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MEMORANDUM

Response to CAP2139: Legal Annex

Section 1 - Introduction and summary

1. This section provides a summary of the legal rules which apply to the CAA's consultation, including on appeal. It considers how those rules apply to the issues under consideration, and whether the CAA has applied them properly.

2. In summary:

   a. The Consultation hardly considers the legal rules at all, instead referring to an incomplete summary of the rules and including a pro forma statement that the summary has been followed;

   b. Unfortunately - and perhaps because of this – a series of factual, legal and analytical errors pervades the entire Consultation; and

   c. Left uncorrected, these errors will almost certainly render the CAA's final decision vulnerable to appeal (in respect of which, for the avoidance of doubt, Heathrow reserves all of its rights).

3. Almost all of the criticisms levelled at the CAA's analysis in the main body of this response represent a legal error of the type described here. They are not set out in this section *in extenso,* but nothing should be drawn from that; rather, the rest of this section picks out (a non-exhaustive) list of five particularly egregious errors in more detail, namely:

   a. The Consultation does not start in the right place: the analysis should begin with the general duty in section 1(1) of the Civil Aviation Act 2012 (the "2012 Act"). Unfortunately, the Consultation consistently ignores that duty, leading to persistent and pervasive errors. See section 2 below.

   b. Failure to further the interests of consumers: see section 3 below.

   c. Mistakes of fact: the approach to evidence in the consultation is likely to lead to a decision based on errors of fact, in breach of the CAA's public law duties. See section 4 below.

   d. Pre-tax v. post-tax WACC: the Consultation evinces a closed mind to the question of the correct approach. This represents a failure in consultation and a possible fettering of discretion. See section 5.

   e. Lack of transparency: see section 6.

4. The next section explains the applicable legal rules and how they apply in the current circumstances.

Section 2 – the relevant law

5. The Civil Aviation Authority's ('CAA') duties and powers are set out in the 2012 Act. The 2012 Act, at section 1(1), defines the CAA's over-riding duty stating that it:

> '*must carry out its functions under this Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services*' (emphasis added).

6. Section 1(3) of the 2012 Act specifies a series of matters to which the CAA must have regard in performing its over-riding duty. These form an instruction set for how to go about its regulatory duties and include:

   a. 'the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services' (section 1(3)(a)),

   b. 'the need to secure that all reasonable demands for airport operation services are met' (section 1(3)(b)),

   c. 'the need to promote economy and efficiency on the part of each holder of a licence' (section 1(3)(c)),

   d. regulatory activities 'should be carried out in a way which is transparent, accountable, proportionate and consistent' and 'should be targeted only at cases in which action is needed' (sections 1(3)(g) and 1(4)). (We refer to these as the "regulatory practice" duties.)

7. There is also extensive case law that shows that the CAA must provide properly reasoned conclusions which properly grapple with the evidence before it.[1]

8. Heathrow is provided with a route of appeal to the CMA against a decision of the CAA to modify its licence[2] under section 25(1) of the 2012 Act. The grounds on which an appeal may be allowed are detailed in section 26 and are as follows[3]:

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

   b. that the decision was wrong in law,

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[1] Including: *R (Alconbury) v SoS for the Environment* [2001] UKHL 23; *Begum v Tower Hamlets LBC* [2003] UKHL 5; *Dover DC v Campaign to Protect Rural England (Kent)* [2017] UKSC 79.

[2] Modification being permitted by section 22 of the 2012 Act subject to restrictions to the CAA's powers detailed in section 23.

[3] The grounds are reproduced in the CMA's Guide to its Airport Licence Condition Appeal Rules, CC20, February 2014, para 11.

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

9. Appeals against errors of fact are regularly found against regulators. One such example is *R (on the application of British Gas Trading) v Ofgem*[4] in which Ofgem's decision regarding a price control was found to be unlawful as it was labouring under a fundamental mistake of fact.

10. In relation to errors of law, according to the judgement in a recent, leading case[5]:

> '*… there is no fixed list of errors that the Tribunal might consider material. Case law indicates that the following might be relevant: failing to take account of relevant evidence; taking into account irrelevant evidence; failing properly to construe significant documents or evidence; drawing inferences of fact from evidence about relevant matters which are illogical or unjustified; failing adequately or sufficiently to investigate an issue that the Tribunal considers to be relevant or potentially relevant to the analysis*.'

11. Indeed, the legal principle that public bodies, such as the CAA, must both disregard irrelevant considerations and take into account relevant considerations when exercising their powers are deeply grounded in long standing and still frequently referenced case law[6].

12. The matters to which the CAA must have regard, outlined in paragraph 6 above, including Heathrow's financeability and its ability to meet both demand and its environmental responsibilities, should be to the forefront of the CAA's thinking for H7.

13. The effects of the Covid-19 pandemic are such that the difficulties of making forward-looking assumptions – already material – are exacerbated. Errors in projections are likely to lead to breaches of statutory duties. This is particularly the case where forecasts claim to be accurate at an unrealistic level of detail; this is likely to lead to errors of fact and render the CAA's decision vulnerable to challenge.

14. In the current difficult trading circumstances it is more, not less, important that the CAA gives due weight to the full range of stipulations in the 2012 Act about how it should perform its duties. Unlike at the time of any of its previous price reviews, Heathrow is currently operating well below capacity and losing money. It remains to be seen if the pandemic, and the widespread adoption of video communications that it has sparked, leads to lasting changes in demand for business travel.

15. It is questionable whether a market power determination under section 7 of the 2012 Act conducted today would come to the same conclusion across all of Heathrow's

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[4] [2019] EWHC 3048 (Admin).

[5] *CMA v Flynn Pharma and Pfizer* [2020] EWCA Civ 339, para 145.

[6] E.g, *Roberts v Hopwood & Others* [1925] AC 578, *Padfield v Minister of Agriculture* [1968] AC 997

product markets as the one completed in January 2014[7] under very different operating conditions.

Section 3 – failure to start in the right place

16. As noted above, the CAA's over-riding duty is to further the interests of passengers and cargo-owners in their use of airport services.[8]

17. The CAA has no legal duty in this regard towards the airlines, which are third parties with an obvious vested interest. Nor does the CAA have a duty to further the interests of consumers as regards their use of airline services (flights), only of their use of airport operation services. Despite this, in its CAP2139 consultation, the CAA has consistently disregarded the evidence placed before it about the priorities and interests of consumers, instead returning repeatedly to the submissions of the airlines and their representative bodies.

18. Throughout the consultation, the CAA appears to treat the arguments put forward by the airlines as a proxy for passengers, and often views its role as a mediator between airlines and HAL. This is clearly at odds with the CAA's primary duty to further the interests of passengers and cargo owners.[9] For example, in paragraph 5.19 of CAP2139, the CAA disregards the external consumer specialist market research put forward by HAL and instead relies on the views made by airlines – despite no evidence being put forward to counter the evidence put forward by HAL, the CAA has instead proposed that HAL and the airlines can agree the 'right' next steps. Surely then the 'right' next steps would be based on actual evidence of what consumers want rather than what the airlines want?

19. Demonstrating the dangers for the CAA of placing reliance on the airlines' evidence, the Alternative Business Plan ("ABP") proposed a WACC of 2.9%. This is lower than the pre-tax WACC for water companies identified by the CMA of 3.12% and is not reflective of the risk of airports in any environment, never mind the current, extremely difficult operating and financing conditions. The ABP's proposal fails even the most superficial sense-check, is baseless and nakedly self-serving. There is no stipulation in the 2012 Act that places responsibility on the CAA to promote the commercial interests of airlines.

20. Indeed, had parliament intended to include 'airlines' in the statutory definition, or had it viewed airlines as a proxy for passengers, it would have said so in the legislation. It is unclear then, why the CAA treats the views and evidence put forward by the airlines as

[7] CAA: CAP1133, Market power determination in relation to Heathrow Airport – statement of reasons, 10 January 2014

[8] Section 69 of the 2012 Act defines 'air transport service users' as a person who is a passenger carried by the service or has a right in property carried by the service. The CAA refers to them as consumers, for consistency we also refer to air transport service users as consumers.

[9] Section 1 of the 2012 Act

that of the consumers and/or attaches inappropriate weight to the evidence put forward.

21. Another example of this can be seen in relation to the CAA's treatment of HAL's opex projections. In its RBP, HAL detailed its approach to forecasting its opex over the H7 period. The airlines commissioned PA Consulting to review HAL's opex projections and noted some concerns, for example that the opex projections were not based on a bottom-up build-up of costs.[10]

22. However, HAL had clearly explained the rationale for its top-down, driver based forecasting approach and illustrated for the CAA in summer 2020 that this was more accurate at forecasting the levels of opex and commercial revenue than the bottom-up approach used in Q6. At paragraph 2.20 of the consultation, the CAA states that HAL has considered airlines feedback on its opex forecasting approach but has not implemented actions to address concerns raised during CE. This appears to suggest that HAL is expected to implement any feedback or take any actions put forward by airlines. This fundamentally misunderstands the purpose of CE. HAL as the regulated business is entitled to not implement actions raised which based on its own evidence will be less accurate and likely to be contrary to consumers' interests.

23. In its consultation the CAA also places much greater emphasis on cost than on the other interests of passengers and cargo owners that it must take into account, i.e. range, availability, continuity and quality. There is extensive and consistent evidence – which HAL has provided to the CAA – that end-users value quality of service and that this is something that they are prepared to pay for[11]. Indeed, quality of service should currently be given even greater attention than it might have at other times, given the high priority placed by consumers on short queuing times, spacing and other pandemic transmission prevention measures. The Consultation, however, falls into legal error in focussing primarily on costs and in failing to balance the different considerations in the general duty properly.

24. In its CAP2139 consultation the CAA has ignored evidence that is pertinent to its over-riding duty while ascribing undue weight to the evidence provided by the airlines, for example the CAA's assessment of measures as detailed at paragraph 206 of HAL's consultation response. Often, the consultation reads like a balancing exercise, as if the aim is to broker a compromise between airlines and Heathrow[12]. This is, of itself, bizarre

[10] Para 2.18 of the Consultation

[11] Systra, *Understanding Consumer Need Priorities in a (Post) Covid-19 World*, November 2020, Systra, *Heathrow Airport Customer Valuation Research,* November 2018

[12] See for example, paragraph 34; 2.59; 4.22; 4.38; 5.19; 5.27 – in which the CAA apparently chooses actively to ignore any views consumers may have but not asking them; 5.29

and an extraordinary position for a regulator to put itself in and entirely divorced from the statutory framework.

25. In addition, in this weighing exercise the unevidenced assertions of airlines are often ascribed equal evidential weight to the detailed, supported evidence provided by Heathrow. For example, at paragraph 5.19 of CAP2139, the CAA takes an airline view on control post measurement, which was derived from an airline brainstorming session – not through consumer engagement – and presents this as a challenge to Heathrow which has not been addressed in the RBP without any interrogation of the consumer evidence. In conducting this exercise, the CAA veers away dramatically from its general duty and is likely to end up relying on an error of fact, a ground on which an appeal may be allowed (§8.a).

26. The CAA continues to disregard the evidence put forward by HAL on what consumers want. For example, the Systra report provides comprehensive insight into consumer priorities for Heathrow airport and the impacts of Covid-19 on consumer behaviour and attitudes.[13] Even in other regulated sectors, where demand for services has increased, such as telecoms, the regulator has conducted and commissioned research on the effects of Covid-19.[14]

27. In these unprecedented times, it is astonishing that the CAA – whose primary duty is to consumers, has failed to carry out or commission any consumer based research on what consumers actually value in a post Covid-19 world. This is made worse by the fact that, in the face of clear evidence to show what is important to consumers and what they are willing to pay for, the CAA has refused to engage with HAL's proposal to use the evidence on what consumers value to update the OBR[15]. The CAA cites a need to retain the flexibility to respond to performance/ operational issues as they arise which is not only nonsensical but also plainly contrary to its over-riding duty to further the interests of consumers (§5 above).

28. The CAA also dismisses HAL's proposal to escalate areas of disagreement to the Consumer Panel for resolution giving the bureaucratic excuse that this is not consistent with the Consumer Panel's current remit[16]. The CAA seems to have given no consideration to the possibility of either changing the Consumer Panel's remit or introducing an alternative body. The CAA has provided no evidence on consumers that

[13] Systra: Heathrow airport passenger priorities in a post-Covid-19 world, draft report, dated 16 December 2020, provided to the CAA on: 18 December 2020

[14] See: https://www.ofcom.org.uk/research-and-data/tv-radio-and-on-demand/news-media/coronavirus-news-consumption-attitudes-behaviour

[15] CAP2139 consultation, paragraph 5.27.

[16] CAP2139 consultation, paragraph 5.27.

would contradict what has been put forward by HAL and has chosen not to examine HAL's evidence, closing its mind and disregarding its over-riding duty to consumers.

Section 4 – likely errors of fact

29. As identified above, public bodies making decisions need to get their facts right. They are not allowed to rely on factual errors; and they are not allowed to make things up. As part of that, they may not treat submissions by interested parties, untested, as if they were reliable factual evidence.

30. It is settled law that – as a subset of the category of reviewable "errors of fact" – evidence relied on by decision-makers must be objective[17] and of genuine probative value[18]. It is not enough for the CAA to balance what they are told; they must establish whether the evidence is reliable, assess its probative value, and give no more than the appropriate weight to any submissions.

31. The Consultation falls into numerous significant factual errors which are likely to render the decision vulnerable. Chief among these is the treatment accorded to the airlines' Alternative Business Plan set out in paragraphs 27 -19 of HAL's consultation response. However, these errors are also found in:

    a. The CAA's statement that there is no "meaningful integration" in the RBP;

    b. The CAA's fruitless quest for impossible levels of detail about future periods – almost certain to produce "facts" which are really no more than unevidenced guesses;

    c. The absence of information about what consumers actually want and what they are prepared to pay for;

    d. Failing to follow its own depreciation policy on Heathrow's Covid-19 RAB adjustment;

    e. The CAA's approach to increasing HAL's reporting requirements on financial resilience and ring fencing, which fails to consider the overall benefits to consumers and whether this justifies the increased regulatory burden placed on HAL; and

    f. On the level of risk sharing - the CAA's incorrect focus on a mechanism that minimises its own forecasting risk which results in fluctuations in performance being passed on to consumers.

32. These errors will have serious consequences for Heathrow - the CAA's H7 decision is being made at a time of peculiar uncertainty, the RAB based, single till price control will

[17] See R (MD (Gambia)) v. SoS for the Home Department [2011] EWCA Civ 121

[18] See, for example, Mahon v Air New Zealand Limited, [1984] AC 808

define Heathrow's revenue, earnings and capacity for investment and rehiring out to the end of 2026. It is well understood that price controls are one of the most serious, profound and intrusive forms of regulatory intervention – and a failure to incorrectly calibrate H7 poses real risks to HAL, consumers and markets in the long term.

33. The implications of some of the CAA's comments is of more intervention and market micromanagement. The CAA's requests for more and more detail on smaller and smaller aspects of Heathrow's operations, for example changes in staffing levels, specific contract costs or the number of car parking spaces and price per product, will only serve to provide the CAA with a spurious sense of accuracy about its understanding of Heathrow's costs and revenues.

34. Attempts at micro-management and pursuit of spurious detail lead to a high risk of conclusions being drawn which are not correct. They are also contrary to the requirements for proportionality in the 2012 Act which states 'regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent' and 'should be targeted only at cases in which action is needed'[19].

Section 5 - the CAA cannot close its mind in relation to pre-tax / post-tax WACC

35. The CAA states that it outlined its preferred approach to setting an allowance for tax costs in H7 in its January 2020 consultation. However, this was merely a suggestion[20]. HAL's understanding is that the CAA has not yet taken a decision on its approach to corporation tax. In the absence of any final decision on this matter HAL has taken the approach which it thinks will overall provide consumers with the most benefits – if the CAA disagrees it must provide clear evidence to support its reasoning.

36. The general rule is that anyone who has to exercise a statutory discretion must not '*shut his ears to an application*'[21]. What the CAA must not do is to refuse to listen at all especially when HAL has provided evidence[22] that its approach to corporation tax allowance best supports an affordable and financeable H7 price control which will ultimately be in the best interests of consumers.

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[19] Sections 1(3)(g) and 1(4) of the 2012 Act (see §6.d above).

[20] CAP1876, paragraph 2.61 "'For the H7 price control, we have suggested in previous consultations that it would be in consumers' interests for the tax allowance to be capped at a level that takes account of its actual level of gearing in the new price control period"'.

[21] *British Oxygen v Minister of Technology* [1971] AC 610 at [625], Lord Reid: '*The general rule is that anyone who has to exercise a statutory discretion must not " shut his ears to an application" … There may be cases where an officer or authority ought to listen to a substantial argument reasonably presented urging a change of policy. What the authority must not do is to refuse to listen at all.*'

[22] See for example paragraph 104 of HAL's response

37. A failure to do so is inconsistent with the CAA's duties as a regulator as well as its own better regulation principles.

Section 6 - Failing to adequately disclose information - Lack of transparency and not providing HAL and other stakeholders with the information that the CAA is relying on

38. As a matter of public law, consultation is obliged to meet certain requirements[23], including that adequate information must be provided to consultees to enable them properly to respond in the consultation exercise. A key reason for this is to check for any errors of fact, judgement, and calculation in FTI Consulting's work on consumer engagement and outcomes.[24]

39. The more widely this information is disclosed, the easier it is for stakeholders to properly scrutinise, especially when the CAA is using the findings of the report to request yet more detailed information from HAL. The appropriate starting point – as a matter of public law – is that all information must be disclosed, and it should be disclosed publicly unless there are cogent and specific reasons for a more restrictive arrangement.

40. Put simply, the CAA has failed to provide HAL with information which handicaps HAL in responding to the consultation and the underlying calculations to its analysis on gearing glide paths[25] – this is unlawful. As discussed above, the 2012 Act requires the CAA, in fulfilling its over-riding duty, to have regard to the principle that regulatory activities should be carried out in a way which is transparent and accountable. For example:

    a. The CAA says that its key findings on HAL's approach to consumer engagement and outcomes have been supported by a consultant (FTI Consulting)[26]. However, FTI's involvement receives only a fleeting mention in an appendix to the consultation and the CAA has failed to publicly disclose FTI's work. HAL's position is therefore that the CAA will not seek to introduce or rely on this evidence at a later stage of its consultation.

    b. The CAA has provided a table in appendix 1 of the Consultation which provides what it refers to as some illustrative analysis on gearing glide paths, however, crucially the CAA has failed to provide stakeholders with the underlying calculations. The lack of transparency is particularly concerning when read with the CAA's conclusion that it may give less weight to the cost of new debt for H7.

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[23] *R v Brent LBC, ex p Gunning* (1985) 84 LGR 168

[24] We note that the CAA also failed to disclose when publishing its consultation the review that it commissioned Arcadis to carry out on HAL's RBP capex plan despite the reliance on this document and the subject matter being directly relevant to HAL, the CAA only provided a draft of the Arcadis report to HAL in April 2021 after several requests through March and April from HAL to have sight of the Arcadis report. This provides HAL with only a short window to appropriately scrutinise the Arcadis report.

[25] See paragraph 69 of the main body of the response

[26] CAA: CAP2139A, Appendix N, para 8.

HAL's position is therefore that the CAA should disclose the underlying calculations as a matter of urgency and allow stakeholders the chance to appropriately scrutinise them, a failure to do so would render the CAA's conclusions on the cost of new debt for H7 unlawful.

41. Given that the consultation aims to outline the CAA's broad approach on HAL's H7 price control programme, we would expect the CAA to welcome the opportunity to ensure that the evidence it is relying on is subject to the appropriate amount of scrutiny – especially where this information is being relied on for calculations and being put forward by third-parties. A failure by the CAA to do this is likely to constitute an error of fact.