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Paul Smith
Group Director of Consumers and Markets
Civil Aviation Authority

17th November 2021

Sent by email to: paul.smith@caa.co.uk

Dear Paul

CAP2265E Appendix C: Notice of Proposed Licence modification to insert a new price cap from 1 January 2022 to 31 December 2022

Thank you for setting out your proposal to modify Heathrow Airport Limited's (HAL's) Licence to impose a price cap for the Regulatory year 2022, we would like to set out our views on this decision.

Summary:

The Airline Community agree with the CAA's assessment that the absence of a cap on the level of aeronautical charges at Heathrow for 2022 would leave consumers exposed[1] and therefore welcome its recognition on the need to intervene, particularly given the unsustainable and unjustified levels being proposed by HAL.

Notwithstanding the above, we are however incredibly disappointed on the level being proposed by the CAA.

As recognised by the CAA, Heathrow is already one of the most expensive airports in the world. The CAA's proposal for 2022 would see an increase in charges of over 50%[2], a level significantly above any cost pressures or demands airlines are experiencing elsewhere. Fundamentally, this cannot be furthering the interests of consumers. Even with a 'true up' mechanism, the balance is weighted against consumers who would, under the current level and timings, disproportionally compensate HAL.

As evidenced further within this response we strongly believe that by correcting for the following, a more accurate and appropriate mid-point level on which to base 2022 charges would be £19.39.

[1] Paragraph 15.21, CAA CAP2265D
[2] Compared with 2021 charges

In particular:

- The CAA's "range" for 2022 prices is skewed in favour of HAL's RBP Update and fails to sufficiently consider detailed analysis carried out by the CAA's own advisors on Opex and Commercial Revenues, which are fundamentally more robust and yet conservatively assessed.

- The suggested price cap of £29.50 is based on an outdated passenger forecast. The passenger forecast should be updated based on recent trends – particularly with the removal of travel restrictions and the recent Eurocontrol STATFOR forecast update. Consumers flying in 2022 should be protected against un-necessarily inflated charges.

- With Opex & Commercial Revenues correctly adjusted and a more realistic and up to date passenger forecast this would provide a more appropriate 'mid-point' for 2022 charges, which we have calculated as £19.39.

- In addition to the above, it is also worth noting there are additional areas that we will be responding to further as part of our response to Initial Proposals which will provide further evidence on why the range has been set too high; particularly the proposed pre-tax WACC range of 4.4% to 7.1% which represents a significant return for HAL shareholders at the expense of consumers with an assumed high cost of debt and exaggerated asset betas, despite the removal of risk resulting from the Traffic Risk Sharing scheme, additional asymmetric risk allowance and 1.07% shock factor to passenger forecasts.

The CAA's H7 process has been suboptimal leading to significant delays in reaching a final settlement with no price cap yet determined for 1st January 2022. The level currently being proposed by the CAA cannot however be the answer when it remains based on the regulated company's inflated lobbying position. The CAA must therefore ensure there is a cap in place in time for January 2022 based on the latest clear evidence available, and following the full process. In the event the CAA is unable to conclude the licence modification within such time, only the existing 2021 level can continue to be applied as precedent from Q5 to Q6 dictates.

1. Consumers are already paying for one of the most expensive airports in the world

As noted by the CAA, Heathrow is already one of the most expensive airports in the world. Given that twenty pence of every pound spent by passengers on travel in Europe (before taxes)[3] is related to infrastructure, any increases at Heathrow will only make the burden on consumers heavier.

Furthermore, we would add that the level of charges being proposed are significantly out of line with anything being seen elsewhere. Heathrow is at least 44% higher when compared with European hub comparator airports and the CAA's proposal if implemented would see this increase to at least 83% more expensive[4]

[3] IATA research

[4] Per Jacob's 2020 review of airport charges, with pro-forma update for 2022 charges applied

Figure 1: Heathrow Costs compared to other major airports

[redacted]

Source: Jacobs review of airport charges

The level of charge proposed by the CAA if applied, would in our analysis mean consumers over-paying in 2022 an up to £728m over-recovery in 2022 to HAL (ie: over £10 per passenger spread across 72m passengers). If this over recovery were paid back to consumers in later years, it would still result in 2022 consumers potentially providing an over £728m cash loan to HAL and being significantly over charged compared to future consumers. This over recovery could also lead to airlines being exposed to a class action in the future, which would clearly not be for the good of the industry.

UK based consumers and UK based airlines are disproportionately impacted by these charges, as they have few alternate options, particularly for longhaul flights.

Why do UK consumers have to pay so much more than other European travellers going through an airport just to fund excessive shareholder returns – this plays straight into the hands of the monopoly CAA is meant to be controlling? How does this support the message of the UK being open for business and that post Brexit we are more competitive?

We have already heard that if these charges are accepted this could lead to airlines that are able to considering alternative transfer routings, either through other European, USA or Middle East hubs. The charges will lead to a reduction in Heathrow's ability to operate as an effective global hub and make it harder for airlines to offer consumers and businesses an extensive range of international destinations and frequencies, again resulting in less choice for consumers.

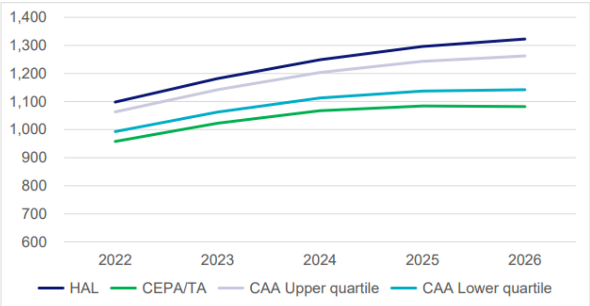
2. The Level of charge the CAA has proposed is incorrect

2.1 The CAA's "range" for 2022 prices is skewed in favour of HAL's Updated RBP operating costs and commercial revenues

The CAA has set a range for 2022 prices (from which it then selects the midpoint of £29.50) which fails to sufficiently weight detailed analysis carried out by the CAA's own advisors on Opex and Commercial Revenues.

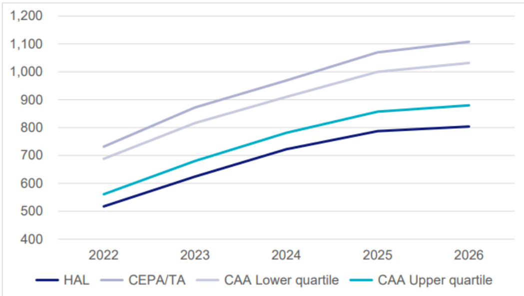
The below graphics are taken from the CAP 2265B and illustrate that the CAA have estimated Opex and commercial revenues as a range between the analysis and recommendations made by the CAA's independent consultants[5] ("CEPA/TA") and HAL's RBP Update 1 cost estimates for H7.

Figure 4.4: Summary of HAL, CEPA/TA and CAA Upper and lower opex projections (£m, 2020 CPI deflated prices)



Source: HAL updated RBP, CEPA/Taylor Airey analysis and CAA analysis

Figure 5.4: Summary of HAL, CEPA/TA and CAA Upper and lower commercial and cargo revenue projections (2020 CPI deflated prices)



Source: HAL updated RBP, CEPA/Taylor Airey analysis and CAA ranges

The CEPA/TA Opex projection is significantly lower than HAL's due to their recommendations that:

- CPI is used for inflation rather than RPI,
- That HAL's 2019 Opex did not represent the frontier of efficiency,
- Covid benefits from structural organisational changes and revised contracts would be expected to be retained during H7 regardless of future passenger volume growth,
- The ongoing efficiency challenge for H7 should not be linked to the size of the capital plan;
- Detailed modelling for operational and non-operational staff costs should be used to challenge HAL's proposed elasticity assumptions, which were not supported by the evidence,
- Security transformation will have a significant benefit on people costs; and
- A different level of opex for the modelling cost overlays should be used because HAL either did not provide sufficient evidence to support the level of additional costs, or provide assurance that costs included in the overlays did not overlap with business-as-usual activities accounted for elsewhere in HAL's forecasts.

The CEPA/TA commercial revenue are higher than HAL's due to their recommendations that

- HAL can increase average revenues per passenger through H7, based on HAL's historical performance of increasing average revenues above passenger growth rates: they have therefore applied a 2% "management stretch" challenge to estimates of relevant revenues for H7, compared to HAL's assumption of no stretch.
- The assessment of the impacts of changes to taxation rules for Heathrow in relation to airside VAT free and duty-free retail, and the impacts of the forecast passenger mix on retail income. be approached by: applying a consistent elasticity framework to estimate the impacts of both tax changes, and explicitly forecasting the impact of the geographical passenger mix on retail revenues, taking account of varying estimated spend per passenger between market segments.
- Use of a lower elasticity of cargo revenues with respect to passenger numbers compared to HAL's approach, to better reflect the actual trends observed for cargo revenues in 2020 and 2021: CEPA/Taylor Airey assesses that these trends are likely to persist for several years during H7, in the context of spare capacity at the airport.

[5] CAA CAP2266A – CEPA and Taylor Airey "Review of H7 Opex and Commercial Revenues: Initial Assessments and Forecasts", dated 13th October 2021

- An alternative set of mode share estimates, using the evidence provided by HAL to better reflect anticipated surface access trends.
- A challenge to HAL's approach of assuming reduced ticket prices of the Heathrow Express premium rail service.

The Airline Community welcome and agree with all the findings from the CEPA / TA recommendations; they are sensible and logically presented with supporting evidence. We note this builds on the Airline Community's own independent analysis undertaken which estimated a greater than £800m (2018p) gap in the Commercial Revenues over the H7 period[6] – primarily driven by Retail Revenues. The Independent experts found that the downside assumptions on legislative changes impact on Retail Revenues to be significantly overstated by HAL. They also found that positive actions that could be applied to mitigate changing circumstances were poorly defined by HAL.

We have also seen and presented similar conclusions drawn on Opex by PA Consulting (Nyras)[7] on behalf of the airline community when compared to CEPA/TA's analysis for the CAA.

Given the above, it is not appropriate for the CAA to treat CEPA/TA's Opex and commercial revenue projections in the same light as HAL's pessimistic projections and to therefore select scenarios between the two competing projections. We would again highlight (as we did with the IBP and RBP) that the HAL estimates of both Opex and Commercial Revenues are based on high level arguments with little or no supporting evidence, whereas the independent advice sourced by the CAA is backed by detailed evidence and analysis. It is simply not appropriate to give the HAL estimates the same weighting.

Whilst there has been a significant level of volatility within the past 18 months we are now seeing much more stability in commercial revenues, the trend of which has been in line with historic performance, as set out by CEPA/TA. Indeed, recent evidence from HAL themselves shows retail revenue per passenger [redacted] from 2019 levels[8].

This evidence is counter to HAL's modelled RBP submission which has Retail revenue per passenger [redacted] in 2022 (see "Heathrow RBP (Update 1) - Outputs H7 v1.00" line 232 – Retail Revenue Per Passenger).

Furthermore, having undertaken permanent structural changes HAL are better placed to manage their operating costs, something not appropriately reflected in HAL's Update RBP. We recognise the need for finding a balance, but we do not believe on the evidence above that the current approach by the CAA correctly reflects that. We still await a full bottom-up analysis as set out in the CAA's previous instructions If scenarios are to be used it would be logical and reasonable to select the CEPA/TA line as the mid-point with upper quartile and lower quartile projections around that.

It is notable that the CAA has given no particular reason why it has given equal weighting to HAL's RBP alongside its own independent analysis (which considered HAL's RBP from an objective point of view). In circumstances where analysis from independent advisors is available, that analysis should be used to set a Maximum Allowable Yield for 2022.

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[6] Taylor Airey report "Heathrow H7 Commercial Revenues Review – RBP Update Briefing Paper", presented to the CAA 24th February 2021

[7] PA Consulting (Nyras) report "Initial Assessment of Operating Costs at Heathrow", Oct 2020

[8] HAL retail update at Terminal 2 Terminal Community Meeting, September 2021

2.2.1 The passenger forecast outlook has improved since the CAA's analysis.

The passenger forecast should be updated based on recent trends – particularly with the removal of travel restrictions. The CAA's passenger forecast is based on HAL's own forecast model which uses input from Oxford Economics from April 2021. Since then, the UK has lifted nearly all travel restrictions, and the United States and other countries around the world have reduced restrictions. This will have a significant impact on passenger growth. We would also note again that it is wholly inappropriate for the CAA as a regulator to rely on the regulated company's own traffic forecasting model.

The latest public announcements coming from airlines reflects this in recent performances and upgraded outlooks for 2022. By way of recent examples: IAG confirmed there was a significant recovery underway since the summer[9] whilst Virgin Atlantic have announced plans to grow in 2022[10]. Other large-scale operators into Heathrow are reporting similar patterns. In its recent Q3 report[11], Lufthansa has announced new bookings reaching 80% of 2019 with a particularly strong demand on business travel, echoed by United highlighting London as its most booked international destination for business, alongside wider announcements of increased operations and a new route into Heathrow[12]. Air Canada and Delta similarly have commented on a faster-than-expected rebound is driving optimistic expectations for 2022[13] with plans to operate 90% of its 2019 transatlantic capacity[14] and we note the likes of Emirates[15] and Qantas[16] have pulled forward operating plans. Furthermore, we continue to see airlines take opportunities to operate into Heathrow next year, Bamboo airlines' recent announcement[17] being an example of such.

We note the CAA's acknowledgement that passenger forecasting is an area that will be updated for the Final Proposals if there is significant change in the path of demand recovery (CAP2265B P 30.) We would recommend the CAA adopt the Eurocontrol STATFOR forecast (published in October 2021-see Figure 6) which has proven an accurate prediction of 2021 traffic levels, with the recovery tracking to the STATFOR forecast.

We would also note and agree with the CAA's independent consultants (Skylark) and believe that the CAA should adopt Skylark's recommendations:

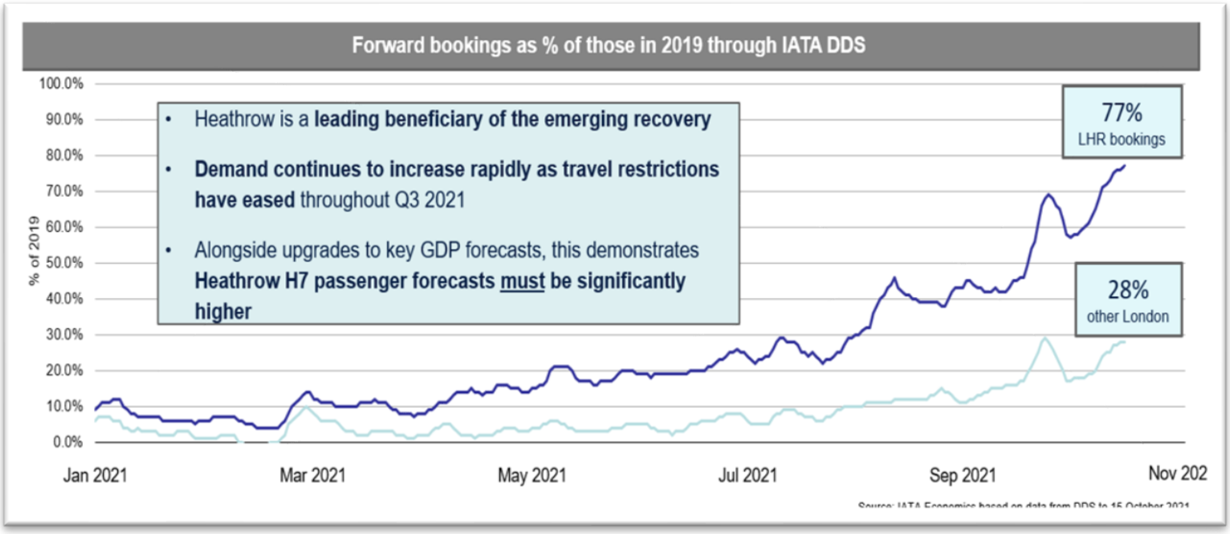
- That a more up to date GDP forecast is used.
- That there is little evidence to support a permanent shift in business behaviour based on the supporting evidence provided by HAL, and that the CAA should consider forecasts underpinned by GDP growth to be a more appropriate mechanism to capture any potential changes in business activity.

[9] Luis Gallego, IAG CEO, IAG Q3 2021 Financial Results
[10] Shai Weis, Virgin Atlantic CEO, 11th November 2021 (https://travelweekly.co.uk/news/air/virgin-atlantic-aims-to-grow-network-from-summer-2022)
[11] Lufthansa Group Q3 2021 Financial Results
[12] https://simpleflying.com/united-london-heathrow-expansion/, 28th October 2021
[13] Lucie Guillemette, Air Canada's Chief Commercial Officer, Air Canada Q3 2021 Financial Results
[14] https://www.businessinsider.com/delta-adding-a-dozen-transatlantic-routes-to-2022-schedule-2021-11?r=US&IR=T, 13th November 2021
[15] https://www.emirates.com/media-centre/emirates-to-recruit-6000-operational-staff-over-next-six-months-to-support-accelerated-recovery/, 25th October 2021
[16] https://travelweekly.co.uk/news/air/qantas-brings-forward-international-flights-relaunch, 15th October 2021
[17] https://travelweekly.co.uk/news/air/bamboo-airways-confirms-vietnam-london-flights, 3rd November 2021

- The use of the overlay Decay Function model potentially leads to an underestimate of traffic recovery which the CAA could challenge further.
- That Heathrow will outperform the UK, particularly in the near term as we see consolidation within and ad-hoc opportunities being taken within the UKs hub airport.

The below chart from IATA's Economics team illustrates how forward bookings have increased significantly since the CAA's forecast was made as the pent-up demand for travel has reacted to the lifting of travel restrictions in the UK.

Figure 2: Heathrow forward bookings growth (IATA Economics based on data from DDS, 15 October 2021)



Although not at full recovery, the recent alleviation of some restrictions has resulted in a strong rebound with UK international ticket sales for September reaching 71% of 2019 levels. In July, before UK government started to lift restrictions, UK international ticket sales were at only 32% of 2019 levels[18] . Although global reopening has been uneven and there is still a need for further alleviations from UK Government, the decisions taken at the last policy review now means we find ourselves in a much more stable situation, which in turn is providing passengers with more confidence to book. (see **Figure 2** for London ticket sales).

In addition, we are seeing further trends that show strong indications of an improving outlook

[18] IATA Report, Air Traffic Recovery Update: European Region, October 2021

Figure 3: Overall growth in passenger bookings (IATA Economics using DDS ticketing data, 11 November 2021)

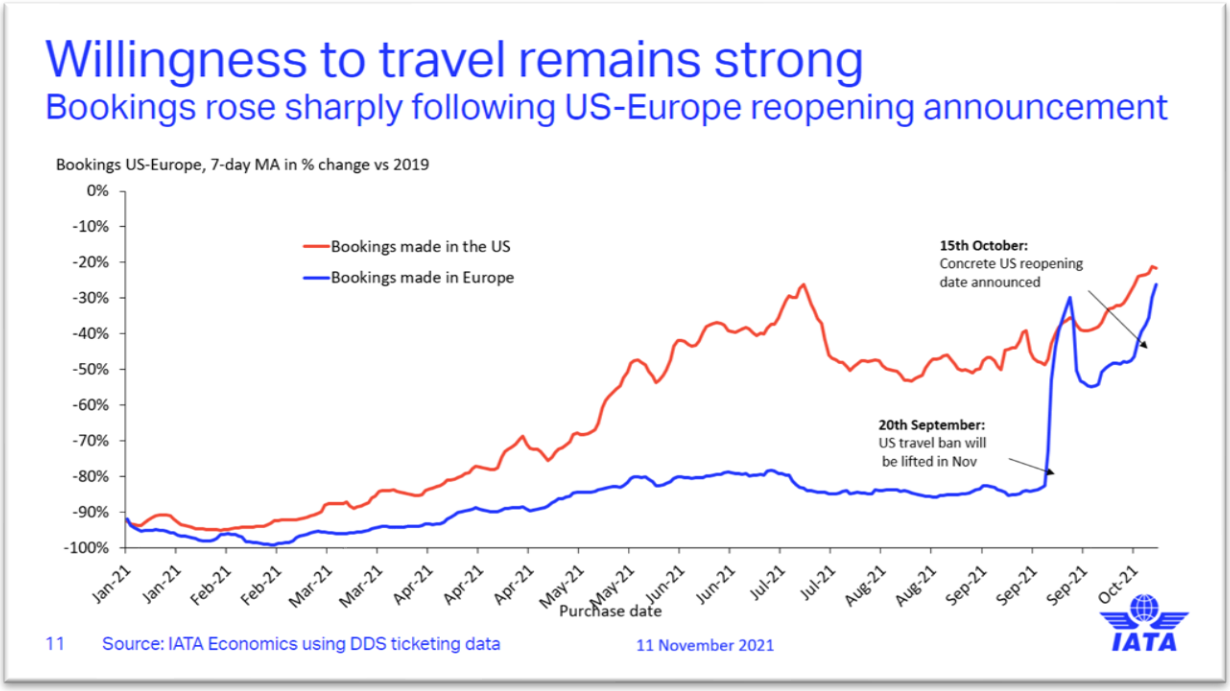


Figure 4: Growth in Aircraft Deliveries (Cirium Fleet Analyzer, 11 November 2021)

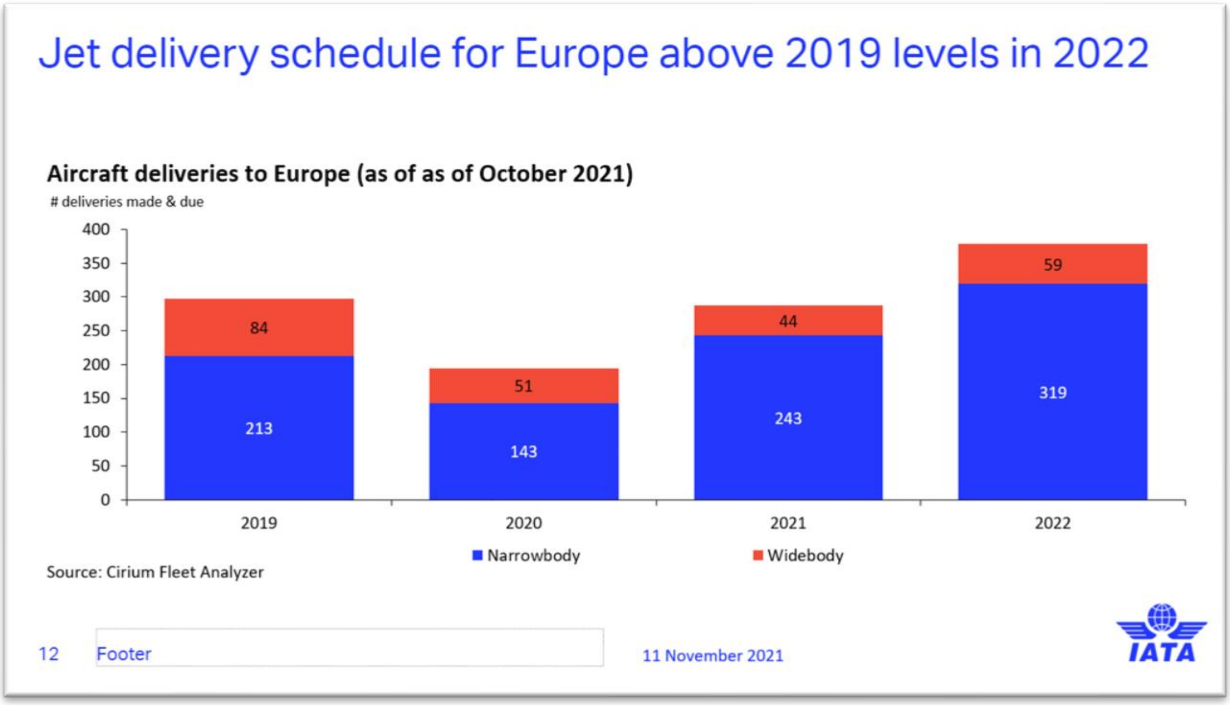
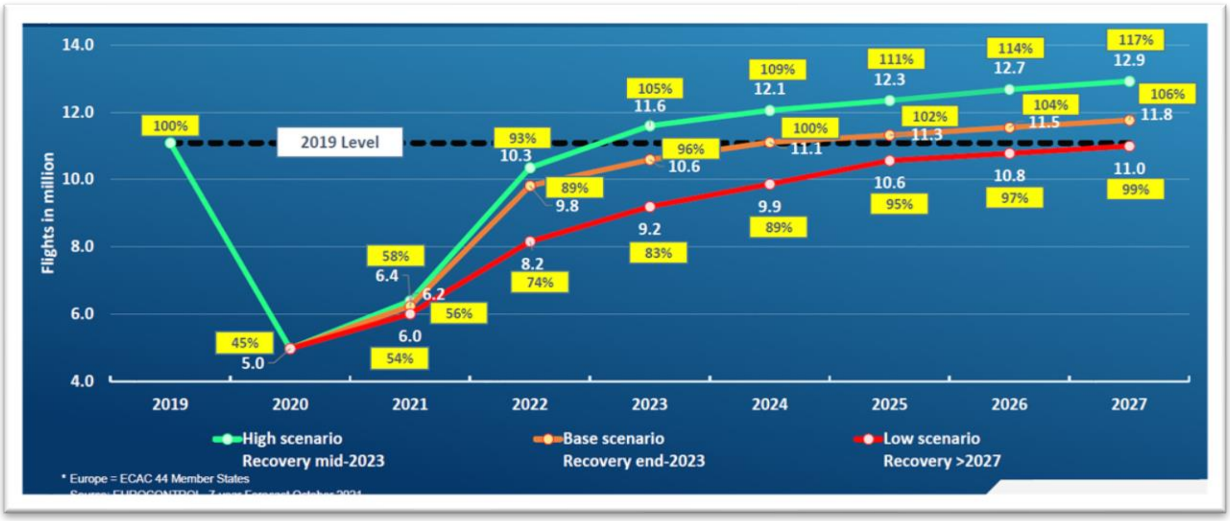


Figure 5: Heathrow seats on sale in Winter 2021 at 88% of 2019 levels (Capacity Data from DIIO (Cirium))

[redacted]

We refer the CAA to Eurocontrol's recently updated movement forecast from October 2021 (see below) which shows the Eurocontrol Base Scenario is forecasting ATMs to recover to 89% of their 2019 levels by 2022 and 100% of their 2019 levels by 2024. This is an upwards revision of 24% when compared to its previous assessment in May.

Figure 6 : Eurocontrol ATM Forecast (October 2021)



Both IATA and ACI Europe are now forecasting a level of 68% of 2019 passenger traffic in 2022 across Europe and from the whole of the UK. (See below latest forecasts). In the past Heathrow has bounced back significantly faster than the rest of the UK from downturns.

Figure 7: November 2021 IATA Forecast for the UK

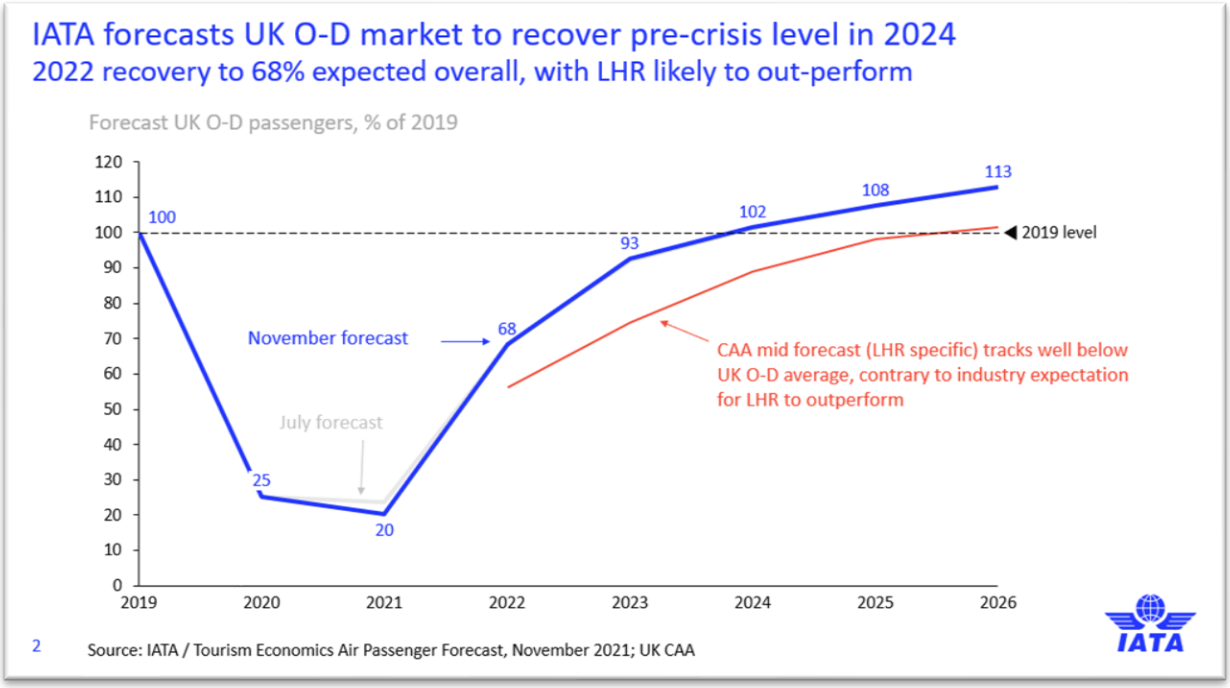
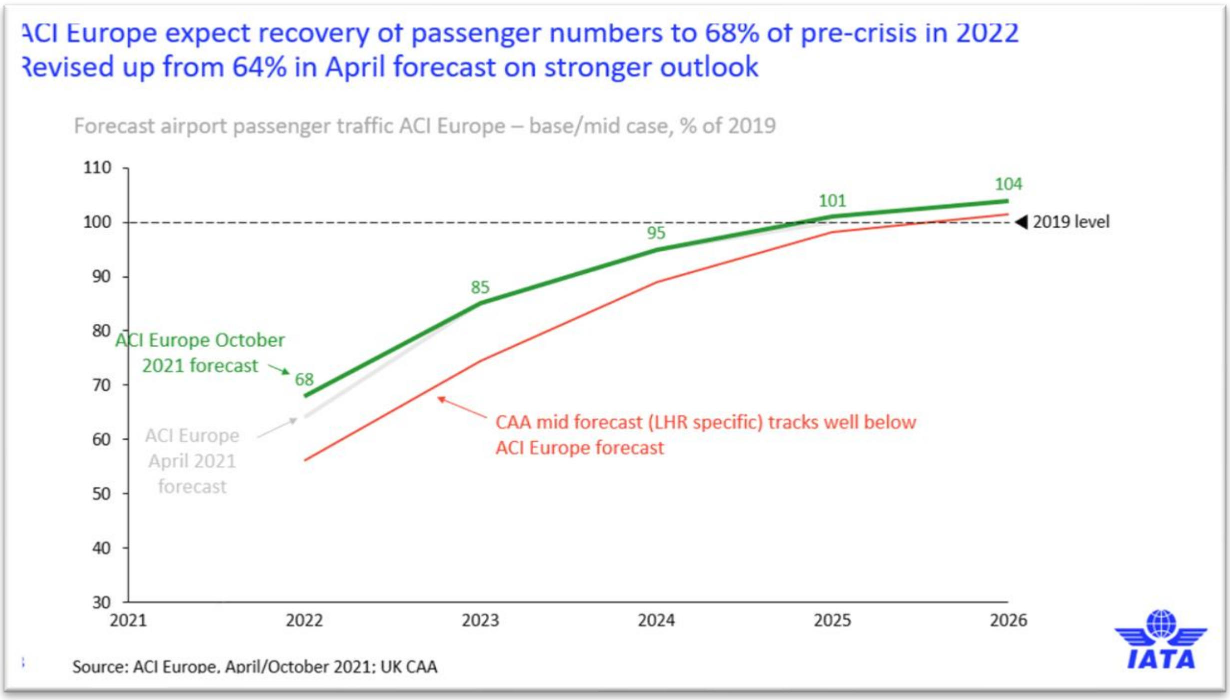


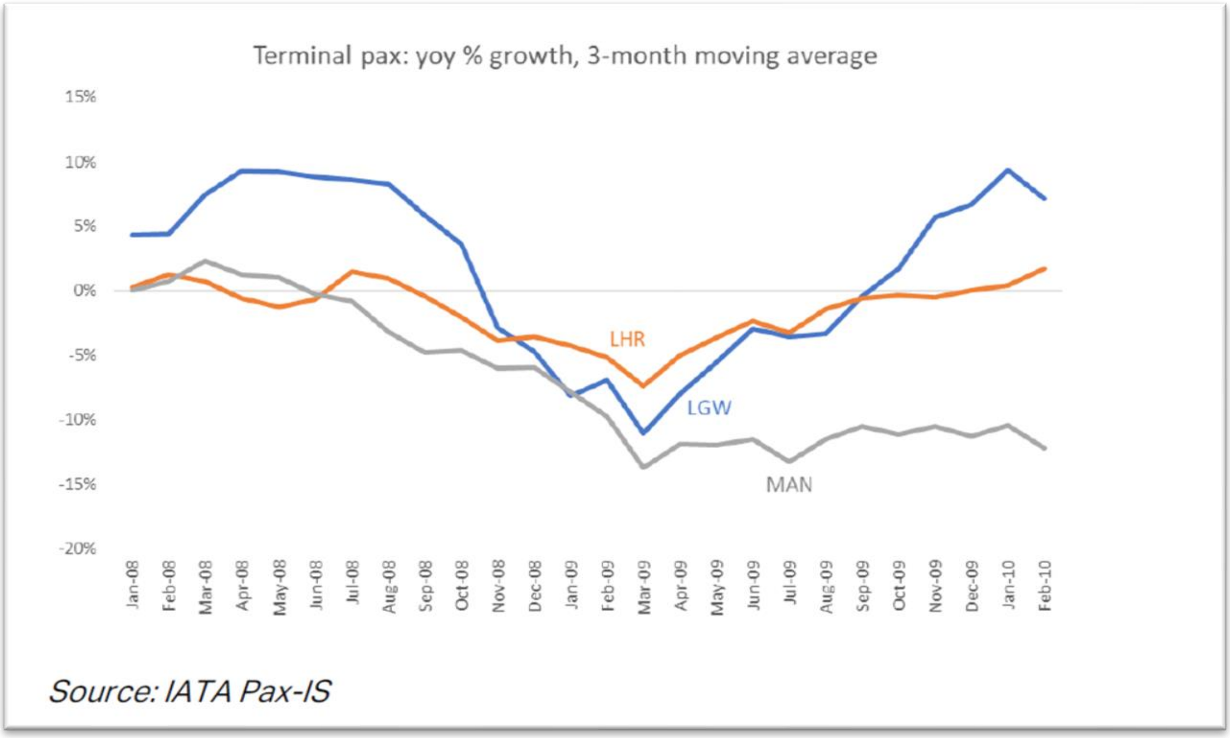
Figure 8: October 2021 ACI Europe Forecast for European passenger traffic



2.2.2 Heathrow Outperforms UK Assessment and seeing strong signs for 2022

The Airline Community have previously presented evidence on Heathrow's general resilience to shocks, as illustrated below.

Figure 9: Heathrow resilience compared to Gatwick and Manchester post 2008 GFC



Heathrow's comparative performance continues to show strong evidence of this trend continuing.

Figure 10: Heathrow 2021 resilience compared to Gatwick

Passengers 2021 vs 2020

	Jan-Sep 2020	Jan-Sep 2021	vly
Heathrow	18,975,014	10,162,525	-46%
Gatwick	9,461,469	3,121,097	-67%

Source: HAL website and CAA

Figure 11: Heathrow Outperforming the rest of the UK

Terminal Passengers 2021 vs 2019 (Rolling years)

	Oct 18-Sep 19	Oct 20-Sep 21	Fraction of 2019	Heathrow Outperform ratio
Heathrow	80.2m	13.3m	16.5%	1.3
UK Airports	296.8m	37.8m	12.7%	

Source: CAA

2.2.3 Heathrow Airlines are planning for 90% of 2019 traffic in 2022.

The below data from published schedules departing from LHR also illustrates the level of capacity growth the airlines that operate from Heathrow are scheduling into 2022 to respond to the increase in forward bookings, with capacity at up to 97% of 2019 levels for the same month. With consensus that pent up demand is at 2019 levels, and that capacity is approaching 2019 levels by April 2022 there is strong evidence to suggest a passenger forecast close to 90% of 2019 levels should be expected in 2022.

Figure 12: Heathrow 2022 Airline capacity plans

[redacted]

Source: DIIO

2.2.4 The Summer 2021 Coordination report and Capacity Declarations support strong growth.

ACL's Initial Coordination Report for LHR Summer 2022 shows that airlines are planning to operate capacity of 65m seats across just the Summer 2022 season. HAL's own Summer 2022 Capacity Declaration declares seat factors of between 80% and 93%. Taking the lowest seat factor in this range of 80% would achieve a total of 52m passengers in Summer 2022 alone.

Load Factors Summer 22

S22 Declared	T2 Domestic	T2 CTA & International	T2 Combined	T3 International		T4 International		T5 Domestic	T5 International (& Domestic Departure)	
Day of Week	A	A	D	A	D	A	D	A	A	D
1	89%	88%	89%	87%	91%	90%	90%	87%	87%	86%
2	83%	85%	87%	85%	90%	90%	88%	83%	86%	83%
3	80%	85%	87%	83%	91%	86%	88%	82%	86%	83%
4	81%	86%	91%	86%	89%	89%	90%	80%	87%	85%
5	85%	87%	90%	90%	92%	89%	90%	83%	89%	88%
6	86%	90%	92%	90%	93%	91%	90%	87%	90%	89%
7	89%	91%	91%	90%	92%	90%	89%	85%	89%	88%

Source: HAL S22 Capacity Declaration

2.2.5 Forecast US travel and tourism spending forecast to exceed 2019 levels in 2022.

A recent report by the World Travel and Tourism Council (12 Nov 2021) forecasts that the travel sector in the US is expected to grow by 28.4% in 2022 to a level that exceeds pre pandemic spending. With Heathrow's strong dependence on the US market, this is further evidence that both HAL and the CAA's traffic forecasts for 2022 are overly pessimistic.

2.2.6 Conclusion: There is strong evidence that traffic will be at 90% of 2019 levels in 2022 (72m).

The latest CAA data **(Figure 11)** demonstrates that total UK traffic was at 12% of 2019 levels in 2021, whereas Heathrow was at 16% of 2019 levels in 2021 (i.e Heathrow is recovering at 1.3 times faster than the rest of the UK.) If we apply this factor to the IATA UK traffic forecast of 68% of 2019 levels in 2022, then Heathrow should be at 88% of 2019 levels in 2022. This matches the capacity that airlines are planning for Heathrow **(Figure 12)**, the forward booking trends we have evidenced above **(Figure 2),** the Eurocontrol forecast **(Figure 6)** and the 20% pts difference we see in 2021 traffic recovery between Heathrow and Gatwick as also evidenced above **(Figure 10)**.

Given all of the above, we strongly urge the CAA to update their forecast in the light of the lifting of the UK's, US and global travel restrictions and to take account of the evidence presented by Skylark, and that we have presented, that passenger traffic in both 2022 and H7 will be significantly higher than that forecast in the CAA's Initial Proposals.

Consumers flying in 2022 should be protected against un-necessarily inflated charges – which, given the importance to the level of charge passenger forecasting has, would occur if the CAA maintains its current passenger forecast for 2022 and H7. The CAA cannot rely on its proposed Traffic Risk Sharing proposals, the merits of which are still being considered, to address the clear shortfall in the forecasts used within the Initial Proposals.

2.2.7 HAL Forecasting Model must be independently assured now

The Airline Community have raised our concerns with the CAA on the lack of transparency of HAL's model that forms the basis of the forecasting analysis[19]. Given such, we would strongly encourage the CAA to address this issue by either undertaking a fully independent evaluation of HAL's model or

[19] Airline Community Response to CAA Consultation CAP2139, Paragraph 1.2.2 (iii)

ensure full access is provided to the Airline Community in a timely manner to enable critical assessment and critique, prior to the CAA publishing its Final Proposals.

2.3 Reducing the Proposed Level of Charges

By making the evidenced based adjustments as set out within paragraphs 2.1 and 2.2 above, the only feasible outcome for consumers in 2022 is to offer a cap in line with the following adjustments:

We would further note that these adjustments should not impact the financeability of the notional company. Increased numbers of passengers should drive increased commercial revenues, and a lesser increase in Opex (due to the large, fixed element).

2.4 Further Areas to address

Whilst we have not explicitly addressed within this response, the Airline Community would highlight further areas within the CAA's Initial Proposals that we will be providing full and further commentary and evidence on, including the proposed range of the cost of capital which we strongly believe will evidence a lower level of charge for H7.

We would also note we remain opposed to the CAA's decision on HAL's request for a RAB adjustment. We have yet to see the purported benefits in financeability and Capital Expenditure and maintain the position stated in our previous responses on this matter.

We remain available and welcome the opportunity to discuss further the points and questions raised within.

Yours sincerely,

Gavin Molloy
Chair – LACC
London (Heathrow) Airline Consultative Committee

Nigel Wicking
Chief Executive – AOC
Heathrow AOC Limited