

22 December 2022

Response to CAP2488 – HAL 2023 Holding Price Cap

This document sets out the response of Delta Air Lines, Inc. (**Delta**) and Virgin Atlantic Airways (**VAA**) to proposals of the Civil Aviation Authority (**CAA**) to introduce an interim or holding cap for Heathrow Airport Limited's (**HAL**) airport charges for 2023, as set out in *CAP2488 - Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023* (the **2023 Holding Price Cap Consultation Document**).

While Delta and VAA agree that a holding price cap is necessary in circumstances where the CAA has yet to come to a final decision for the H7 period (**Final Decision**), Delta and VAA are disappointed both in the substantive position that the CAA has come to (applying a holding price cap that is too high and represents the mid-point of an old and flawed methodology) and the process that the CAA has followed to get to that position.

Delta and VAA consider that the timelines that the CAA have set suggest that it will not realistically have sufficient time to revisit the level of the holding price cap suggested in the 2023 Holding Price Cap Consultation Document, in response to the consultation responses it receives. This consultation closes three days before Christmas and the CAA envisages the price cap taking effect in February 2023. Given the statutory requirement that licence modifications may only take effect six weeks following the publication of the CAA's notice in relation to the licence modification,¹ this suggests that the CAA will have very limited time to do material work to amend the interim cap in light of consultation responses.

Moreover, Delta and VAA now understand that the CAA intends to issue its Final Decision for the H7 price control review together with the associated licence modifications early in 2023, and does not intend to consult further before making its Final Decision. All credible evidence suggests that there should be a downwards revision from the 2023 holding price cap. In those circumstances, and in light of the imminent conclusion to the H7 decision making process, Delta and VAA consider that the CAA should commit to promptly replacing the interim price cap with such lower cap that it ultimately finds appropriate. This would be a more straightforward and workable solution to further the interests of consumers than *maintaining* a higher interim cap past the point that the Final Decision is reached, and then relying on true-up mechanisms that apply two years thereafter.

In the remainder of this response, Delta and VAA set out comments as to: (i) why the interim charge is too high and the level has been chosen in error; (ii) the procedural shortcomings inherent in the 2023 Holding Price Cap Consultation Document; and (iii) suggestions as to how the CAA's process should conclude from this point.

1 The suggested holding price cap

- 1.1 Delta and VAA agree that a holding price cap is necessary in circumstances where there is no Final Decision on the H7 price cap: absent a price cap, consumers could expect HAL to set unconstrained monopoly prices for the passenger charge.

¹ Civil Aviation Act 2012, section 22(9).

- 1.2 Delta and VAA also agree with the CAA's disagreement in the 2023 Holding Price Cap Consultation Document regarding HAL's proposed interim charge of £36.00.² The CAA was right to highlight the flaws in HAL's proposals; HAL was wrong both to focus on its actual debt structure and in its analysis of how credit rating agencies would react to the level of a short term interim charge that is subject to a true-up mechanism.³
- 1.3 However, the interim cap suggested by the CAA is still demonstrably too high and therefore wrong. This follows from the responses made by Delta, VAA and the airline community to the CAA's CAP2365 – *Economic regulation of Heathrow Airport Limited: H7 Final Proposals* (the **Final Proposals**) and we do not repeat those arguments here. Critically, the CAA has been in possession of all the relevant evidence and arguments that would have allowed it to reach a decision on an interim charge without having to rely on flawed data and analysis that underpinned the Final Proposals. As the CAA recognises in the 2023 Holding Price Cap Consultation Document,⁴ there were issues in the data used to prepare the Final Proposals. Nevertheless, the CAA has proposed an interim cap for 2023 of £31.57, a price derived from those same Final Proposals.
- 1.4 In short, this means that the CAA has been provided with the evidence that demonstrates why this interim price cap is not set at the right level and is wrong. As Delta and VAA wrote in their response (dated 17 November 2021) to the 2022 interim charges consultation document contained as part of CAP2265 – *Economic Regulation of Heathrow Airport Limited: H7 Initial Proposals* (**2022 Consultation Response**): "The question of an appropriate price cap, including any holding cap of short duration, raises matters of detailed empirical evidence and analysis".⁵ It is not appropriate for the CAA to apply, year-on-year, interim price caps which are not supported by considered analysis of the relevant up-to-date evidence.

Passenger forecasts

- 1.5 The most material aspect in which the CAA must know that the interim price cap is wrong is in respect of passenger forecasts. As Delta and VAA have previously highlighted to the CAA,⁶ the Final Proposals, and thus the proposed 2023 interim charge, are based on pessimistic and outdated passenger forecasts.
- 1.6 Indeed, in its December investor report, HAL has increased its own passenger forecast for 2023 to 67.2 million passengers (unshocked) or 66.6 million passengers (shocked).⁷ Given that even HAL considers the 2023 number on which the interim price cap is calculated is too low, it is wrong for the CAA to continue to rely on an outdated and overly pessimistic figure.
- 1.7 The pessimistic nature of HAL's forecasting model is clearly evidenced when looking at the various iterations of its 2022 forecast. In HAL's second update to its revised business plan (referred to as "RBPu2" and dated December 2021), HAL forecasted 45.5 million passengers.⁸ In its response to the Final Proposals (dated 9 August 2022), HAL recognised that actual

² CAA, 2023 Holding Price Cap Consultation Document, December 2022, 2.6, pages 12.

³ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.3-2.6, pages 11-12.

⁴ CAA, 2023 Holding Price Cap Consultation Document, December 2022, Summary, paras 10-13, page 6.

⁵ Delta and VAA, 2022 Consultation Response, November 2021, para 1.12, page 3.

⁶ For example, in their responses to the CAA's Final Proposals.

⁷ Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report, December 2022, page 11.

⁸ HAL, RBP Update 2, December 2021, Table 7, page 58.

passenger numbers for 2022 would likely be higher: in the region of 54.4 million.⁹ HAL once again revised its 2022 passenger forecast as part of its Q3 financial results, noting that it was expecting 60-62 million passengers during 2022.¹⁰ HAL's most recent update to its 2022 passenger forecast, published in its December investor report and so with the benefit of actual data for most of 2022, expected passenger numbers to be at the upper end of its previously proposed range, at a level of 61.4 million (unshocked).^{11,12} HAL's repeated need to revise its 2022 forecasts upwards clearly demonstrates the pessimistic and flawed nature of its forecasting, which the CAA was wrong to rely on.

- 1.8 The expected number of passengers for 2023, assuming that the trajectory of recovery continues as expected, would not be 67.3 million as set out in the Final Proposals (or indeed the 65.2 million as proposed in the interim charge formula), but rather a good deal higher. It is not credible that the passenger forecasts as proposed in the Final Proposals (in June 2022) should continue to be used to inform the interim cap in circumstances where those forecasts are clearly outdated and materially underestimated the number of passengers flown even in 2022.
- 1.9 As the actual number of passengers at Heathrow shows, demand in 2022 has been strong despite the imposed capacity caps, continued Covid-19 restrictions in some parts of the world and industrial action in the UK.¹³ VAA estimates that 2023 passenger numbers are likely to be within the range of 76 to 79 million. This is based not only on VAA's consistent and robust internal forecasts (and which have proven to be more reliable than HAL's forecasts for 2022) but also on calculations it has undertaken based solely on independent industry forecasts, as explained further in the **Annex** to this response. While we understand that the CAA plans to revisit passenger forecasting when making its Final Decision for the H7 price control, it is not at all clear why *no adjustment whatsoever* has been made in coming to its view on an interim cap for 2023.
- 1.10 When updating the interim cap to take account of the latest available 2022 passenger forecast of 61.4 million and the mid-point of VAA's current 2023 passenger forecast of 77.4 million, Delta and VAA calculate,¹⁴ based on the models Delta and VAA have access to, the 2023 profiled yield would be reduced from £25.88 in the Final Proposals (based on 2020 prices) to £25.50. A proportionate change to the proposed nominal 2023 interim holding cap would result in a

⁹ HAL, Economic regulation of Heathrow Airport Limited: H7 Final Proposals (CAP2365), Heathrow's response, August 2022, Table 3, page 17.

¹⁰ Heathrow (SP) Limited, Results for the 9 months ended 30th September 2022, page 1.

¹¹ Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report, December 2022, page 4.

¹² Delta and VAA also note that HAL has presented a shocked forecast for 2022 of 60.7 million. It is not clear to Delta and VAA how such a wide variation between the unshocked and shocked forecasts can remain at this point in the year given that 2022 is almost complete.

¹³ The actual number of passengers travelling through Heathrow during 2022 is consistent with Heathrow's ability to recover relatively quickly from demand shocks. Post financial crisis, passenger numbers at Heathrow dropped less than 2% in the four-year period from 2007 to 2010, unlike Gatwick and Manchester which experienced drops of 11% and 17% respectively across the same period. The CAA also recognised this in its Final Proposals noting that "*demand at Heathrow has historically been more robust in the face of economic headwinds than that at the rest of the UK airports, helped by the pressure on airlines to protect valuable Heathrow slots*" (see CAA, Final Proposals, Section 1: Regulatory Framework, June 2022, Chapter 1, para 1.74, page 26). HAL's December 2022 investor report refers to HAL recording "*the busiest summer out of any European hub airport*", and notes that HAL's "*increase in passenger numbers this year [was] higher than at any other airport in Europe*" (see Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report, December 2022, page 5 and 9).

¹⁴ Delta and VAA also updated the forecasts in subsequent years since they will impact the profiled price in 2023. For consistency across years, we have also adjusted up the 2024 forecast to 79.25m. This is the mid-point between the mid-point VAA forecast for 2023 and the original FP forecast for 2025. These updates are indicative only.

reduction from £31.57 to £31.11. Of course, the pessimistic HAL forecasts used by the CAA also mean that the interim price cap for 2022 was set too high in the first instance.

- 1.11 In summary, the CAA must significantly revise upwards the passenger forecast relied upon to calculate the interim charge, because it is outdated, but also because it is unduly pessimistic, out of step with external industry forecasts and leads to an unjustifiable interim per passenger charge.¹⁵

Heathrow remains the most expensive airport in the world

- 1.12 The interim price cap proposed will allow HAL to continue to charge at a level even higher than the interim cap for 2022. Delta and VAA wrote in their 2022 Consultation Response:

“However, the Initial Proposals put forward by the CAA, to increase the charges of the world’s most expensive airport by a further 52% in 2022, simply cannot be justified. It is clear that the proposals are not in the best interests of consumers. Neither are they in line with the CAA’s statutory duty to carry out its functions in a manner that will further the interests of users of air transport services, particularly regarding the cost of airport operation services, or its duty to have regard both to the need to promote economy and efficiency on the part of operators of dominant airports, and to the principle that regulatory activities should be carried out in a way which is proportionate.

*To provide some context as to the extent to which consumers are already paying the highest charges in the world, in 2020, HAL’s total charges were 44% greater than the next most expensive European hub, Frankfurt, and the CAA’s proposals would see this gap widening even further, potentially to 83% in 2022”.*¹⁶

- 1.13 The sentiment continues to apply, and the CAA should, in finalising its work for H7, continue to be mindful of Heathrow’s position as the most expensive airport in the world and be very cautious about permitting any further unjustified and unsustainable increase in prices. With that in mind, Delta and VAA are pleased that the CAA has recognised that the *“proposal for the level of the holding price cap should not be interpreted as indicating that the CAA would necessarily take the view that the figure proposed as part of Final Proposals is the appropriate price cap for the full H7 period when we come to make the Final Decision on the H7 price control”*.¹⁷ It is clear that the appropriate price cap should be set significantly lower.
- 1.14 The 2023 Holding Price Cap Consultation Document suggests that the interim cap will be applied for 2023. However, in the days following its publication, the CAA made clear that its intention was to publish its Final Decision on H7 in “early” 2023. In the circumstances, it would therefore only be appropriate for a holding price cap to apply until there is a 2023 price cap resulting from the

¹⁵ This point was raised by Delta and VAA in their 2022 Consultation Response in the following terms: “Secondly, as the CAA itself recognises, the suggested price cap of £29.50 is based on an outdated passenger forecast. This is not a robust or lawful basis on which to take a decision, in particular when, as we have previously explained to the CAA, there is more up-to-date and reliable data available. In the current circumstances, where a matter of months can make a significant difference to the forecasts, the passenger forecast should be updated based on the most recent trends, particularly with the removal of travel restrictions. Consumers flying in 2022 should be protected against charges which have been significantly inflated purely because they have unnecessarily been based on incorrect and irrelevant figures.” See Delta and VAA, 2022 Consultation Response, November 2021, para 2.4.2, page 5.

¹⁶ Delta and VAA, 2022 Consultation Response, November 2021, paras 1.5 – 1.6, page 2.

¹⁷ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.13, page 14.

CAA's Final Decision which Delta and VAA would expect to be significantly lower. The CAA should therefore limit the duration of its interim price cap until that point.¹⁸

Present vs. future consumers

- 1.15 The CAA writes in the 2023 Holding Price Cap Consultation Document that *"the absence of a price control condition (even for a relatively short period of time) could create a conflict between the interests of "present consumers" travelling during the first half of 2023 and "future consumers" travelling later in the H7 period if the charges HAL sets for 2023 were to be very significantly different from those in the final H7 price control"*.¹⁹ It is wrong to suggest that that issue is wholly avoided by an interim cap. Indeed, given the CAA is clearly setting the interim cap too high, the conflict pertains: 2023 customers will overpay relative to later customers. Creating a situation where one cohort of consumers subsidises another, in the course of a price control period, because the CAA has not sought to set an interim price cap by reference to the best evidence, conflicts with the CAA's duty to protect consumers' interests.²⁰ This is not alleviated by the CAA's proposal that *"any difference between this holding price cap for 2023 and the Final Decision we take for H7 will be trued up or down as against the yield set out in our Final Decision"*,²¹ as such adjustments are not likely to be applied until 2025 and any over-recovery therefore benefits HAL at the expense of consumers in the short term.

2 The CAA process

- 2.1 In April 2021, the CAA published its 'Way Forward' document which, amongst other points, set out the CAA's proposed next steps for the H7 price control, in which the CAA stated its intention to set a 5-year price control, which would begin on 1 January 2022.²² In the twenty months since then, there have now been two consultations on interim price controls and every targeted date for publication of the major consultation documents has been missed.
- 2.2 Each round of delay comes at the expense of certainty for the industry at large, and the longer the CAA takes, the more review of prior evidence it will have to carry out (as the evidence base becomes increasingly outdated). The CAA suggests that, if it implements the interim charge as set out in the 2023 Holding Price Cap Consultation Document *"the wider H7 price review programme will continue at an appropriate pace"*.²³ This erroneously suggests that the CAA's pace has been appropriate to date. It is in the interests of all stakeholders that the CAA does reach the Final Decision in good time, and Delta and VAA set out some comments on the way forward in Section 3.

¹⁸ There is also reference in the 2023 Holding Price Cap Consultation Document to the interim price cap protecting consumers *"travelling during the first half of 2023"*, which is erroneous if the intention is for the price cap to apply for the full year. See CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 1.14, page 10).

¹⁹ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 1.14, page 10.

²⁰ As noted above, this is what has happened to passengers flying in 2022.

²¹ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.16, page 14.

²² CAA, Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward, April 2021, para 13, pages 8-9.

²³ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.18, page 14.

Certainty for customers and airlines

- 2.3 In its 2023 Holding Price Cap Consultation Document, the CAA writes: “*Certainty over HAL’s charges for 2023 also enables airlines to set ticket prices and organise their services, which ultimately provides benefits for consumers*”.²⁴ As the CAA will be aware, airlines have planned their schedules for 2023 and already sold tickets for flights in 2023 to and from Heathrow.
- 2.4 Even if airlines only sold tickets for flights a week or so ahead, the CAA’s consultation is too late to be properly effective at the beginning of 2023. In general, HAL consults on the *actual pricing*, given it can price *up to* the cap, and so time should be allowed for that process. Of course, given HAL’s position, Delta and VAA expect that HAL will continue to price at the cap. Finally, the licence modification required to implement the interim price cap can only take effect after six weeks from the date on which the notice of the licence modification is published.²⁵ That means that the CAA (and consumers) are relying on HAL to abide by “the spirit of” the CAA’s decision further to this consultation. The CAA does not address this directly, or suggest what safeguards it would put in place, but only notes that “*We expect the new holding price cap for 2023 will come into effect during February 2023*”.²⁶ Delta and VAA would expect that any final decision for a 2023 interim cap addresses this point directly.
- 2.5 This concern should not come as a surprise to the CAA. In their 2022 Consultation Response, Delta and VAA explained:
- “We are in the latter part of November and, through no fault of our own, are still no clearer in knowing what price airlines will be expected to charge consumers in the way of Maximum Allowable Yield (“MAY”) at Heathrow from the 1st January 2022. Notwithstanding the particular circumstances of the pandemic, this consultation has been severely delayed and, together with HAL’s unhelpful position on 2022, this delay has left airlines and consumers in the dark as to what level of charges will be ultimately levied. As an airline, we are therefore unable to take informed commercial decisions as to how to approach charges going forward. This issue affects all tickets being sold for flying at any point in 2022.”*²⁷
- 2.6 The only differences this year are that the 2023 Holding Price Cap Consultation Document has come at an even later point in the year, and the particular circumstances of the Covid-19 pandemic provide less of a reason for a delay.

Transparency

- 2.7 Delta and VAA have made prior submissions to the CAA as to the transparency of its consultation processes. On a number of occasions, they raised concerns about the lack of clarity in the CAA’s methodology, and the information asymmetry between HAL, the CAA and other stakeholders.²⁸ In particular, the airlines have raised repeated concerns about the lack of access to the HAL passenger forecasting model, the key input for estimating the passenger forecasts. Despite Delta

²⁴ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 1.14, page 10.

²⁵ Civil Aviation Act 2012, section 22(9).

²⁶ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.20, page 15.

²⁷ Delta and VAA, 2022 Consultation Response, November 2021, para 3.1, page 6.

²⁸ See, for instance, Delta’s and VAA’s Joint Response to the Final Proposals, 9 August 2022, para 1.19.1, 1.19.5 and 1.19.9, pages 4-6.

and VAA, together with British Airways, requesting access to the model in letters sent to the CAA on 20 July 2022 and 12 October 2022, these letters have not received any meaningful engagement from the CAA.

- 2.8 In that regard, Delta and VAA note that the 2023 Holding Price Cap Consultation Document made frequent reference to letters sent by HAL to the CAA which, inter alia:
- (a) Stated that HAL would be amenable to a holding price cap of £31.57 (18 October 2022) and then,
 - (b) Suggested instead that the interim price cap should be £36.00 *"to reflect higher passenger number forecasts together with the impact of inflation and interest rate expectations"* (9 November 2022).²⁹
- 2.9 As noted above, Delta and VAA agree with the points made by the CAA in paragraph 2.6 of the 2023 Holding Price Cap Consultation Document, albeit that they do so without sight of either of the letters in question. Given that these letters were wholly and directly part of the consultation process for H7 and go to the heart of the price cap level that should be set by the CAA for HAL, Delta and VAA expect that these will be published on the CAA website imminently. It is contrary to the principles of good regulation that such documents are not published immediately so that other stakeholders are able to comment on them.
- 2.10 If other stakeholders had been able to comment, in good time, on the proposals being discussed between the CAA and HAL, views as to the correctness of using outdated passenger forecasting data could have been given due consideration in the 2023 Holding Price Cap Consultation Document. As it was, airline views were given very little consideration, with the true up mechanism given undue prominence as a cure for the likely overcharging of customers travelling in 2023.
- 2.11 Instead, given that its intention is to *"publish details of our decision on the matter of the holding price cap for 2023 as soon as reasonably possible after the close of this consultation"*,³⁰ and there are only four working days between the end of the consultation and the expiry of the current cap, it is hard to see how the CAA has left itself enough time to consider issues raised by consultees.

3 Wider process for H7

- 3.1 Delta and VAA can see the need for an interim price cap to avoid there being any period where HAL is able to set prices without constraint, but, as above:
- (a) the cap is too high, and based on outdated evidence, and so must be wrong; and
 - (b) the process continues to be beset by a lack of transparency and efficiency.
- 3.2 In terms of the wider H7 process, the CAA wrote in the 2023 Holding Price Cap Consultation Document that:

²⁹ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.5, page 11.
³⁰ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 16, page 7.

- (a) *“If the CAA decides to implement the modifications set out in this notice, the wider H7 price review programme will continue at an appropriate pace with the aim of allowing both the CAA’s Final Decision and any appeal to the CMA to be concluded during 2023”;*³¹ and
- (b) *“We intend that this holding price cap will remain in place for the entirety of 2023.”*³²

3.3 A week into the two week consultation process, the CAA then wrote to stakeholders to say:

*“we currently intend to issue the final determination for the H7 review together with the associated licence modifications early in the new year. That document will include our assessment of the responses to the Final Proposals, our updated views on passenger forecasts and our assessment of the latest macroeconomic forecasts. We do not intend to consult further before making the final determination.”*³³

3.4 These two sets of statements, made roughly a week apart, present very different pictures of the wider H7 process. The 2023 Holding Price Cap Consultation Document suggests that no Final Decision is imminent, and that a holding price cap is required for the duration of 2023. The later statement suggests that the CAA does not see the need to undertake any further consultation – and therefore must be close to issuing a Final Decision – and that it considers that it will do so in early 2023.

3.5 Frustratingly, the CAA has not actually given any detail on the expected timing for a Final Decision. Without clarity as to the next steps in the H7 process, it becomes impossible for stakeholders to comment sensibly on the CAA’s approach. In circumstances where a Final Decision is imminent, it becomes very unclear as to the rationale for having a holding price cap for a full year (instead of the *actual* cap, based on the CAA’s Final Decision). If, for example, the CAA reached a Final Decision on 1 January, then choosing to prefer a higher *interim* price cap level to the actual price cap level for 2023 would be irrational.

3.6 As it is not clear to Delta and VAA what work will be conducted in the run up to the CAA’s Final Decision, Delta and VAA wish to take this opportunity to bring to the CAA’s attention an error that appears to have been made in respect to the cost of index-linked debt. It appears that the CAA’s starting point for the calculation of cost of index-linked debt is nominal cost fixed-rate debt. In order to calculate the real cost of index-linked debt, the CAA added a positive premium, to reflect that index-linked debt is more expensive than nominal debt.³⁴ However, index-linked debt should carry a negative premium, as it removes inflation risk and should be cheaper than nominal debt.

³¹ CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.18, page 14.

³² CAA, 2023 Holding Price Cap Consultation Document, December 2022, para 2.15, page 14.

³³ Email (Subject: H7 next steps) sent from Robert Toal <Robert.Toal@caa.co.uk> on 14 December 2022 at 10:09 to: Chris Annetts <chris.annetts@heathrow.com>; Mike King <mike.king@heathrow.com>; regulation <regulation@heathrow.com>; Lucy Squire <lucy.squire@heathrow.com>; Manish Madhas <manish.madhas@heathrow.com>; Gavin Molloy <gavin.molloy@ba.com>; Alexander Dawe <alexander.dawe@ba.com>; Matthew Webster <Matthew.Webster@fly.virgin.com>; David Hill <DavidHill@aoc-lhr.co.uk>; Workman, Rhett <rhett.workman@aa.com>; Nigel Wicking <nigelw@aoc-lhr.co.uk>; Simon Laver <lavers@iata.org>; Simon Scoggins - SRScoggins <simon@srscoggins.co.uk>; Matt Davies - BA matt.davies@ba.com, Cc: Paul Smith <Paul.Smith@caa.co.uk>; Andrew Walker <Andrew.Walker@caa.co.uk>; Kalpesh Brahmabhatt (CMG) <Kalpesh.Brahmbhatt@caa.co.uk>; Charlotte King Charlotte.King@caa.co.uk, CC: Paul Smith <Paul.Smith@caa.co.uk>; Andrew Walker <Andrew.Walker@caa.co.uk>; Kalpesh Brahmabhatt (CMG) <Kalpesh.Brahmbhatt@caa.co.uk>; Charlotte King <Charlotte.King@caa.co.uk>.

³⁴ CAA, Final Proposals, Section 3: Financial issues and implementation, June 2022, Chapter 9, paras 9.209 – 9.213 and Figure 9.2, pages 47-48.

Accordingly, the premium on index-linked debt should be negative (to reflect lower costs of taking index-linked debt).

3.7 Delta and VAA also note that at the time of making its April 2021 RAB adjustment decision (CAP2140 – *Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment*) (the **RAB Adjustment Decision**), the CAA stated that:

- (a) *“If evidence were to emerge of HAL failing to deliver on quality of service then we will take steps to further protect the interests of consumers by conducting a review of these matters (and we would seek to protect consumers from the costs of any such failures). This should help further incentivise HAL in delivering an appropriate level of investment and quality service to consumers”*; ³⁵ and
- (b) *“...This [review] would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in a timely way and maintained service quality. In the event that such a review were to show that HAL had not responded appropriately, including in respect of service levels where this is within HAL’s control, we would look to introduce additional protections around service quality in H7 and we would consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue. The existing Service Quality Rebates and Bonus scheme provides metrics that can help to give an early indication of any issues with service quality”*. ³⁶

3.8 To Delta’s and VAA’s knowledge, the CAA has not yet conducted a review of its RAB Adjustment Decision despite committing to do so if clear evidence were to emerge that HAL had failed to deliver on investment or quality of service (and that it would seek to protect consumers from the costs of any such failures).

3.9 The evidence that has emerged over the past two years (in particular during the 2022 summer season) unequivocally shows that HAL failed to properly prepare and invest in 2021 for the eventual increase in passenger numbers following the Covid-19 pandemic, with HAL having failed to provide sufficient capacity to meet forecasted demand and having delivered an extremely poor level of service quality following the re-opening of international travel. By way of example: for a period of 6 months from May 2022 to October 2022, HAL missed every target for security queue performance across all terminals at Heathrow. ³⁷ This sustained failure to meet the required performance standard demonstrates that HAL has failed in its duties to serve consumers including by not investing the RAB adjustment in such a way as the CAA had originally intended in its RAB Adjustment Decision. ³⁸

3.10 The CAA should conduct a thorough review of these matters ahead of issuing its Final Decision for the H7 regulatory period. Failing to do so, and failing to reverse the RAB Adjustment Decision,

³⁵ CAA, RAB Adjustment Decision, April 2021, para 4, page 7.

³⁶ CAA, RAB Adjustment Decision, April 2021, para 32, page 13.

³⁷ For clarity, this does not take into account Terminal 4 June 2022 performance as Terminal 4 opened part way through the month. See <https://www.heathrow.com/company/about-heathrow/performance/airport-operations/central-security-queues>.

³⁸ These issues with security were highlighted by VAA repeatedly on bilateral calls with the CAA throughout the summer and also summarised in the presentation by the Airline CEOs to members of the CAA Board on the 11 October 2022.

has caused and will continue to cause significant harm to consumers both in the short and the long-term.

3.11 There are, of course, other inputs into the Final Proposal's price cap with which we disagree and made clear to the CAA in Delta's and VAA's responses to the Final Proposals. These remain and will further reduce the price relative to the Final Proposals. We look forward to these being addressed in the CAA's Final Decision.

3.12 In light of the above, Delta and VAA would request that:

- (a) the CAA publishes a timetable for its Final Decision and indicates what, if any, further work it is doing at this stage;
- (b) the CAA reviews HAL's service quality, in line with the commitment made in the RAB Adjustment Decision;
- (c) the CAA commits to utilising an interim price cap *only* for the period before it reaches a Final Decision, so that there is no period when a higher interim cap is being preferred to the actual cap imposed by the CAA;
- (d) to the extent that the Final Decision timetable means that applying (c) above means the holding price cap suggested in 2023 is for a matter of weeks, the CAA simply rolls over the existing 2022 holding price cap; and
- (e) any over-collection of per passenger yield by HAL should be returned to passengers at the earliest opportunity once a Final Decision has been made in 2023 (through lowering the per passenger charge).³⁹

³⁹ As previously raised with the CAA, including in the presentation to the CAA Board in October 2022.

Annex

VAA additional passenger forecasting and data for 2023

This annex summarises VAA's updated passenger forecast for Heathrow for 2023 as well as presenting an external industry-based forecast.⁴⁰

1 VAA passenger forecast

- 1.1 The updated VAA passenger forecast is based on the same methodology as outlined in Appendix 1 of Delta's and VAA's joint response to the Final Proposals. In summary, VAA's methodology is based on applying modelled load factors to sale capacities where available and then forecasting capacities beyond the current on-sale period (which is currently to October 2023). Overlays for suppressed demand owing to Covid-19 restrictions as well as the Russia-Ukraine conflict are included alongside overall market dampening. The overlays are discussed in more detail below.
- 1.2 Heathrow's average load factor since 2005 has been 74% and typically follows the same peak pattern throughout the calendar year. The years 2019 (with an average of 79%) and 2022 (with an average of 75%) have been used as a baseline to forecast load factors for 2023, applying a monthly weighting to map to historic patterns and a recovery rate factor based on 2022 vs 2019. On this basis, the load factor across all flights for the 2023 forecast is 77% (vs 79% in 2019).
- 1.3 Capacity on sale has changed markedly over 2022 owing to various market caps and external pressures. Applying forecasted load factors to on-sale capacity as of May 2022 would have yielded forecasted annual passenger figures of 65.1 million for 2022. Reductions in capacity as of July 2022 (due to the HAL-imposed capacity restrictions) led to initial VAA forecasts of 61.6 million. Now, in December, HAL has updated its 2022 forecast to 61.4 million passengers.
- 1.4 The VAA model forecasts 77.4 million passengers for 2023. This assumes there will be no change to the current capacity in markets affected by strict Covid-19 travel regulations as well as no change to markets and/or routes affected by the Russia-Ukraine conflict. This is illustrated in Table 1 below.

Table 1: VAA's 2023 passenger forecast based upon current travel restrictions (on a monthly basis)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2019	5.9m	5.5m	6.5m	6.8m	6.8m	7.2m	7.8m	7.7m	6.8m	7.0m	6.2m	6.7m	80.9m
2022	2.6m	2.9m	4.2m	5.1m	5.3m	6.0m	6.3m	6.0m	5.8m	5.9m	5.6m	6.4m	61.9m
2023	5.6m	5.2m	6.4m	6.5m	6.5m	7m	7.5m	7.4m	6.5m	6.7m	6m	6.4m	77.4m

Forecasted data denoted by shading

- 1.5 If China and other Asian markets were to fully remove travel restrictions between now and 2023 with Chinese carriers maintaining Russian overflight rights, the model forecasts annual passenger numbers of around 80 million (in line with 2019 levels). This is illustrated in Table 2 below.

⁴⁰ The information contained in this annex is based on the latest available data.

Table 2: VAA's 2023 passenger forecast based on the lifting of travel restrictions in Asia (on a monthly basis)

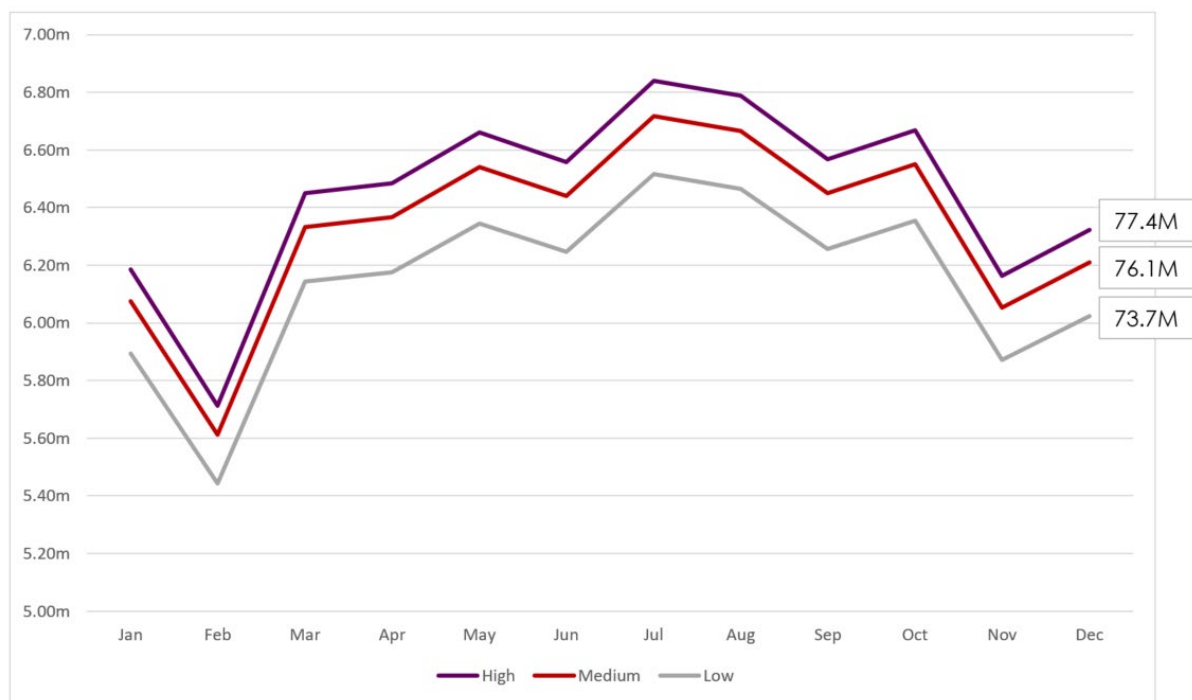
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
2019	5.9m	5.5m	6.5m	6.8m	6.8m	7.2m	7.8m	7.7m	6.8m	7.0m	6.2m	6.7m	80.9m
2022	2.6m	2.9m	4.2m	5.1m	5.3m	6.0m	6.3m	6.0m	5.8m	5.9m	5.6m	6.4m	61.9m
2023	5.6m	5.2m	6.5m	6.8m	6.8m	7.4m	7.7m	7.0m	6.9m	6.7m	6.5m	6.5m	79.7m

Forecasted data denoted by shading

2 External passenger forecast

- 2.1 VAA has also prepared a passenger forecast for 2023 based solely on independent industry forecasts from Oxford Economics/IATA.
- 2.2 Oxford Economics/IATA's latest UK air passenger forecast specifies low, medium and high scenarios for total UK air travel recovery.⁴¹ Applying these scenarios to Heathrow's 2022 passenger numbers, weighting them to reflect Heathrow's proportion of UK traffic, alongside a correction factor to account for Heathrow's more detached relationship with the UK economy gives rise to a 2023 passenger forecasts ranging from 73.7 million to 77.4 million. This is illustrated in Figure 1 below.

Figure 1: 2023 passenger forecast based on Oxford Economics/IATA forecasts (on a monthly basis)



- 2.3 This forecast is based solely upon economic indicators and available capacity as of November 2022. The underlying forecast does not include industry upside potential based upon airlines adjusting yield. This would lead to a drop in average ticket price that would likely see further rises

⁴¹ The latest Oxford Economics/IATA forecast is from November 2022.



in air passenger demand. As such, VAA believes this to form a worst-case unshocked scenario for 2023.

3 Summary

Looking at both forecast methodologies, alongside other wider industry and economic forecasts, VAA considers that 2023 passenger numbers are likely to fall between 76 and 79 million. This is a significantly higher amount than the passenger forecast of 67.3 million in the Final Proposals and the 67.2 million passengers (unshocked) which HAL has most recently forecasted for 2023.