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**Heathrow response to Draft Terms of Reference for the Independent Review of Heathrow Airport Limited's cost allocation methodology for Other Regulated Charges**

Dear David

Thank you for your letter dated 1 November 2023 and the opportunity to comment on the CAA's draft terms of reference for the Independent Review of Heathrow's cost allocation methodology for Other Regulated Charges. This is a critical piece of work which will address the outstanding issues following the H7 Final Decision (FD).

Heathrow welcomes the broad scope of the terms of reference and the inclusion of the legal obligations that are placed upon Heathrow, including compliance with competition law. In addition, we are supportive of the timelines suggested by the CAA for the Independent Review. For this exercise to have maximum value, we agree that any output must come, as planned, in advance of the start of the 2025 ORC pricing process to allow any changes prior to the consultation period, which will commence in August 2024. Considering the complexity of the matter, ahead of submitting a final report, we request the CAA provides Heathrow the opportunity to review a draft for factual accuracy and that this step is built into the schedule.

We also want to clarify that the annuity cost included in the H7 FD was a CAA decision based on numbers provided by Heathrow as part of the constructive engagement process for a different purpose. It was not based on a Heathrow calculation of either the fixed costs or the appropriate non-airline share of them. Heathrow advocated that no annuity costs be included in ORCs.

In your letter you state that the proposed allocation of annuities is in consumers' interests because it excludes costs solely related to non-airline activities from the scope of the Airport Charges. We consider that this statement neither represents consumers' interests correctly nor is consistent with the current single till framework at Heathrow.

Overall, Heathrow is an ecosystem of companies providing services to air passengers and Airport charges reflect the overall costs of delivering this service. To a large degree, we do not differentiate charges to airline by the costs they incur nor which terminal they fly from. Whilst making sure different users incur the different marginal costs they create is important (and reflected in ORCs), breaking down non-marginal costs for some issues and not others is not consistent with how Charges are currently levied. Moreover, moving away from levying marginal costs for ORCs to non-airlines is likely to lead to inefficient economic outcomes.

In addition, the Single Till means that the costs of many non-airline activities have an impact on Airport charges. For example, retailers' costs impact their contribution to the single till. Increasing the proportion of costs passed on to retailers would result in the single till revenue received by Heathrow reducing by an equivalent amount. Furthermore, charging at above marginal cost, e.g. for electricity, could lead to excessive investment to reduce consumption. This would increase costs and thus lead to even further reductions in single-till income. In other words, allocating costs away from the Airport charge rather than reducing it, could actually lead to it being higher.

To ensure a successful review of ORC costs, we would request additional clarification from the CAA on two matters that are of particular relevance to the question of cost allocation and resolution:

- A definition is required for 'airline' and 'non-airline'. For example, is this definition related to ownership or activities, and if activities which ones; and
- what would constitute a 'windfall loss' or 'windfall gain' which would require adjustment through the Licence.

We look forward to working with ORC users and the CAA to ensure the successful implementation of the Independent Review. If you have any questions, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mike King', with a stylized, cursive script.

Mike King  
**Director of Regulation & Economics**