m) **the Q6 Capital Investment Triggers Handbook** means the handbook in existence when this Licence comes into force, having been agreed by the Licensee and the airlines. This handbook contains details of the triggers, milestone months and monthly trigger payments for core capex projects and details of how future changes to those elements can be made with the agreement of the Licensee and the airlines;
- (n) **relevant air transport services** means air transport services carrying passengers that join or leave an aircraft at the Airport, including air transport services operated for the purpose of business or general aviation;
- (o) **reevaluation impact is equal to one plus the difference between the actual increase in rateable value** measured as a percentage change and +9%, (being the percentage increase assumed in the regulatory allowance) occurring as a result of the rate revaluation undertaken by the Valuation Office Agency in 2017. The actual change will be calculated by multiplying the actual percentage increase in the Cumulo Rateable Value due to the revaluation and the actual percentage increase in the national Uniform Business Rate.
- (p) **specified rate** [\(from 2014 to 2017\)](#) means the average of the Treasury Bill Discount Rate (expressed as an annual percentage interest rate) published weekly by the Bank of England, during the 12 months from the beginning of May in Regulatory Period or Regulatory Year t-2 to the end of April in Regulatory Period or

Regulatory Year t-1.

- (q) [specified rate \(from 2018 to 2021\) means the average of the three month Treasury Bill Discount Rate \(expressed as an annual percentage interest rate\) published by the UK Debt Management Office \(https://www.dmo.gov.uk/data/treasury-bills/tender-results/\), during the 12 months from the beginning of May in Regulatory Year t-2 to the end of April in Regulatory Year t-1.](https://www.dmo.gov.uk/data/treasury-bills/tender-results/)

Condition C2 shall be modified as follows:

### **C2 Charges for other services**

- C2.1 By 30 September 2014 and by 30 September in each subsequent year the Licensee shall inform the CAA of the system used by it to allocate costs to the Specified Facilities. The Licensee shall make any amendments to its cost allocation system if so requested by CAA by 31 December prior to each charging year commencing on 1 January.
- C2.2 By 30 September 2014 and by 30 September in each subsequent year the Licensee shall provide to the CAA statements of actual costs and revenues in respect of each of the Specified Facilities for the year ending the previous 31 December.
- C2.3 By 31 December each year, the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives prior to implementing any price changes a statement of the pricing principles for each item charged including the assumptions and relevant cost information adequate to verify that the charges derive from the application of the pricing principles.
- C2.4 Where charges for the Specified Facilities are not established in relation to cost the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives a statement of the principles on the basis of which the charges have been set with full background information as to the calculation of such charges including statements of any comparables used.
- C2.5 Where in respect of any relevant Regulatory Period or Regulatory Year (apart from the 2019, 2020 and 2021 Regulatory Years) actual revenue for any of the Specified Facilities differs from that forecast for the purposes of the price control review for the period 1 April 2014 to 31 December 2018 (as specified by the CAA), the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences.

C2.6 Where in respect of the 2019, [2020 and 2021](#) Regulatory Years actual revenue from any of the Specified Facilities differs from actual revenue in the [2018 preceding](#) Regulatory Year, the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences.

### Definitions

C2.7 In this Condition C2 the Specified Facilities are:

- (a) check-in desks;
- (b) baggage systems;
- (c) services for PRMs;
- (d) staff car parking;
- (e) staff ID cards;
- (f) fixed electrical ground power;
- (g) pre-conditioned air;
- (h) airside licences;
- (i) waste, recycling and refuse collection;
- (j) taxi feeder park;
- (k) heating and utility services (including electricity, gas, water and sewerage);
- (l) facilities for bus and coach operators;
- (m) common IT infrastructure; and
- (n) HAL contribution to the funding of the AOC.

Condition C4 shall be modified as follows:

### C4 Charges for cargo only operators

C4.1 In the Regulatory Period and the subsequent [five seven](#) Regulatory Years, the Licensee shall not levy airport charges in respect of air services that do not fall within the definition of passenger air services that are higher than are levied in respect of equivalent air services falling within that definition.

### Definitions

- C4.2 In this Condition C4 passenger air services means air services carrying passengers that join or leave an aircraft at the Airport, including air services operated for the purpose of business or general aviation.

### **Proposed modifications to Part D: Service quality conditions**

Condition D1 shall be modified as follows:

#### **D1 Service quality standards, rebates, bonuses and publication**

- D1.6 The CAA may by notice modify the Statement with immediate effect where there is written agreement between:
- (a) the Licensee; and
  - (b) the AOC.
- D1.7 Where the Licensee and the AOC cannot reach agreement, either party may request that the CAA determines the modification.
- D1.8 Where a request has been made under Condition D1.7, the CAA may by notice determine the modifications, following a reasonable period of consultation.
- D1.9 The modifications that can be made under Conditions D1.6 and D1.8 are any modifications to Schedule 1 except:
- (a) any modifications to the elements listed in the 'Element' columns of Table 1a to Table 6 and Table 10a to Table 10e;
  - (b) any modifications to the table of bonuses (Table 8) and to the calculation of the bonus factor set out in the Statement; and
  - (c) any modifications to Table 9.
- D1.10 Modifications can be made to the Statement under Conditions D1.6 and D1.8 ~~no more frequently than one group of changes in each three month period~~ at any time.

### **Proposed modifications to Part E: Financial conditions**

Condition D1 shall be modified as follows:

#### **E1 Regulatory accounting requirements**

- E1.1 This Condition applies for the purpose of making available, in a form and to a standard reasonably satisfactory to the CAA, such audited regulatory

accounting information as will, in furtherance of the requirements of this Licence:

- (a) enable the CAA, airlines and users of air transport services to assess on a consistent basis the financial position of the Licensee and the financial performance of provision of airport operation services and associated services provided in connection with the Airport;
  - (a) assist the CAA, airlines and users of air transport services to assess performance against the assumptions underlying the price control conditions in Conditions C1 and C2 of this Licence; and
  - (b) inform future price control reviews.
- E1.2 The Licensee shall keep and, so far as it is able, procure that any related undertaking keeps the accounting records required by the Companies Act 2006 to keep in such form as is necessary to enable the Licensee to comply with this Condition and the Regulatory Accounting Guidelines.
- E1.3 The Licensee shall prepare on a consistent basis from the accounting records referred to in Condition E1.2, in respect of the Regulatory Period and each subsequent Regulatory Year, regulatory accounts in conformity with the Regulatory Accounting Guidelines for the time being in force in accordance with this Condition.
- E1.4 The Regulatory Accounting Guidelines prepared pursuant to Condition E1.3 shall, without limitation:
- (a) provide that, except so far as the CAA reasonably considers otherwise, the regulatory accounts shall be prepared in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU from time to time; and
  - (b) state the accounting policies to be adopted.
- E1.5 The Licensee shall:
- (a) procure, in respect of the regulatory accounts prepared in accordance with Condition E1.3 in respect of a Regulatory Period or Regulatory Year, a report by the Auditors addressed to the CAA which provides their opinion on those accounts. The opinion should be worded in the form required by those professional bodies accountable for prescribing the form of audit reports on regulatory accounts and should refer to compliance with the Condition and the Regulatory Accounting Guidelines; stating whether in their opinion those accounts including accompanying commentary on performance have been properly prepared in accordance with this Condition and the Regulatory Accounting Guidelines and on that basis fairly present the

~~financial position and the financial performance of the Licensee;~~

- (b) deliver to the CAA the Auditors' report referred to in sub-paragraph a) and the regulatory accounts referred to in Condition E1.3 as soon as reasonably practicable, and in any event not later than six months after the end of the Regulatory Period or Regulatory Year to which they relate; and
- (c) arrange for copies of the regulatory accounts and Auditors' report referred to in Conditions E1.5 a) and b), respectively, to be made publicly available and, so far as reasonably practicable, to do so when the annual statutory accounts of the Licensee are made available.

#### E1.6 The Licensee shall also:

- (a) make reasonable endeavours to secure agreement between itself, the CAA and the Auditors on Agreed Upon Procedures which are designed to provide the CAA with factual findings, where, from time to time, the CAA reasonably considers such procedures are relevant to the fulfilment of its duties and proportionate to any concerns of the CAA in respect of its fulfilment of those duties
- (b) procure, as required from time to time by the CAA, in respect of the regulatory accounts prepared in accordance with Condition E1.3, a report by the Auditors addressed to the CAA which states that they have carried out Agreed Upon Procedures and which sets out their findings.

#### **Definitions**

**E1.7** In this Condition E1 Regulatory Accounting Guidelines means the guidelines, published from time to time by the CAA so as to fulfil the purpose set out in Condition E1.1, which govern the format and content of such regulatory accounts and the basis on which they are to be prepared.

**E1.8** In this Condition E1 Agreed Upon Procedures means procedures which are from time to time agreed between the CAA, the Auditors and the Licensee and which the Auditors carry out and report on factual findings.

## Proposed modifications to Schedule 1

### Statement of Standards, Rebates and Bonuses

Schedule 1 shall be modified as follows:

#### 2. Components of the service quality rebates and bonuses (SQRB) scheme

- 2.1 The SQRB scheme consists of elements, standards, bonuses, rebates and publication requirements as set out in Table 1a to Table 10e of this Schedule. In these tables and in this Schedule:
- (a) Group defines the group in which the related elements belong to;
  - (b) Element identifies the relevant element  $i$  of service;
  - (c) Metric defines the basis of measurement for each relevant element  $i$ ;
  - (d)  $\text{Standard}_{i,j,a}$  defines the relevant standard of element  $i$  in month  $j$  in terminal  $a$ ;
  - (e)  $\text{ANNMAX}_i$  is the maximum percentage of Airport Charges (relating to air transport services for the carriage of passengers for the relevant terminal) payable by the Licensee as rebates for any service failure in element  $i$  in the relevant Regulatory Period or Regulatory Year as specified in Table 1a to Table 6 of this Schedule;
  - (f)  $R_{i,j,RP}$  is a proportion of  $\text{ANNMAX}_i$  for any service failure in element  $i$  in month  $j$  for the Regulatory Period as specified in Table 1a to Table 6 of this Schedule;
  - (g)  $R_{i,j,Ry}$  is a proportion of  $\text{ANNMAX}_i$  for any service failure in element  $i$  in month  $j$  for any relevant Regulatory Year as specified in Table 1a to Table 6 of this Schedule;
  - (h) Passenger-sensitive equipment (PSE) includes lifts, escalators and travelators. PSE (priority) is a set of assets for each terminal agreed locally between the Licensee and the AOC and notified in writing from time to time to the CAA;
  - (i) Specified element identifies the relevant element  $k$  of service for which bonuses shall be recovered by the Licensee;
  - (j)  $\text{MB}_k$  is the maximum percentage of Airport Charges (relating to air transport services for the carriage of passengers for the relevant terminal) recoverable by the Licensee as bonuses for performance of specified element  $k$  in the relevant Regulatory Period or Regulatory Year as specified in Table 8 of this Schedule;

- (k)  $LPL_k$  is the lower performance limit for specified element k used in the calculation of bonuses as specified in section 4(b). It has the values assigned in Table 8 of this Schedule; and
- (l)  $UPL_k$  is the upper performance limit for specified element k used in the calculation of bonuses as specified in section 4(b). It has the values assigned in Table 8 of this Schedule.

## 2(a) Quality of Service Monitor (QSM)

2.2 QSM is the Quality of Service Monitor survey. The results of the QSM survey are used to assess the Licensee's performance in the passenger satisfaction elements as specified in Table 4a 2a to Table 5d and Table 8 of this Schedule.

2.3 The performance for passenger satisfaction elements is measured by moving annual averages weighted by passenger numbers in the relevant terminal, using the formulae:

- (a) Except for the period within 12 months after air transport services for the carriage of passengers commence at Terminal 2, performance of element i in month j in terminal a is:

$$\text{Performance}_{i,j,a} = \frac{\sum_{m=1}^{m=12} [\pi_{j-m+1,a} \text{Monthly performance}_{i,j-m+1,a}]}{\sum_{m=1}^{m=12} \pi_{j-m+1,a}}$$

- (b) For the 12 months after air transport services for the carriage of passengers commence at Terminal 2, performance of element i in month j in Terminal 2 is:

$$\text{Performance}_{i,j,2} = \frac{\sum_{m=1}^{m=\mu} [\pi_{j-m+1,2} \text{Monthly performance}_{i,j-m+1,2}]}{\sum_{m=1}^{m=\mu} \pi_{j-m+1,2}}$$

where:

$\pi_{j,a}$  is the number of passengers in month j in terminal a;

Monthly performance<sub>i,j,a</sub> is the performance of element i in month j in terminal a;

m is a counter of the 12 months ending in month j; and

$\mu$  is a counter of months where

- the month in which air transport services for the carriage of passengers commence at Terminal 2 = 1;

- the month after air transport services for the carriage of passengers commence at Terminal 2 = 2, so on and so forth;
- the eleventh month after air transport services for the carriage of passengers commence at Terminal 2 = 12.

#### 4. Bonuses

##### 4(a) Payment

4.1 The Licensee may recover bonuses from Relevant Parties. Bonus payments shall be included in the calculation of the Airport Charges in respect of relevant air transport services in Condition C1.

##### 4(b) Calculation

4.2  $B_t$ , the bonus factor as specified in Condition C1, is based on performance achieved in respect of specified elements in the relevant Regulatory Period or Regulatory Year  $t$  as set out in Table 8 of this Schedule.

4.3 For the purposes of calculating  $M_t$  as specified in Condition C1, the corresponding periods for which bonuses are recoverable by the Licensee to be included in the calculation of  $M_t$  are set out in Table 9 of this Schedule.

4.4 For the purposes of calculating  $M_t$  for the Regulatory Period,  $B_{t-2} = B_{2012/13}$  is set to zero; for the purposes of calculating  $M_t$  for the Regulatory Year  $t$  starting on 1 January 2015,  $B_{t-2} = B_{2013/14}$  is set to zero. This is because bonuses earned in 2012/13 and 2013/14 should have been recovered through the K factor as specified in Condition C1.

4.5  $B_t$  for the Regulatory Period, i.e.  $B_{2014}$ , shall be calculated as follows:

$$B_t = \sum_{j=\text{April}}^{\text{December}} \sum_k \text{Max} \left[ 0, \text{Min} \left[ \text{BNS}(T1)_{kj}, \text{BNS}(T2)_{kj}, \text{BNS}(T3)_{kj}, \text{BNS}(T4)_{kj}, \text{BNS}(T5)_{kj} \right] \right]$$

For each month  $j$  and specified element  $k$ ;

$$\text{BNS}(T1)_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(T1)_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(T2)_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(T2)_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T3})_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T3})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T4})_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T4})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T5})_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T5})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

where:

$\text{MB}_k$ ,  $\text{LPL}_k$  and  $\text{UPL}_k$  are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and

$\text{MP}(\text{T1})_{kj}$ ,  $\text{MP}(\text{T2})_{kj}$ ,  $\text{MP}(\text{T3})_{kj}$ ,  $\text{MP}(\text{T4})_{kj}$  and  $\text{MP}(\text{T5})_{kj}$  are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in ~~Terminal 1~~, Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.

4.6  $B_t$  for any subsequent relevant Regulatory Year t shall be calculated as follows:

$$B_t = \sum_{j=\text{January}}^{\text{December}} \sum_k \text{Max} \left[ 0, \text{Min} [\text{BNS}(\text{T1})_{kj}, \text{BNS}(\text{T2})_{kj}, \text{BNS}(\text{T3})_{kj}, \text{BNS}(\text{T4})_{kj}, \text{BNS}(\text{T5})_{kj}] \right]$$

For each month j and specified element k;

$$\text{BNS}(\text{T1})_{kj} = \frac{1}{12} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T1})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T2})_{kj} = \frac{1}{12} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T1})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T3})_{kj} = \frac{1}{12} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T2})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T4})_{kj} = \frac{1}{12} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T4})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

$$\text{BNS}(\text{T5})_{kj} = \frac{1}{12} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(\text{T4})_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$$

where:

$MB_k$ ,  $LPL_k$  and  $UPL_k$  are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and

$MP(T1)_{kj}$ ,  $MP(T2)_{kj}$ ,  $MP(T3)_{kj}$ ,  $MP(T4)_{kj}$  and  $MP(T5)_{kj}$  are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in ~~Terminal 1~~, Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.

~~4.7 The calculations set out in paragraphs 4.5 and 4.6 are subject to the following conditions:~~

~~For the months including or after 'Such time when Terminal 1 is decommissioned',  $BNS(T1)_{kj} = 0.36\%$ ; and~~

~~For the months before or including 'Such time when air transport services for the carriage of passengers commence at Terminal 2',  $BNS(T2)_{kj} = 0.36\%$~~

7. Tables<sup>29</sup>

Table 1 a: Terminal 1 – passenger satisfaction elements [Not used]

i	Element	Metric	Time of day over which performance counts for rebates	Standard <sub>i,j,a</sub>	ANNMAX <sub>i</sub>	R <sub>i,j</sub> RP	R <sub>i,j</sub> RY	
1	Departure lounge seating availability	Moving annual average QSM scores weighted by monthly passenger numbers	Unrestricted	3.80	0.36%	0.0800%	0.0600%	
2	Cleanliness			4.00	0.36%	0.0800%	0.0600%	
3	Way-finding			4.10	0.36%	0.0800%	0.0600%	
4	Flight information			4.30	0.36%	0.0800%	0.0600%	
5	Security			Publication only				
6	Wi-fi			Publication only				

<sup>29</sup> In Tables 42a to Table 5d, for the time of day over which performance counts for rebates, where relevant, if the Licensee and the AOC fail to agree a period for a particular element, the default time period will be the period specified for central search. In Tables 42a to Table 6, ANNMAX<sub>i</sub> is defined in paragraph 2.1(e) and is measured to two decimal places. R<sub>i,j</sub>RP and R<sub>i,j</sub>RY are defined in paragraphs 2.1(f) and 2.1(g) respectively and are measured to four decimal places. In Table 7, the calculation of ACT rebates in thousands is specified in section 2(e) and is measured to two decimal places. In Table 8, MB<sub>k</sub>, LPL<sub>k</sub> and UPL<sub>k</sub> are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) and are measured to two decimal places.

**Table 1b: Terminal 1 – security<sup>30</sup>**

<i>i</i>	<b>Element</b>	<b>Metric</b>	<b>Time of day over which performance counts for rebates</b>	<b>Standard<sub><i>t</i>,<i>j</i>,<i>a</i></sub></b>	<b>ANNMAX<sub><i>t</i></sub></b>	<b>R<sub><i>t</i>,<i>j</i></sub>RP</b>	<b>R<sub><i>t</i>,<i>j</i></sub>RY</b>
<i>7-i1</i>	<i>Central search (interim)</i>	<i>Percentage of queue times measured once every 15 minutes that are less than 5 minutes</i>	<i>05:00 to 22:30</i>	<i>95.00%</i>	<i>1.00%</i>	<i>0.2222%</i>	<i>0.1667%</i>
<i>7-i2</i>		<i>Percentage of queue times measured once every 15 minutes that are less than 10 minutes</i>	<i>05:00 to 22:30</i>	<i>99.00%</i>			
<i>8-i1</i>	<i>Transfer search (interim)</i>	<i>Percentage of queue times measured once every 15 minutes that are less than 10 minutes</i>	<i>05:00 to 22:30</i>	<i>95.00%</i>	<i>0.50%</i>	<i>0.1111%</i>	<i>0.0833%</i>
<i>9</i>	<i>Staff search</i>	<i>Percentage of queue times measured once every 15 minutes that are less than 10 minutes</i>	<i>Period agreed locally between the Licensee and the AOC</i>	<i>95.00%</i>	<i>0.38%</i>	<i>0.0844%</i>	<i>0.0633%</i>

<sup>30</sup>—The standards for central and transfer search (interim) (elements 7-i1, 7-i2 and 8-i1) remain in effect until air transport services for the carriage of passengers cease in Terminal 1.

**Table 1c: Terminal 1 – passenger operational elements**

i	Element	Metric	Time of day over which performance counts for rebates	Standard <sub>ij,a</sub>	ANNMAX <sub>i</sub>	R <sub>ij</sub> RP	R <sub>ij</sub> RY
10	PSE (general)	% time serviceable and available for use, independent of any other element	Period agreed locally between the Licensee and the AOC	99.00%	0.35%	0.0778%	0.0583%
11	PSE (priority)			99.00%	0.35%	0.0778%	0.0583%
12	Arrivals baggage carousels			99.00%	0.35%	0.0778%	0.0583%
13a	Track transit system	% one train serviceable and available for use, independent of any other element	Not applicable	Not applicable			
13b		% two trains serviceable and available for use, independent of any other element					

**Table 1d: Terminal 1 – airline operational elements<sup>34</sup>**

i	Element	Metric	Time of day over which performance counts for rebates	Standard <sub>t,j,a</sub>	ANNMAX <sub>t</sub>	R <sub>t,j</sub> RP	R <sub>t,j</sub> RY
14	Stands	% time serviceable and available for use, independent of any other element	Period agreed locally between the Licensee and the AOC	99.00%	0.25%	0.0556%	0.0417%
15	Jetties			99.00%	0.25%	0.0556%	0.0417%
16	Fixed electrical ground power			99.00%	0.20%	0.0444%	0.0333%
17	Stand entry guidance			99.00%	0.25%	0.0556%	0.0417%
18	Pre-conditioned air		Not applicable	Not applicable			
19	Pier-served stand usage	Moving annual average of % passengers served (last 12 months)	Unrestricted	95.00%	0.30%	0.0667%	0.0500%

<sup>34</sup>—In this table, pier-served stand usage (element 19) would be a combined Terminal 1/Terminal 2 element. Its standard is subject to exceptions to be agreed by the Licensee and the AOC.

**Table 9: Periods of bonuses earned to be taken into account when setting  $M_t$  as specified in Condition C1<sup>32</sup>**

To set the maximum revenue yield per passenger $M_t$	$M_t$ representing the period	Take account bonuses earned in $B_{t-2}$	$B_{t-2}$ representing the period
$M_{2014}$	April 2014 – December 2014	$B_{2012/13}$	April 2012 – March 2013
$M_{2015}$	January 2015 – December 2015	$B_{2013/14}$	April 2013 – March 2014
$M_{2016}$	January 2016 – December 2016	$B_{2014}$	April 2014 – December 2014
$M_{2017}$	January 2017 – December 2017	$B_{2015}$	January 2015 – December 2015
$M_{2018}$	January 2018 – December 2018	$B_{2016}$	January 2016 – December 2016
$M_{2019}$	January 2019 – December 2019	$B_{2017}$	January 2017 – December 2017
<a href="#"><u><math>M_{2020}</math></u></a>	<a href="#"><u>January 2020 – December 2020</u></a>	$B_{2018}$	<a href="#"><u>January 2018 – December 2018</u></a>
<a href="#"><u><math>M_{2021}</math></u></a>	<a href="#"><u>January 2021 – December 2021</u></a>	$B_{2019}$	<a href="#"><u>January 2019 – December 2019</u></a>

<sup>32</sup> In Table 9, for the purposes of calculating  $M_{2014}$ ,  $B_{2012/13}$  is set to zero; for the purposes of calculating  $M_{2015}$ ,  $B_{2013/14}$  is set to zero.