

EDITED FOR CONFIDENTIALITY

[] INDICATES A REMOVAL

25th April 2019

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Dear Simon,

Thank you for the proposed offer for the iH7 period (“rebate agreement”). We are supportive of HAL’s plan to reach commercial agreement with airlines, reducing the burden on the CAA and allowing us all to focus on the expansion.

We believe that consumer benefit and the CAA’s obligations under CAA12 are optimised in iH7 by returning over-earn as directly as possible to those consumers most affected.

This is achieved when complying with the following principles:

1. Returning the rebate as closely as possible to the competitive industry sector closest to the relevant consumer: airlines
2. Providing certainty to airlines, which will allow them to compete with clarity of rebate and on an equal playing field during the iH7 period.
3. Returning the rebate as closely as possible to the airlines responsible for the over-earn so that it is more likely to flow through to those consumers contributing to the over-earn.
4. Returning the rebate during the iH7 period so that it returns to the consumers driving the over-earn, not future consumers in subsequent regulatory periods.

SUPPORT FOR CONCEPT OF COMMERCIAL AGREEMENT

We support the concept of a rebate agreement within the iH7 period []. In line with principle (2) above, an early agreement gives the industry certainty, clarity, and in a competitive market maximises flow-through of the rebate to iH7 passengers rather than deferring the benefit to H7 passengers.

ISSUES

We have a number of concerns with the proposed rebate agreement. Given that our concerns clearly align with consumer interest, we are optimistic that we can resolve these issues with HAL and the CAA.

We have not been granted the opportunity to raise or negotiate concerns on commercial aspects of the proposed rebate agreement through a consultative process or negotiation. After we were presented with the offer, the initial time frame communicated by HAL for a decision did not allow for a detailed analysis of the methodology and forecasts by all airlines. This may have resulted in over-reliance on Heathrow’s growth forecasts.

We are raising these concerns with a view to reaching a new agreement acceptable to the airlines signing this letter. These airlines comprise around ____of passenger revenue, and ____of seat capacity at LHR.

KEY CONCERNS

1. **Apportionment Method:** The apportionment methodology proposed in the rebate agreement is not consistent with principle (3) above as it re-distributes revenue on the basis of passengers carried, rather than proportionately to reflect airport charges paid and there is a material difference between the two.
2. **Volume Rebate:** The combination of a conservative forecast, growth hurdles and a sharing methodology mean that HAL is likely to retain a significant portion of the over-earn that should be returned to airlines, this being inconsistent with principle (1) above.
3. **H7 Impacts:** There is a risk of HAL giving with one hand and taking with another if pricing is reset in H7 to recoup the benefit conferred during the iH7 period under the proposed rebate agreement (as highlighted in paragraph 1.30 of the CAA's paper *Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements (CAP1769)*). Without a clearer commitment from HAL, who should understand the market and their balance sheet, we do not have adequate information to assess this risk.

DETAIL OF CONCERNS & PROPOSED RESOLUTIONS

1. Apportionment Methodology

Under the proposed rebate agreement, the proposed over-earn is re-distributed to airlines based on passenger numbers rather than surplus contribution received from each airline during iH7.

Long-haul passengers pay roughly three times the amount paid by UK domestic passengers and two and a half-times the amount paid by carriers on EU routes. In addition, home-based carriers receive substantially lower average aeronautical prices due to their ability to target connecting passengers (which are heavily discounted by HAL, particularly in Winter). We estimate that ex-EU passengers represent approximately 50% of HAL's passenger volumes, but contribute in excess of 70% of the airport's aeronautical revenue.

This skew is in addition to the existing differential in the Air Passenger Duty which is an even higher multiple and noting that key non-aero market passengers also come from longhaul markets.

As foreign based airlines, we are unable to carry passengers other than on ex-EU routes and have a materially lower ability to attract transfer passengers, thereby paying a materially higher average aeronautical contribution to HAL for a comparable service. During the iH7 period, the proposed apportionment method is likely to result in a transfer of value from:

- i) Airlines that operate long-haul routes to airlines that operate short-haul routes; and
- ii) Foreign carriers to home carriers.

On the assumption that competitive pressures between airlines will likely result in the flow-through of rebates to passengers, this could further skew passenger demand by benefiting:

- i) short-haul travellers over long-haul travellers; and
- ii) travellers on home-based airlines over foreign-based airlines,

This is contrary to the CAA's obligations under the Civil Aviation Act 2012 (CAA12) to protect all consumers and to promote competition in the provision of airport operation services.

Additionally, given different point-of-sale strengths, this could ultimately impact visitor numbers due to the preferencing of transfer traffic and the point of sale strength/brand of home-based carriers.

Accordingly, we seek an amendment of the apportionment methodology to allocate the rebate according to each airlines' revenue contribution to HAL.

2. Volume Rebate

We believe that HAL has underestimated its likely over-earn and that the Volume Rebate in the proposed rebate agreement will result in HAL capturing a large share of the likely incremental over-earn; reducing the chance for benefits to flow to iH7 passengers. This does not align with principle (1).

a) Baseline Over-earn

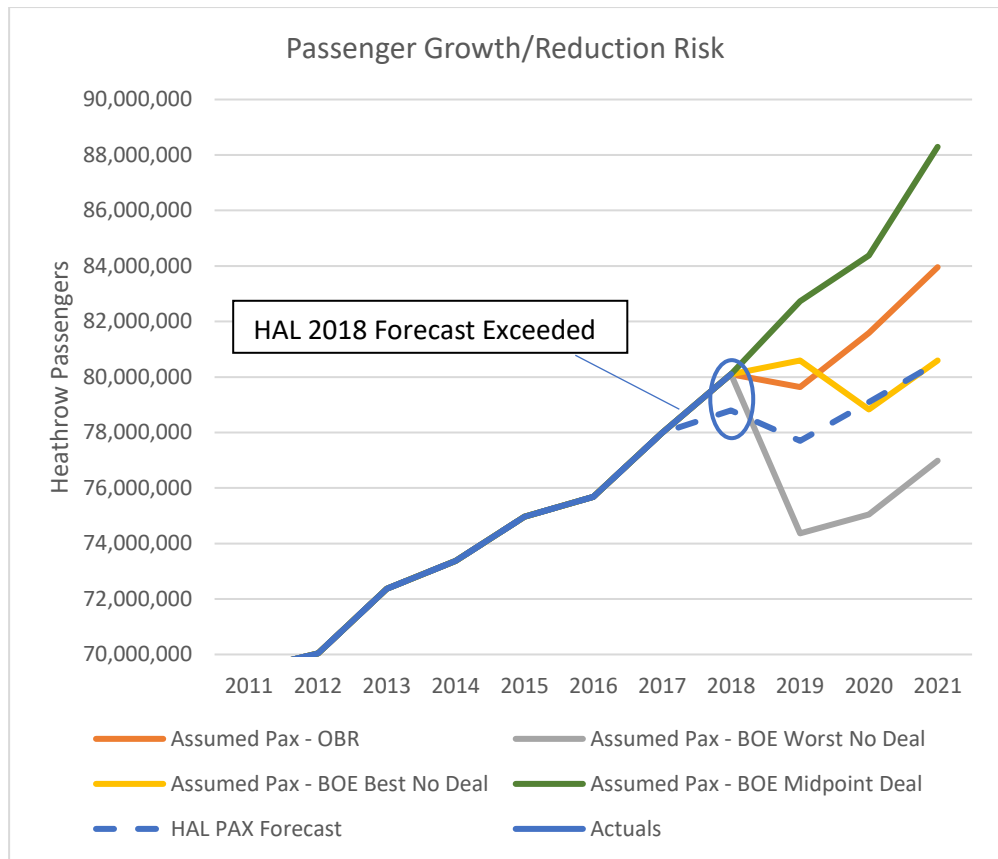
We believe LHR's over-earn is likely to be substantially higher than that forecast to the CAA.

- i. As you are aware, the 2018 forecasts provided by HAL to the CAA have already been exceeded.
- ii. In recent years, HAL's publicly available passenger numbers have correlated predictably with the UK's GDP in Pounds. Using the formula below gives us an R² of 0.981 on data to 2011.

$$y = 298,695,930.79650900x^3 - 1,620,720,437.74911000x^2 + 2,945,959,066.51508000x - 1,720,727,402.76471000$$

- iii. When we apply this correlation to a range of GDP forecasts around Brexit, we find HAL's traffic forecast to be pessimistic.¹ At the current time, 2018 has outperformed the index, Brexit has been delayed, and parliament has voted against no deal. We also note that whilst Brexit is likely to impact passenger growth, it may also increase non-aeronautical revenue per passenger.

¹ Estimates derived from published graphics, application of published growth estimates to existing published data and otherwise using reasonable efforts. Data may not be accurate and recipients should undertake their own research. Sources (<https://qz.com/1444298/the-outlook-for-the-uk-economy-after-brexit-looks-bleak/>, <https://www.bankofengland.co.uk/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability>)



- iv. It is possible that HAL’s planned over-earn could be materially higher in the event of a deal or a remain scenario (up to doubled)
- v. Under the current methodology, only the original estimated over-earn (£260m of £295m) will be fully returned to customers. This reflects the over-earn up to the blue HAL forecast passenger line.
- vi. Any over-earn where traffic exceeds the dashed blue line above will not be fully returned to airlines and will fall under the ‘Growth Rebate’ provision which is subject to conditions, and which is shared between HAL and airlines. This means the full share will not be returned to airlines, a deviation from principle (1). Details are below.

Conditions On Over-Earn

Beyond the conservative baseline over-earn, each airline is required to grow to access the ‘Volume Rebate’ that provides for over-earn above HAL’s conservative baseline.

As Heathrow is slot-constrained, growth is principally limited to two means:

- i) Up-gauging of Aircraft

Only possible where airlines are not already operating their largest aircraft or the largest aircraft capable of that sector-length. Many long-haul carriers already operate under these conditions. []

ii) Increasing Load Factor

There are finite limits to the economic opportunities to increase load factor. Airlines tend to be closer to those limits at slot-constrained airports.

It is likely that this constraint will apply more to long-haul airlines and to airlines with a smaller range of destinations across which to balance capacity. It will likely result in funds being retained by HAL, contrary to principle (1) above; and potentially to a disproportional sharing, contrary to principle (3) above.

b) Sharing of Over-Earn

Generally, we support rewarding both airlines and airports for efforts that result in traffic growth where that growth e.g. sales efforts, marketing, absorption of economic risk etc.

Although HAL has agreed to fully refund over-earn up to this passenger line; over-earn above the dashed blue is shared with HAL. As the baseline has been set too low, HAL is likely to gain a share of over-earn that isn't consistent with the spirit of current regulation, and is contrary to principle (1) above.

c) No Risk Transfer To Justify Sharing

HAL has put in place floors under which it will not pay out the Fixed Rebate.

There is no suggestion that airlines have agreed to share Brexit risk with HAL through this agreement. HAL therefore stands to benefit from passenger upside, without any downside risk.

Volume Rebate

To maximise consumer benefit and compliance with CAA12, we suggest that underneath a reasonably-expected growth scenario, there should be no HAL share, and no airline-growth conditions applicable to the airline share of the over-earn. Levels of fixed rebate should be defined to apply in different Brexit scenarios.

Only above those passenger numbers would HAL be entitled to a share of a growth-scheme to reflect its overperformance in sales, marketing and optimisation activity.

This approach will maximise consumer benefits.

3. H7 Impacts

We note from CAP1769 1.30 that airlines are not protected from a compensatory price uplift in H7 if required by HAL.

This suggests that the iH7 deal could represent giving with one hand, and taking back with the other.

There should be a clear and firm commitment from HAL prior to entering into the rebate agreement that there will be no pricing uplift in H7 arising directly or indirectly from the iH7 proposed rebate agreement.

NEXT STEPS

The signatories to this letter request that HAL consider the issues raised above and propose an improved fixed rebate and apportionment system that is fair to airlines and consumers. Set out below are some options for further consideration.

Deal vs RAB Reduction

The existing deal is to be preferred when compared to the CAA's original RAB reduction. However, we believe it can be improved for airlines and consumers. We do not recommend a reversion to RAB reduction as it will defer benefits from iH7 passengers to H7 passengers.

Suggested modifications

We are open to consider a revised HAL proposal, or to consider a possible CAA-mandated deal outcome for iH7.

Apportionment Method

In respect of changes to the apportionment method which could prejudice existing signatories to the rebate agreement, we are open to an all-airline change to the apportionment method, or to HAL funding commitments to existing signatories, whilst ensuring longhaul carriers are fairly rebated if that simplifies the process. If HAL wishes to absorb the cost of different apportionment schemes, we will raise no objection.

Growth Rebate

In respect of changes to the Growth Rebate, we understand changes are not expected to negatively impact existing signatory airlines and therefore a change could be offered as a supplement to the existing rebate agreement.

In the expectation of a favourable response, we look forward to hearing from you.

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cc: Andrew Walker, Head of Markets and Performance, Civil Aviation Authority