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17 December 2021

Re: Response to Economic Regulation of Heathrow – CAP2265 H7 Initial Proposals

Thank you for the opportunity to respond to the CAA's above consultation, setting out the CAA's initial proposals regarding the future H7 price control period at Heathrow ("Initial Proposals").

This submission is made jointly by the LACC, AOC and IATA (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address. Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

In responding, we have broadly followed the structure within the consultation document itself, broken across four sections with supporting documentation, as follows:

A. Summary, Context and General Concerns: This section sets out our broad, high-level position on the Initial Proposals and some more general comments;

B. The Level of Charge set out by the CAA is Incorrect: This section identifies a number of issues across several of the building blocks where we believe errors have been made which has led to an incorrect range of charges being proposed. We also set out here our own interpretation and rationale;

C. Other Matters for Consideration: This section addresses other points raised within the Initial Proposals not covered under Section B;

D. Annexes and Appendices:

   a. Annex 1: PA Nyras Consultancy Report: Initial Proposals Operating Costs and Commercial Revenues Review

   b. Annex 2: CEPA Report: Initial Proposals Cost of Capital Review

   c. Annex 3: Houlihan Lokey: Heathrow Financeability Analysis

   d. Appendix 1: Breakdown of Airline Community calculations as to the proposed level of charge

A. Summary, Context and General Concerns

A.1 Summary

Heathrow is already one of the world's most expensive airports. The proposals by the CAA are significant and range from a proposed increase of between 25 - 75% when compared with today which will have a significant bearing on consumers.

The Airline Community maintain our strongly held position that H7 should see an overall fall in the level of aeronautical charge. Applying the analysis from both CAA and the Airline Communities' independent consultants within the CAA's PCM model suggests a level of charge between **£11.30 - £14.72**, as further evidenced within this response.

Such findings are based on addressing four particular errors we have identified within the Initial Proposals:

- The CAA has set an unexplained range on operating costs and commercial revenues between HAL's Updated RBP and the 'mid case' scenario of the CAA's own advisors. Such an approach is not appropriate and fails to sufficiently weight the more robust analysis submitted by the CAA's own independent advisors which also follows similar conclusions drawn by PA Nyras Consulting who have undertaken a further review on behalf of the Airline Community (PA Consulting Report[1]). Given the level of evidence submitted and independent supporting analysis we believe a much greater weighting must be placed on the advice being given to the CAA ,and it is inappropriate to rely upon the regulated company's lobbying position to reach its determination.

- The CAA's proposal is based on an outdated passenger forecast which does not reflect latest industry analysis, such as those published by Eurocontrol STATFOR, IATA and ACI – all of which point to a significantly higher forecast across H7. Analysis by the Airline Community suggests the current CAA estimate to be in the range of circa 58m passengers lower than our analysis suggests.

- The CAA has made a determination that substantially over-estimates the cost of capital at Heathrow, as evidenced by the work undertaken on behalf of the Airline Community by CEPA (CEPA Report[2]) which sets out a more appropriate and financeable range of 1.3 – 2.8% real vanilla WACC.

- The approach the CAA has taken appears irrational in placing undue weight on short-term financeability considerations at the expense of balancing its primary duty to consumers and efficient pricing. In particular, the approach has applied over-estimates alongside a number of mechanisms that seeks to safe-guard HAL, such as 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, all of which ultimately over-compensates HAL.

Notwithstanding the above we are broadly supportive of particular aspects of the Initial Proposals including the overall approach and level of capital plans and framework; the ORCs proposals; and for

[1] PA Nyras Consulting Report: Review of the Taylor Airey / CEPA H7 Operating Costs and Commercial Revenues, 15th December 2021 and attached as Annex 1 to this response.

[2] CEPA Report: Response to CAA Initial Proposals – Cost of Capital, 17th December 2021 and attached as Annex 2 to this response.

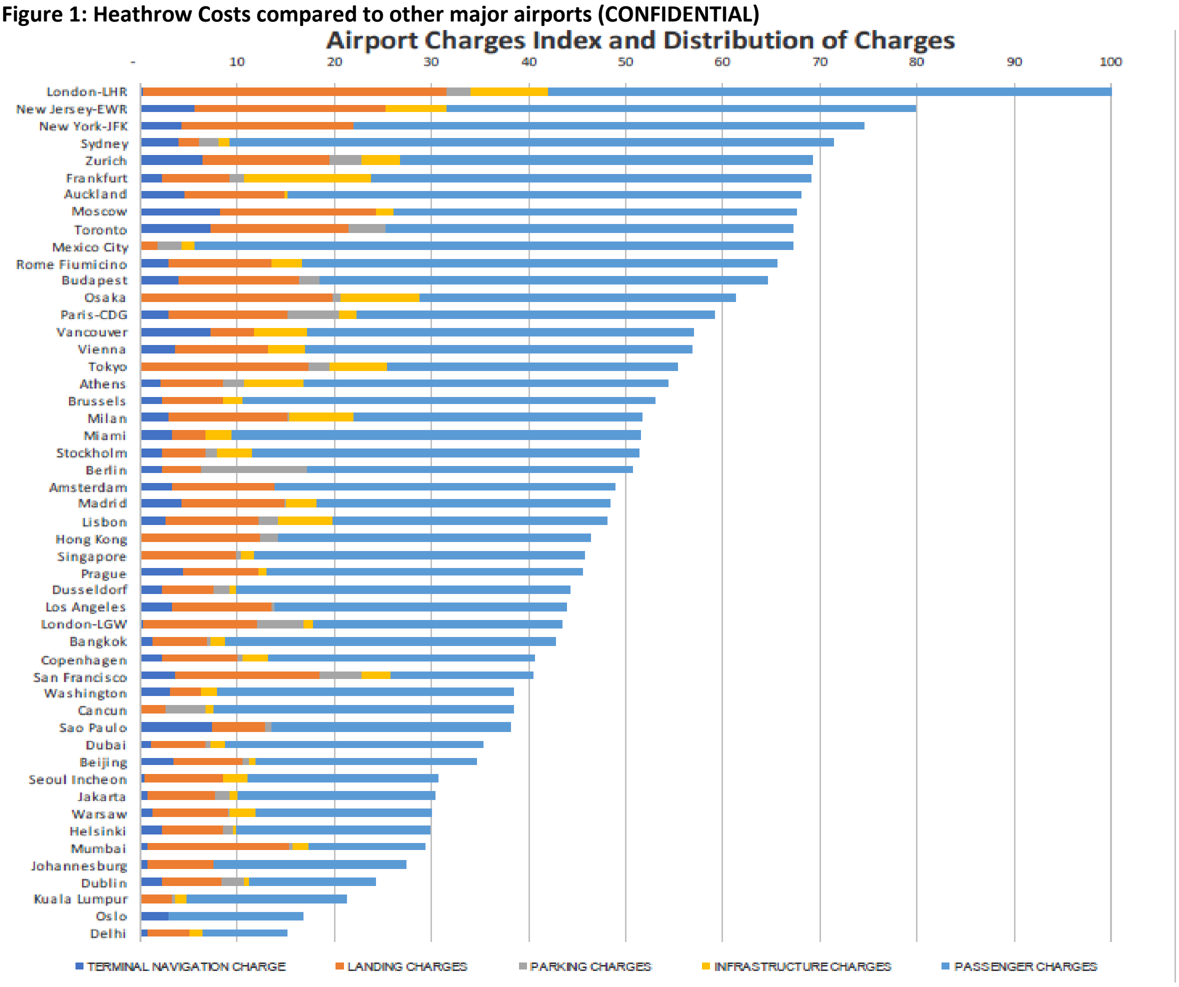
stronger safeguards and measures in H7, ensuring greater transparency and engagement from HAL and the ability for the CAA to intervene, particularly in those areas that directly affect airlines and consumers.

A.2 Context

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, and is an even greater burden at Heathrow, 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 at the mid-point of the CAA's Initial Proposal range, if implemented, would see this differential increase to at least 83% more expensive[4]

Figure 1: Heathrow Costs compared to other major airports (CONFIDENTIAL)



Source: Jacobs review of airport charges

[3] IATA research

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

The level of charge proposed by the CAA if applied at the mid-point of its range would, in our analysis mean consumers over-paying in H7 by £3,972m (ie: over £10 per passenger spread across 397m passengers).

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 passengers considering alternative transfer routings, either through other European, USA or Middle East hubs. The charges will lead to a reduction in airlines' ability to use Heathrow to operate a 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.

A.3 General Concerns

The Airline Community have set out in responses[5] and re-iterate here that the H7 process to date has been problematic.

Out of line with the approach taken by other regulators, the CAA has been slow to reveal its positions on certain matters and when positions are finally revealed, they have not addressed specific points raised, for example evidencing on the value in the cost of capital for the proposed risk mitigation measures. Furthermore, the continued failings by HAL[6] in producing fully formed plans, despite CAA instructions, has also been particularly challenging.

We also remain concerned that the overall challenges of Covid and the financial impact on HAL is casting a 'shadow effect', with short-term challenges having a disproportionate bearing on the longer term. For example, setting a passenger forecast which appears particularly pessimistic when compared to broader industry analysis, or setting a cost of capital that is predicated on Heathrow's financeability. The effect of this appears to create a layering of measures and assessments that, as set out in Section B, compound to create a significantly higher level of charge – which we would highlight falls out of line with other examples we are seeing elsewhere, such as the recent AENA determination where charges have been held flat and the cost of capital fallen.

Given the above, we strongly encourage the CAA to consider and set out clear plans as to how stakeholders can continue to engage on the issues raised within before the CAA settles on its Final Proposals, particularly where HAL will have the opportunity to submit another updated Business Plan as part of its evidence base.

[5] Most recently the Airline Community Response to CAA Consultation CAP2139, dated 23rd June 2021

[6] As commented upon by the Airline Community to the CAA, most recently as per footnote 5 above

B. The Level of Charge Proposed by the CAA is Incorrect

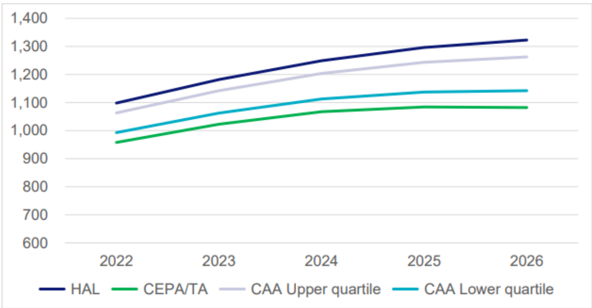
The Airline Community believe the CAA has made several errors in its approach to a number of key aspects of the regulatory building blocks which ultimately results in an incorrect level of charge being suggested within the Initial Proposals. In particular:

B.1 The CAA's "range" for H7 prices is skewed in favour of HAL's Updated RBP operating costs and commercial revenues

The CAA has set a range for H7 prices which fails to sufficiently weight detailed analysis carried out by the CAA's own advisors on Opex and Commercial Revenues.

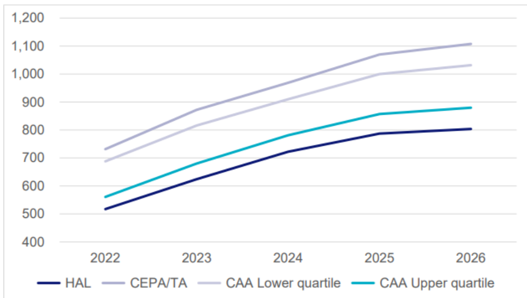
The below graphics are taken from the CAP 2265B and illustrate that the CAA have estimated Opex and commercial revenues as a range between the analysis and recommendations made by the CAA's independent consultants[7] ("CEPA/TA") and HAL's RBP Update 1 cost estimates for H7.

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

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

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 should 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.
- 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 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[8] – 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.

Following the publication of the Initial Proposals, the Airline Community commissioned PA Consulting to undertake an independent review of the CEPA/TA work, included as part of this response as Annex 1. Full details can be found within the report itself but in summary it supports the approach and outcomes produced by CEPA/TA.

Given the above, we believe it would be an error 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, with subsequent verification by the Airline Community's independent consultants. It is simply not appropriate to give the HAL estimates the same weighting.

We understand that commercial revenue performance remains strong on a per passenger basis, 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 to be unchanged[9] from 2019 levels[10] and the PA Consulting Report also highlights similar trends in other airports with spend

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

[9] Confidential Data

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

significantly increase on a per passenger basis and a 2 – 3% increase in total-duty free sales in airports similar to Heathrow[11].

This evidence is counter to HAL's modelled RBP submission which has Retail revenue per passenger dropping by -40%[12] 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 to find a balance, but we do not believe on the evidence above that the current approach by the CAA correctly reflects that. We have legitimate expectations that the CAA will conduct a full bottom-up analysis as set out in the CAA's previous consultations.

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 Profiled Maximum Allowable Yield for H7.

B.2 The Passenger Forecast outlook has Improved since the CAA's analysis

B.2.1 Industry Outlook

The passenger forecast should be updated based on recent trends – particularly with the removal of travel restrictions[13]. 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 that have material market connections into the UK, and Heathrow in particular, have reduced restrictions. This will have a significant impact on passenger growth, particularly near term.

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[14] whilst Virgin Atlantic have announced plans to grow in 2022[15]. Other large-scale operators into Heathrow are reporting similar patterns. In its recent Q3 report[16], 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[17]. Air Canada and Delta similarly have commented on a faster-than-expected rebound is driving optimistic expectations for 2022[18] with plans to operate 90% of its 2019 transatlantic capacity[19]

[11] Pages 23 and 24 of the PA Consulting Report
[12] Data Confidential
[13] At the time of writing measures have been introduced and subsequently amended relating to the Omicron Covid variant
[14] Luis Gallego, IAG CEO, IAG Q3 2021 Financial Results
[15] Shai Weis, Virgin Atlantic CEO, 11th November 2021 (https://travelweekly.co.uk/news/air/virgin-atlantic-aims-to-grow-network-from-summer-2022)
[16] Lufthansa Group Q3 2021 Financial Results
[17] https://simpleflying.com/united-london-heathrow-expansion/, 28th October 2021
[18] Lucie Guillemette, Air Canada's Chief Commercial Officer, Air Canada Q3 2021 Financial Results
[19] https://www.businessinsider.com/delta-adding-a-dozen-transatlantic-routes-to-2022-schedule-2021-11?r=US&IR=T, 13th November 2021

and we note the likes of Emirates[20] and Qantas[21] have pulled forward operating plans. Furthermore, we continue to see airlines take opportunities to operate into Heathrow next year, Bamboo airlines' recent announcement[22] being an example of such.

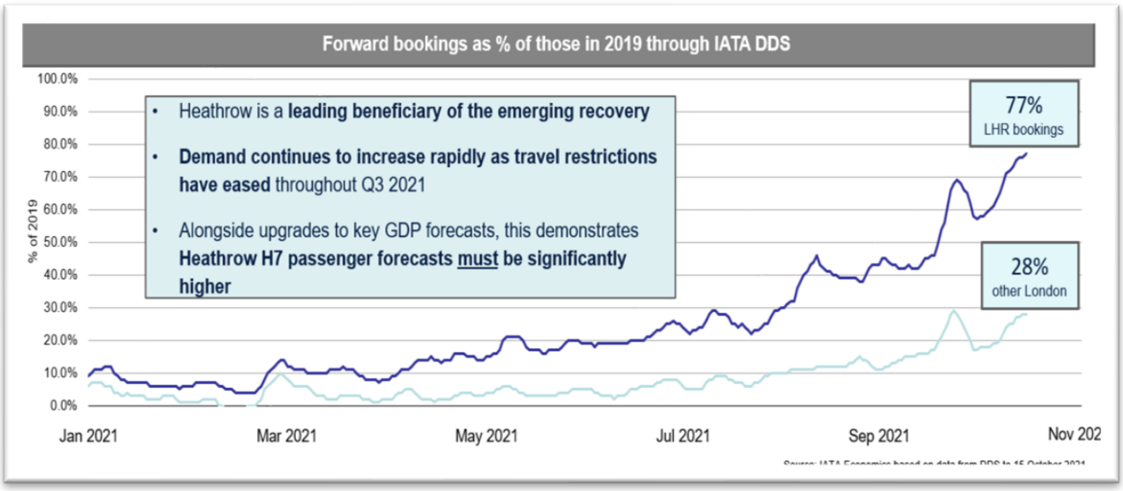
We note the CAA's acknowledgement that passenger forecasting is an area that will be updated for the Final Proposals if there is significant change in the path of demand recovery[23] We would recommend the CAA adopt the Eurocontrol STATFOR forecast (published in October 2021-see Figure 6) which has proven 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.
- 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)



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[20] https://www.emirates.com/media-centre/emirates-to-recruit-6000-operational-staff-over-next-six-months-to-support-accelerated-recovery/, 25th October 2021

[21] https://travelweekly.co.uk/news/air/qantas-brings-forward-international-flights-relaunch, 15th October 2021

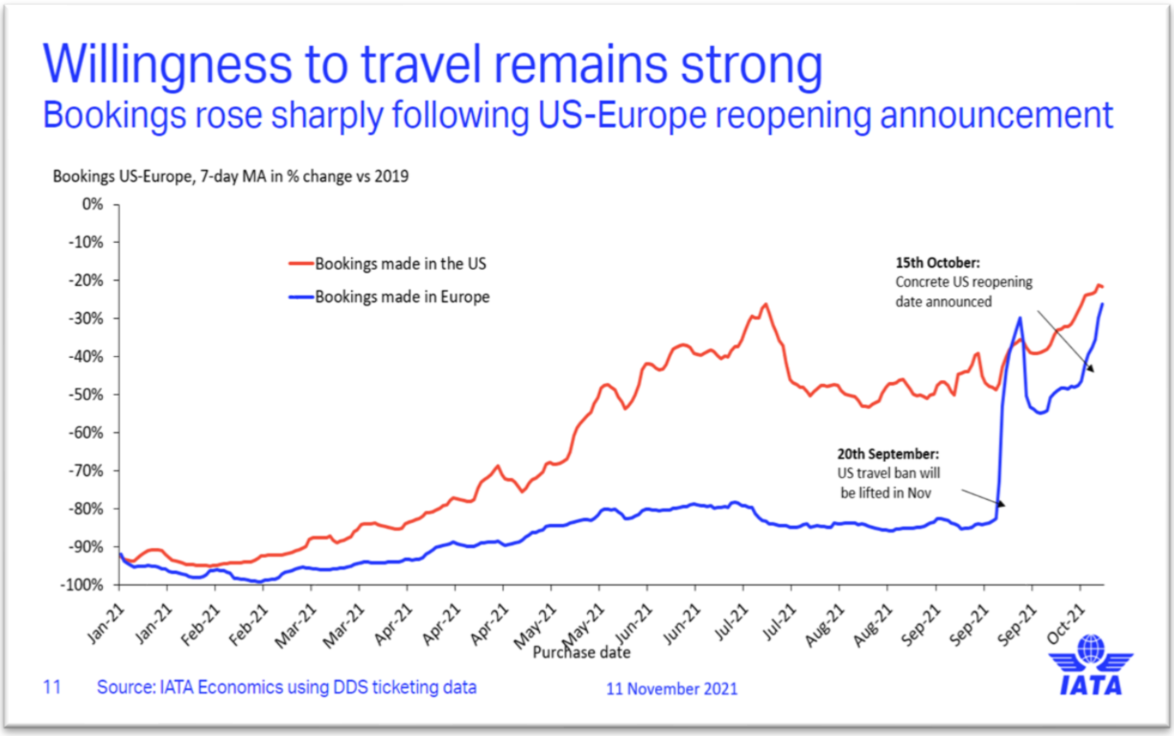
[22] https://travelweekly.co.uk/news/air/bamboo-airways-confirms-vietnam-london-flights, 3rd November 2021

[23] Page 30, CAA CAP2265B

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[24] . 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

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



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

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

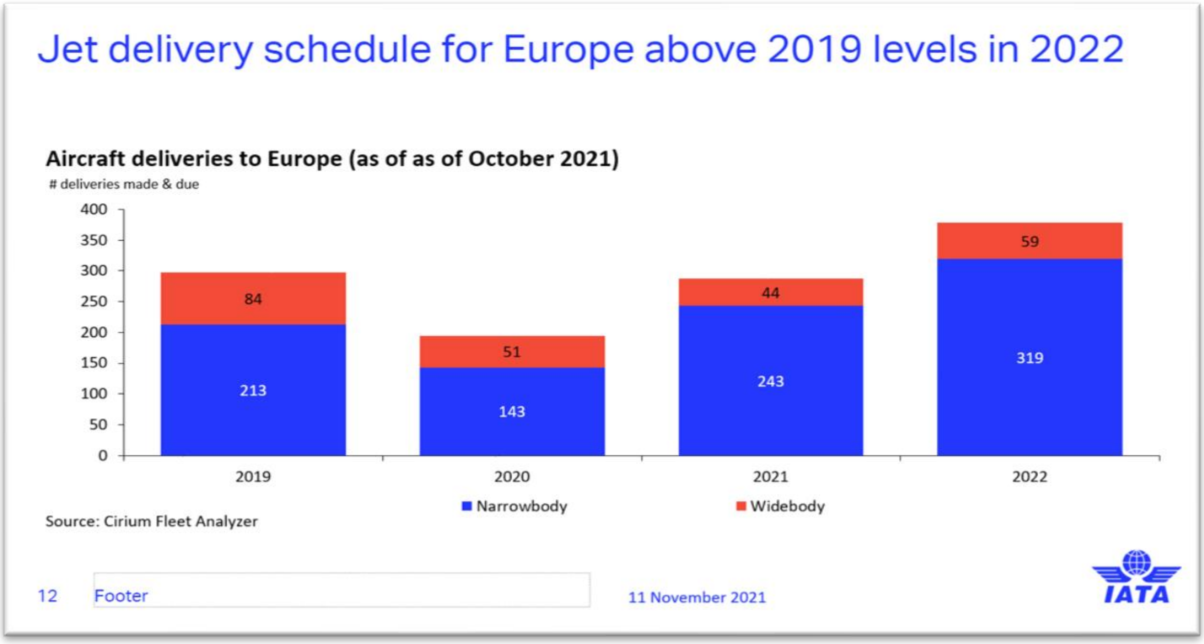
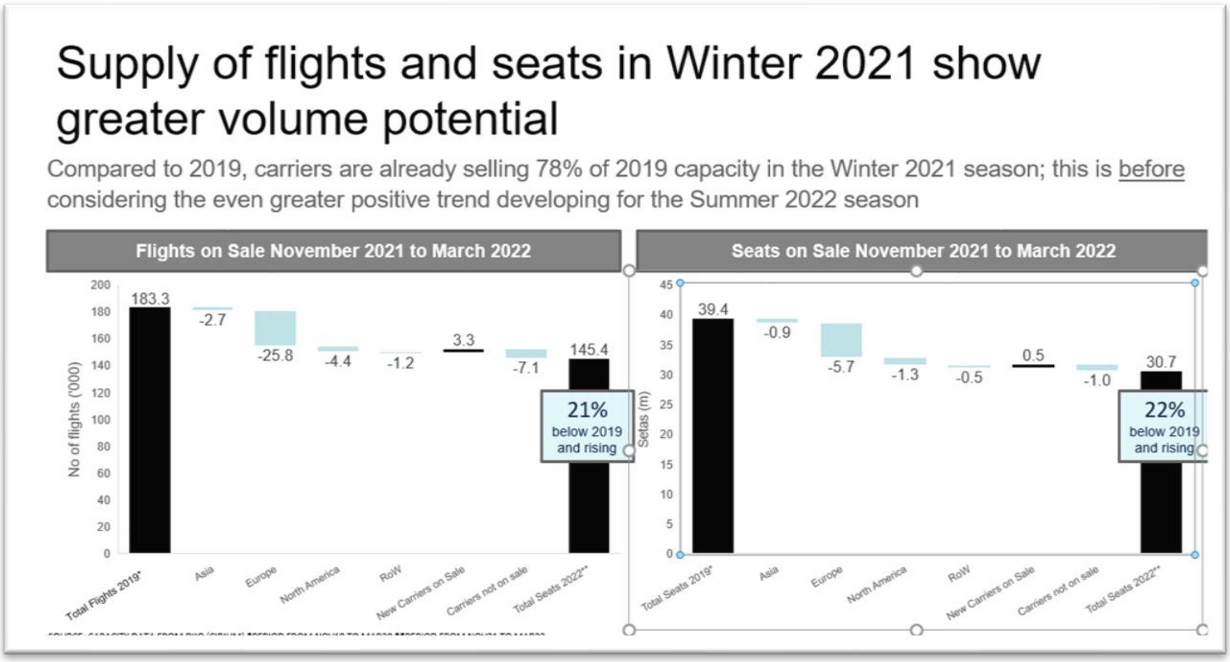
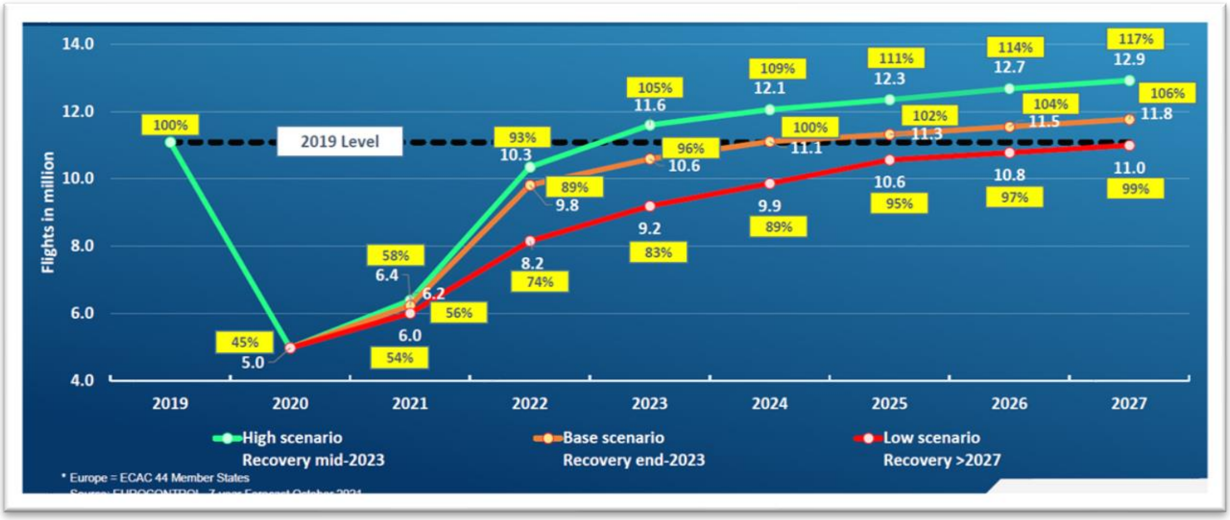


Figure 5: Heathrow seats on sale in Winter 2021 at 88% of 2019 levels (Capacity Data from DIIO (Cirium))(CONFIDENTIAL)



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

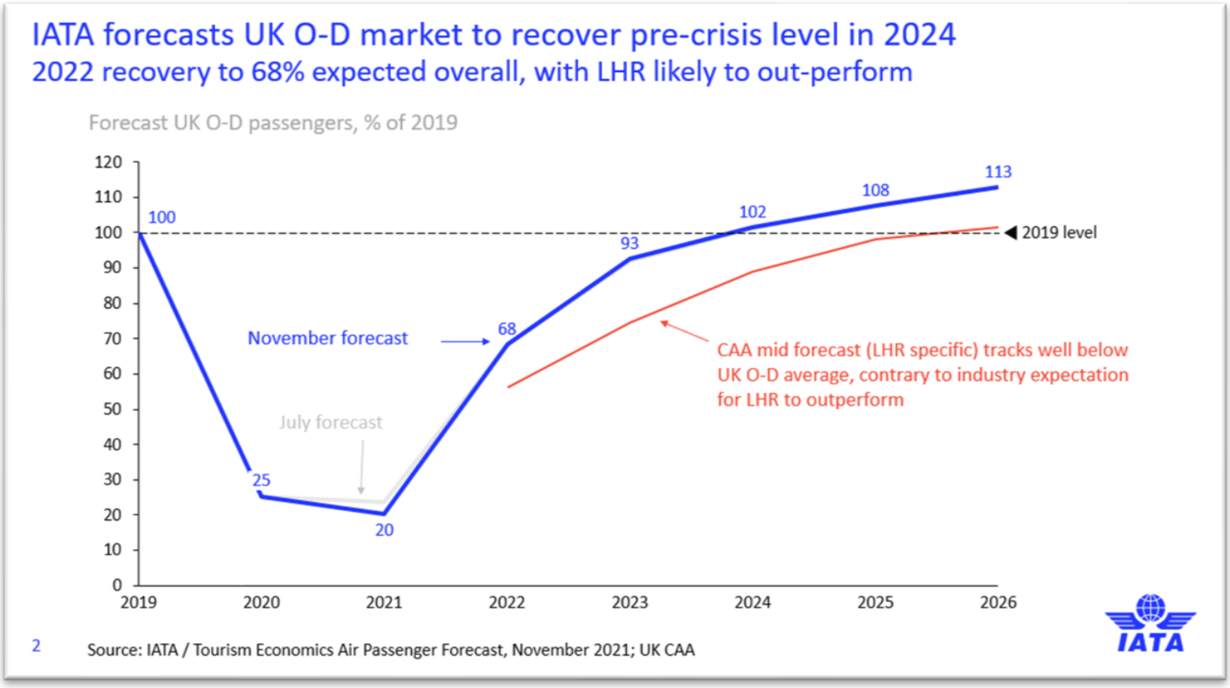
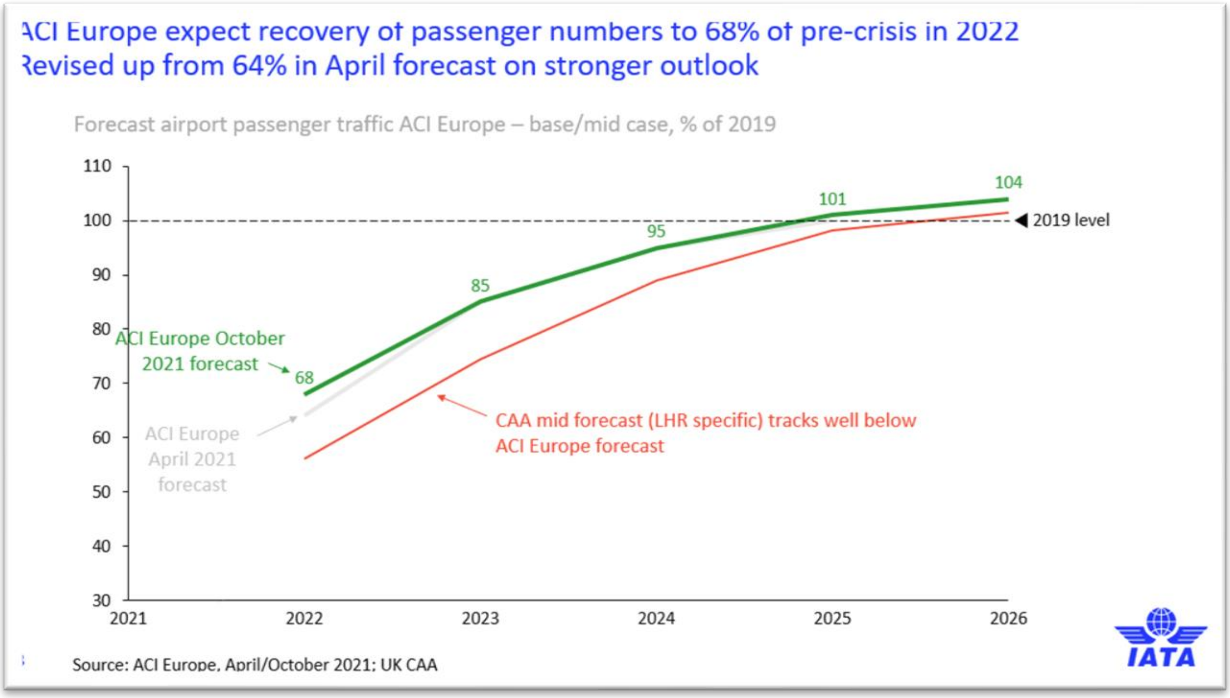


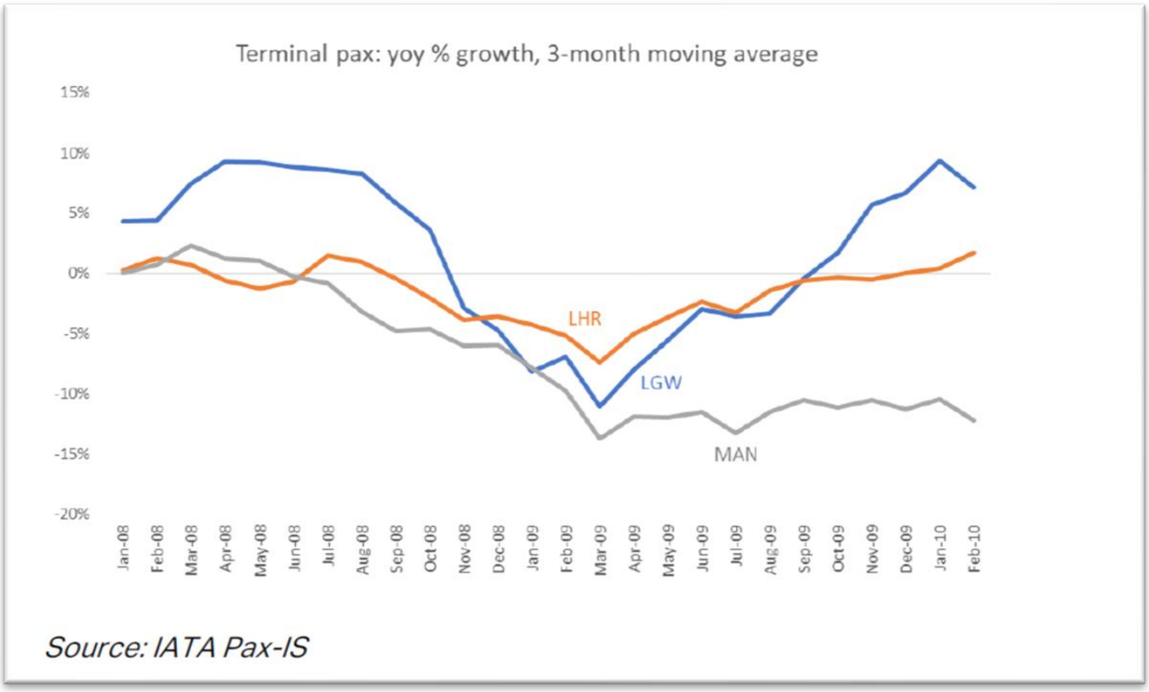
Figure 8: October 2021 ACI Europe Forecast for European passenger traffic



B.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

B.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 (CONFIDENTIAL)

Monthly Departing and Arriving Scheduled Seat Capacity from LHR					
Month	2019	2021	vs. 2019	2022	vs. 20192
Jan	8,162,239	2,006,371	25%	5,988,783	73%
Feb	7,539,639	1,247,753	17%	6,202,336	82%
Mar	8,509,731	1,452,620	17%	7,292,574	86%
Apr	8,555,252	1,547,290	18%	8,254,988	96%
May	8,787,876	1,817,088	21%	8,582,287	98%
Jun	8,652,657	2,250,342	26%	8,429,792	97%
Jul	9,025,175	3,006,299	33%	8,676,561	96%
Aug	8,955,803	3,576,147	40%	8,697,042	97%
Sep	8,665,311	4,149,675	48%	8,433,617	97%
Oct	8,799,976	4,757,665	54%		
Nov	8,133,816	4,789,900	59%		
Dec	8,343,525	5,567,091	67%		

Source: DIIO

B.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

B.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.

B.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)**.

B.2.7 Passenger traffic will continue to grow across H7, with total traffic forecast at 397m.

Post 2022 we expect passenger traffic to grow at the rate forecast by Eurocontrol's STATFOR. This results in LHR outperforming the IATA UK-International forecast in 2023 for the reasons set out in B.2.2 above and in previous feedback to the CAA[25], but then dropping below that forecast for 2024, 2025 and 2026 as the capacity constraints at LHR slow the airlines ability to grow to higher than 2019 levels.

[25] Airline Community Revised Business Plan Feedback to CAA, 19th February 2021

	2022	2023	2024	2025	2026	Total
Annual Passengers (m)	72.0	77.7	80.9	82.5	84.9	397.2
% of 2019	89%	96%	100%	102%	104%	

This also follows general longer-term trends, as set out in Figures 6 – 8 above.

B.2.8 Impact of Omicron variant to the H7 traffic forecast is anticipated to be minimal for H7.

Whilst the outbreak of the Omicron variant is forecasted to see a significant rise in Covid cases, it is still too early to understand the implication across H7, which covers the next five-year period; it is likely that any government restrictions will be short-lived given the extent to which it has already spread through the population. Furthermore, the IATA UK passenger forecast produced in November 2021, which is one key reference informing the Airline Community's LHR passenger forecast, already factors into its baseline forecast the impact of additional Covid variants emergence on travel restrictions and passenger demand in 2022 based on the assumption that existing vaccines remain largely effective against new variants. While it will still be some time before the characteristics of Omicron are fully understood, initial indications are that existing vaccines are still effective. Based on this current understanding we are confident that the Omicron variants impact on our passenger forecast over the H7 period will be minimal.

We would also note the following insights provided by Gridpoint Consulting in a recent publication.[26] Gridpoint's analysis showed that it took approximately 6 months for the Delta variant to become the dominant variation across the world and for travel restrictions to be lifted. Gridpoint then showed that the Omicron variant was spreading at twice the speed of Delta, and that it would therefore expect that Omicron would become prevalent as the dominant strain worldwide by January and that travel restrictions will become largely pointless by February or March 2022.

B.2.9 Passenger Forecasting Conclusion

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

Consumers flying in H7 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 H7. The CAA cannot rely solely 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.

[26] "Implications of Omicron for Travel", Gridpoint Consulting, 6th December 2021

B.3 WACC

Throughout this process, CEPA have provided advice and support to the Airline Community on the WACC, including undertaking on-going evidenced analysis and rationale for their suggested range which, as per the attached Annex 2 (CEPA Report), has been updated to 1.3% - 2.8% (real, Vanilla). This compares against the CAA's range of 3.6% - 5.7%.

The CEPA Report sets out why, in their expert opinion, the CAA's determination substantially over-estimates the cost of capital for Heathrow and highlights particular areas of differences, most notably in the asset beta and cost of debt, full details of which are further set out within the CEPA Report.

In reviewing the CEPA Report we believe the CAA have erred in their judgement and agree with findings within that the CAA's approach has fundamentally over inflated the level of risk HAL is exposed to which has had a material impact on the WACC. We believe addressing these matters, as per the CEPA Report, would suggest a range within as set out by CEPA.

B.4 Conclusion

By making the evidenced based adjustments as set out within this Section B we believe that the adjustments give a **financeable profiled yield range of between £11.30 and £14.72**[27]

B.5. Financeability

Notwithstanding the comments on the approach to setting the WACC[28], the prime determinant of financeability, the Airline Community have considered the financeability of the above assessment and believe it is demonstrably financeable, due to the similar results from the same financial metric characteristics used in the CAA's analysis which are comfortably met at the upper end of the WACC range.

In particular a member of the Airline Community retained Houlihan Lokey to conduct analysis which demonstrates financeability within credit rating agency thresholds, including a substantial cumulative dividend.

The full details of this assessment is provided to the CAA (Annex 3) and we encourage your consideration of this alongside other bodies of evidence from other member airlines, including evidence demonstrating with the CAA's metrics that the financeability of our proposals, including using our WACC ranges, should not be any more challenging than that of the CAA's own proposals.

In addition to the above we note that BBB+ offers two notches of buffer within investment grade – maintenance of which is not a requirement in legislation or license – and, given the evidence above, we believe using these metrics should support the financeability if modified to reflect BBB or BBB- of our full WACC .

In addition, PMICR should not be as constraining as portrayed since, as noted by the CAA, this metric "will give a more negative impression of post-maintenance cash interest cover than will be the case in reality"[29]

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[27] Appendix 1 sets out the specific figures for such calculations
[28] As set out under C.1
[29] CAP2265C: Chapter 11, Calculating a price cap and financeability, para 11.78

C. Other Matters for Consideration

C.1 Form of Regulation and Financial Matters

The Airline Community has employed CEPA to consider several of the matters relating to the cost of capital and associated financial issues, reviewing the CAA's proposals on risk. The Airline Community and CEPA have engaged on an ongoing basis with the CAA through the H7 process. Included as Annex 2 is the latest CEPA Report which forms the basis of our response to this section and should be read alongside previous submissions made as part of our responses to feedback on HAL's H7 business plans and formal CAA consultations.

C.1.1 Cost of Capital

The Airline Community supports the positions set out within the CEPA Report in particular a vanilla real WACC range of 1.3 - 2.8%. CEPA has raised a series of questions about the approach that the CAA has adopted and we anticipate the regulator will respond in detail to those points either before or as part of its final determination. Key points for the Airline Community are set out below and in further detail within the CEPA Report.

C.1.2 CAA's Approach to Addressing Financeability and Risk

We note that the CAA is to have "have regard" on financeability but highlight that this requirement is subsidiary to its duty to the consumer, including on ensuring efficient pricing. The CAA's approach however does not appear to be consistent with financeability being assessed in this manner.

We are conscious that a reduction in the real cost of capital places greater pressure on financeability metrics and understand that the CAA must have regard to this, but we consider it an error and therefore inappropriate to develop a cost of capital that is predicated on addressing Heathrow's financeability issues at the expense of a suitable cost of capital estimate. We consider that the CAA should first produce its WACC estimate drawing in relevant evidence, precedent and latest data and only then manage any financeability issues that the WACC range creates. This is important because adjusting the cost of capital is just one solution and the downside of it is that it risks embedding a higher cost of capital for future price controls or failing to address specific issues that may be able to be addressed in a more targeted manner – for example a specific in year adjustment.

Airlines (and other businesses) have been forced to look to shareholders for further borrowing to ensure their ongoing viability, with Virgin Atlantic being a most recent example[30]. While we acknowledge that there are acute cash-flow pressures from Covid on businesses, they are relatively short-term. In the real-world breaches of metrics in such circumstances are tolerated by lenders. The notionally efficient firm would be talking to its lenders to ensure that it avoids an overreaction to a one-off breach. Instead, the CAA's approach tends towards HAL's in asserting that consumers alone should bear the cost. This is inconsistent with the CAA's primary duties to protect the consumer.

We are further concerned that the introduction of material additional risk provisions within the regulatory framework provides protection to HAL that is not adequately reflected in a reduction to the WACC. Even at this late stage of the process, the CAA has not indicated where it will land on the impact of the numerous risk sharing mechanisms that it proposes for H7. It indicates that it will take

[30] https://corporate.virginatlantic.com/gb/en/media/press-releases/virgin-atlantics-400m-investment.html

risk mitigation into account as part of setting a point of the WACC but has not made transparent the basis on which that assessment might be undertaken. Yet risk sharing is a fundamental issue for the airlines. Taking on more risk must result in a material reduction to the WACC and consequently airport charges; why else would the Airlines support it. The CAA's approach is unsatisfactory, in light of its duties and the established good practice of transparency that is expected from a regulatory body.

When we look at the CAA's range, we find that it has elected to 'aim up' on many parameters, even excluding evidence that would result in lower parameter estimates. Each of those decisions ultimately impacts passenger charges. When we step back from its detailed calculations and consider the results in the round we see a lack of consistency with previous precedent (without a strong rational for departure) and a WACC calculation that is not intuitively sensible overall.

The CEPA Report expands on these concerns, raising a series of issues and question that the Airline Community will expect the CAA to answer.

C.1.3 Traffic Risk Sharing

As set out in C.1.2 above, the Airline Community cannot support the CAA's Traffic Risk Sharing (TRS) in the form proposed within Initial Proposals given:

(i) There has not been an evidenced, corresponding and appropriate reduction in the WACC despite the clear reduction this brings in relation to HAL's volume risk. The CAA should not be sidestepping the provision of its views here simply because estimating the impact is challenging. As set out further in the CEPA report, we believe that such an intervention brings the level of risk that HAL is exposed to closer to levels of the water and energy companies and the WACC should reflect that. The TRS is not solely a mechanism that assists with traffic uncertainty, but transfers a large amount of risk onto airlines; as a result, it must result in a permanent reduction in the cost of capital to reflect this transference and the de-risking of Heathrow.

(ii) The proposed TRS structure results in a significant imbalance (or asymmetry) in risk between HAL and the consumer. There is downside protection to zero for HAL but limited upside to the consumer due to the overall capacity constraints at LHR. We note in this context that we expect to return to 2019 levels by 2023 (as set out further in our evidence on Passenger Forecasting) and that HAL will have a significant cash advantage given the additional revenue will not be returned to consumers until H8. Such a position is clearly at odds with the CAA's duty to consumers.

C.1.4 Asymmetric Risk

The CAA has proposed the introduction of an asymmetric risk allowance we understand to address the 'low frequency, high impact shock' not already accounted for within its passenger forecasting shock factor. Having considered the arguments put forward we believe the inclusion is unjustified, particularly given the implications of this for future control periods. It seemingly seeks to eliminate all downside risk on HAL firstly by placing cost onto the consumer through a fixed ex-ante allowance, secondly through the beta term being unadjusted, and thirdly through the costs imposed when the risk does materialise, without an appropriate reflection within the cost of capital of such a policy.

The CEPA Report sets out further arguments on this point that we support and incorporate herein.

C.1.5 RAB Adjustment

We note we remain opposed to the CAA's decision on HAL's request for any 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.

C.2 Passenger Forecasting

In addition to the points on passenger forecasting raised under Section B above, the Airline Community further note the following points:

C.2.1 Passenger Forecasting Methodology

Whilst noting the CAA has made changes to some of the assumptions HAL has made, this still only equates to a circa 7% increase in passenger volumes across the period and continues to fall significantly short of wider industry expectations for the UK, let alone Heathrow. The CAA suggest Heathrow traffic will only return to 2019 levels by 2026[31] which raises significant concerns there are fundamental errors within the assumptions or model driving such a discrepancy.

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[32] and the appropriateness of the CAA using HAL's model. Given such, we would strongly encourage the CAA to address this issue by either building its own forecasting model or, undertaking a fully independent evaluation of HAL's model and allowing full access to be provided to the Airline Community in a timely manner to enable critical assessment and critique, prior to the CAA publishing its Final Proposals.

C.2.2 IATA Initial Comment on HAL's Updated Forecast

We note that in its latest passenger forecast update HAL has made references to aligning closely with "the forecast published by IATA". Our understanding is this is based on references to the IATA / Tourism Economics November 2021 Forecast which set a global average international recovery of 57% (the 'about 60%' that HAL cite).

We reject this comparison as evidence of alignment with HAL's forecast on the basis that:

(i) As set out in Section B, the IATA analysis for the international recovery for the UK market in 2022 is expected to be 67% (and further evidence beyond the IATA forecast has been provided as to why Heathrow would likely outperform this);

[31] Table 2.1, CAA CAP2265B

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

(ii) It is reasonable to expect the UK to outperform the global average because 85% of the UK market is short haul operations within Europe and routes to North America. Both these route areas are connecting locations of relatively high vaccination rates and greater freedom of movement (due to lower levels of travel restrictions); and

(iii) The global average recovery for 2022 is weighed down by the still very restrictive policies affecting travel to / from / within Asia Pacific, a major driver of global traffic volumes. However only 7% of the UK market is related to Asia Pacific.

C.3 Capital

C.3.1 Context

Following on from the publication of the CAA's Initial Proposals, we understand HAL have started undertaking further work on their capital plan based upon the comments and recommendations set out within, for example the approach to setting out Obligations and breaking out the Asset Management plan. We are also expecting a further and more detailed iteration of the capital plan to be published by HAL later this month in a further updated business plan (Revised Business Plan Update 2) which will provide an updated position, and we hope greater detail, on the structure and detail of their proposed capital plan.

Whilst some of this information has started to be shared by HAL with the Airline Community through various governance forums, this is still emerging and therefore we are only able to provide limited comment on these material developments at this point. For example, we have yet to see a fully consolidated capital plan from HAL, broken down across the proposed cost categories – which will invite further comment and development, nor have we agreed on an approach to integrating a programmatic approach[33] with the existing capital gateway process, though work has begun on an H7 Operating Model concept.

As a result, many of our previous comments, including the feedback on the capital plan[34] still stands.

HAL and the Airline Community have agreed to a number of workshops to run throughout January in order to further develop these, and other, elements of the capital building block, particularly in relation to the plan and the governance arrangements that would be required to support such. As these develop, we will continue to provide the CAA with updated feedback on the matters raised within to which the CAA has agreed.

C.3.2 Overall Approach

The Airline Community are broadly supportive of the approach the CAA has taken in assessing HAL's proposals, particularly given the lack of information or rationale for certain aspects as the CAA sets out within the Initial Proposal.

The Arcadis approach reflects similar challenges by the Airline Community in seeking to fully understand the absolute requirements of meeting safety, security and compliance within H7 and the

[33] The Programme Lifecycle developed in 2019, which complemented the Project Lifecycle has been based on the "Managing Successful Programmes" (MSP) methodology and was being used in two programmes: Heathrow Additional Capacity and Future T2. Although we recognise these two programmes are 'paused' the Airline Community support HAL in continuing to implement and utilise the Programme Lifecycle process and plans to roll out further across the portfolio

[34] Airline Community comments on the HAL RBP Update 1 Capital Plan, 1st September 2021

benefits of those more discretionary programmes. We welcome the CAA's support in ensuring that the appropriate level of information is made available by HAL and in a format that allows a fuller and consolidated understanding than that to date where the Airline Community have had to rely on our own work in connecting the high-level plans within the HAL business plans, and the more detailed reports being shared through the existing capital forums. We are supportive of the use of technical advisors to assist in determining the overall level of expenditure, particular in such areas of the asset management programme given the breadth it is looking to cover, and technical nature of the scope, we encourage their on-going assessment in assuring an appropriate allowance is set out with the opportunity for deep-dives with the Airline Community where specific areas of interest.

We support and concur with the CAA's assessment, as supported by the work of Arcadis, regarding the introduction of an ex-ante framework and applying that to most of the capital plan, except post G3 rollover projects and the Crossrail contribution. We cover specific points and issues further in this Section C.3 but believe the framework set out by the CAA does build on the current approach whilst retaining some of the core values of the existing arrangements such as Development to Core, airline approval and allows for flexibility and an enhanced role for the IFS.

C.3.3 Transition Arrangements

We are supportive of the CAA's definition (post G3) and approach to transition projects, including the proposed treatment of Crossrail Contribution. We also concur with the continued application of the existing 'triggers' – at the time of writing those being T4 HBS, Main Tunnel and Magenta with discussions on TTS being undertaken.

We would note however that in the Initial Proposal the CAA state T4 HBS has not passed its G3[35]. To clarify, T4 HBS has passed its G3 and will require an ex-post review by the CAA. The current discussions between HAL and the Airline Community are on the de-scoping of a certain element that may be required within H7 once Terminal 4 re-opens. Subject to the successful resolution in de-scoping, we agree that this scope would be subject to the H7 capital governance and incentive arrangements because it would be started as a new project.

We also note here on the need for the CAA to conduct an ex-post review on a number of the key 'transitional projects' within H7, notably both the Main and Cargo Tunnels, KAD, TTS, Magenta and HBS.

C.3.4 Overall Level of Capital Plan and Dealing with Changes in the Capital Plan

We welcome the approach in setting a capital plan that meets the absolute requirements of the airport related to safety, security and regulatory compliance – as set out with the CAA's base case – with the ability to increase this level in order to meet a change in conditions from those at the time of finalising the settlement.

From the information seen to date, the CAA's mid-case capital portfolio broadly aligns with the Airline Community's assessment[36] and we are supportive of this as an appropriate level of capital expenditure, notwithstanding the information challenges set out in C.3.2 above. It is important to note however that this work in reviewing the capital plan is seeking to establish an efficient level

[35] Para 12.33 CAP2265D

[36] Airline Community Response to CAA Consultation CAP2139 and Airline Community comments on the HAL RBP Update 1 Capital Plan, 1st September 2021

which will deliver against the broader strategies and requirements set out by the CAA in its final settlement and is not in itself an approval for such expenditure.

We agree with the CAA in ensuring there is flexibility to allow for the uplifting of the overall level, as opposed to starting with a higher-baseline as suggested by HAL. In terms of uplifting the overall level of the capital portfolio, we would clarify that any such increase must be reflective of the existing capital governance process being built on which requires airline "approval". The drafting of the Initial Proposals suggests HAL should "consult" with airlines which could be seen as a worrying loosening of such established arrangements and particularly where HAL have previously suggested a capital portfolio of c £4bn – nearly 25% higher than that of Q6. Any such increase to an existing Cost Category or the creation of a new Cost Category should be accompanied by associated SMART Delivery Objectives and Obligations as per the baselined capex.

Should conditions arise where either party believe such an increase of the capital envelope is required we would recommend this is worked through the capital governance structure but, given the wider implications, that the Joint Steering Board (or any iterations of) is used as the approval forum.

We strongly support the continuation of the Development to Core process as part of the capital governance framework and believe this has improved outcomes, particular when comparing Q5 and Q6.

C.3.4 Cost Categories

The Airline Community's feedback on the development of cost categories remains unchanged from that set out prevision[33] in that we are supportive of the approach and in particular the proposals by Arcadis and the CAA to separate the Asset Management programme in particular given its overall size relative to the capital plan.

We agree with the Arcadis and CAA findings within the Initial Proposals that each category meets the assessment undertaken by Arcadis and therefore suitable for ex-ante treatment. We also believe that the approach being developed by HAL with the Airline Community in the setting of Objectives and Obligations, as set out further below, and the current Gateway process allows for a level of assurance by HAL prior to commitment that mitigates any concerns raised by HAL (through the report by Jacobs referenced within the Initial Proposals) to the contrary.

We understand that HAL are responding to these findings and will be submitting an updated plan which will include some changes to the cost categories a breakdown of the Asset Management category which differs slightly from that proposed by Arcadis; notwithstanding this we remain open to HAL's approach where there is a clear rationale for doing so. We look forward to receiving and commenting in full in due course.

C.3.5 Development of Obligations and Objectives

We welcome the build by Arcadis in providing a framework using the SMART methodology in setting out the Objectives which we understand HAL have started to use in their development. These developments have started to be shared by HAL and we have begun to provide some feedback (for example we have challenged the Objectives opening with *"Heathrow will spend…."*) but we have a number of workshop sessions planned in January to develop these further, the outputs of which we will feedback back to the CAA.

As noted, we are open to a targeted approach in setting the Objectives for the different cost categories given the variance in nature – in particular the distinction between a rolling programme of works required for asset management and those programmes or projects which have greater definition at the start, such as the Security and T2 Baggage programmes for example. Whilst still emerging thinking, we are agreeable to looking at how those under Asset Management might be addressed in 'tranches' where they are based on definable outcomes which relate back to a single overarching Objective.

C.3.6 Incentives (Level and Timing)

The Airline Community do not agree with the CAA's proposed symmetrical approach to incentives.

An appropriate allocation of how overspends on Capital projects are allocated between HAL and the consumer would be that HAL take 30% of any overspends versus G3 budget as suggested by the CAA although we believe this should be higher on the overspend and nearer 40% to be an appropriate incentive strength. We support the measure suggested by the CAA that capital inefficiency is calculated as either the difference versus budget or failure to achieve delivery obligations as set out within the business case. This is a far simpler way of assessing performance and removes the subjectivity of an ex-post capital efficiency review. Moreover, it is far more transparent for both HAL and airlines and therefore is easier to manage expectations.

Airlines are not supportive of HAL having any 'bonus share' when capital programmes and projects are delivered under plan. HAL already have an incentive to beat forecast costs as it results in an average 15% gain in any regulatory period under the Dev to Core process and we believe this is already a large enough benefit that far outstrips any normal gain share that airlines currently contract with suppliers. In addition, this would not be good for the consumer as any 'bonus' arrangement would still be added to the RAB and take away from valuable funds available to invest in consumer enhancements. Any 'bonus' would still be paid out of a capital plan. We therefore believe that an effective 15% bonus that HAL achieves today through the Dev-Core mechanism is sufficient and does not harm consumer interests.

In addition, by agreeing to reduce HAL's downside exposure from 100% to 30% it would not be palatable to also increase their opportunity to further gain on the upside without significant recognition in the WACC. This is not how commercial entities work, by increasing risk and decreasing opportunities for no apparent gain. Airlines are commercial entities that operate in a competitive market and we could not agree to anything other than HAL taking 30% of all project overspends and 0% of project underspends as adjustments to the RAB at the regulatory period reset.

We are also concerned on the CAA's approach to timing incentives in that it loses a core function of the current triggers process whereby HAL do not earn a return (by way of rebate) where benefit is not being delivered past a date, ultimately determine by HAL. Whilst the CAA have proposed a 'back-stop' timing mechanism we do not believe this sufficiently addresses this issue and, having explained this further, welcome further consideration by the CAA on this.

C.3.7 Governance

The Initial Proposal identifies a number of areas the Airline Community have already raised with regards to improvements within the process, particularly in relation to Risk, Procurement, Leadership and Logistics which we welcome the CAA's engagement on as these are developed further with HAL.

Given some areas of challenge experienced, particularly recently following the response to Covid which has seen issues on certain projects (such as Magenta, T4 HBS), we:

- agree with the proposed strengthening of HAL complying with the capital protocol documents through the inclusion within the license; and

- reiterate that CCRS's must be submitted before HAL assume airline agreement on project changes, either cost, scope or risk. We will not accept retrospective CCRS's and this must be re-enforced in any update to the capital efficiency handbook that will be used to govern capital interactions throughout the H7 period. Submitted CCRS's are not guaranteed to be approved and if HAL proceed without this important documentation it is at their own risk with no consequence to the consumer.

C.3.8 Q6 Capex Review (Appendix E)

The Airline Community submitted a detailed response[37] to the CAA's consultations on the Q6 Capital Efficiency Review which is hereby fully incorporated by reference within this response.

C.4 Operating Expenditure, Commercial Revenues and Other Regulated Charges

C.4.1 Operating Costs (Opex) & Commercial Revenues

The Airline Community welcome the findings of the PA Nyras Consulting Report in addition to the comments made under Section B which provides further evidence in support of the case for the CAA to put greater weight on its own advisors.

The report sets out a number of findings and analysis which overall validates the approach and analysis undertaken by CEPA/TA and provides further insights and examples on certain elements – such as the increased level of per passenger spend being seen. As set out in the report, given the time and availability of further information, on certain aspects PA Consulting have relied on professional judgement and have highlighted some areas that would require further analysis, though in many of the areas the reviews concur with the CEPA / TA approach and outcomes and provided additional insight that corroborate CEPA/TA findings .

C.4.1.1 Terminal Drop Off Charge

The Airline Community are continuing to review the merits of the CAA's proposals with a number of queries we are seeking to address. We look forward to further engagement with the CAA on this in due course.

C.4.2 Other Regulated Charges (ORCs)

The Airline Community are broadly supportive of the proposals set forward and will continue to consider matters through the Other Regulated Charges Group, as required, including consideration on the proposals for the bus and coaches, the merits of which we are open to understanding further and will consider in the context of both opex and capex.

We agree with the CAA's assessment that business rates are non-controllable and therefore don't fit the definition of ORCs. We do note however there is some pass-thru; given such we believe it is

[37] Airline Community Response to CAA Consultation CAP1996 Q6 Capital Efficiency Review, 23rd June 2021

important to establish some form of airline / HAL governance to review and sign off, the frequency of which to be confirmed.

We welcome the review and drafting a revised Protocol given some of the challenges we have had to date. In particular we believe:

- The CAA need to be a visible presence and part agreement to a new Protocol
- The Protocol should facilitate effective and balanced governance, with clear criteria for escalation
- The Protocol should provide clarity on NDA based transparency of cost and commend a strategic partnership approach to primary ORC services, ensuring airline/HAL partnership in the service specification and requirements, provider engagement and procurement process.

C.5 Outcome Based Regulation

The Airline Community shall be submitting comments on the issues raised within the Initial Proposals related to Outcome Based Regulation (OBR) alongside our response to the CAA's Working Paper (CAA CAP2274) by the agreed deadline of Tuesday 18th January 2021.

C.6 Other Matters Raised

C.6.1 Governance Arrangements

The Airline Community continue to encourage the CAA to set out stronger safeguards and measures in H7 to ensuring greater transparency and engagement from HAL and the ability for the CAA to intervene, particular on those areas that directly affect airlines and consumers such as ORCs

C.6.2 Proposals on Expansion Costs (Appendix F)

As set out in our response to CAA CAP1996[38], the Airline Community remain deeply frustrated in the outcome of the CAA's assessment.

The Airline Community reiterate here that, in the event of the expansion programme being reconvened, future engagement can only be on the basis of the CAA having an established policy on the treatment and governance arrangements that has been subject to prior consultation. The Airline Community engaged in good faith with HAL's programme despite recorded issues with the overall timetable yet never gave approval for early Category C costs and made it clear to HAL and the CAA that any spend would be made 'at risk'. Clearly, there has been no consequence to HAL of continuing 'at risk' and that consumers are now bearing the cost of early Category C costs regardless of the fact they were unapproved by the Airline Community.

C.6.3 Financial Ring Fencing (Appendix G)

Whilst welcoming the information requirements set out by the CAA, we believe a case to further enhance these still remains, particularly given the risk of conflict between investors involved in a WBS and consumers. It has strong merit that the CAA should be notified in a timely manner on any information that has a material bearing on Heathrow in order to allow the CAA to fulfil its duties to consumers and where such existing, or proposed measures, may not go far enough.

[38] Airline Community Response to CAA CAP1996: Q6 and Expansion Cost Assessment, 23rd June 2021

C.6.4 Holding Price Cap for 2022

The Airline Community submitted a detailed response[39] to the CAA's proposals for a holding cap on the aeronautical charges in 2022 (as further detailed in CAA CAP2265D and Appendix C of CAP2265 E) which is hereby fully incorporated by reference within this response.

We await the full details on the CAA's published decision as of 16th December 2021 but set out here our deep frustration on the outcome of the CAA's determination.

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

Sergio Fernandez
Regional Director – Airport, Passenger, Cargo and Security
International Air Transport Association (IATA)

[39] Airline Community Response to CAA CAP2265E: 2022 Interim Holding Cap, 17th November 2021

D. Annexes and Appendices

Annexes:

1. PA Nyras Consulting Report: Review of the Taylor Airey / CEPA H7 Operating Costs and Commercial Revenues, 15th December 2021
2. CEPA Report: Response to CAA Initial Proposals – Cost of Capital, 17th December 2021.
3. Houlihan Lokey: Heathrow Financeability Analysis, December 2021 [Confidential]

Appendix 1: PCM Calculations of the Airline Community Level of Charge

Inputs:

(i) Opex and Commercial Revenue Figures from Taylor Airey / CEPA analysis;

(ii) Passenger Forecasts (as per Section BXXX of this response);

(iii) WACC range of 1.3 – 2.8% (real, Vanilla);

(iv) Removal of the Asymertic Risk Allowance

NB: These calculations include the ORC figures within the PCM model that require updating

Live Scenario		2022	2023	2024	2025	2026	Total
Opex	£'m CPI-real 2020	1,080	1,101	1,106	1,098	1,091	5,475
Opex bonus (+ve) / penalty (-ve)	£'m CPI-real 2020	-	-	-	-	-	-
Regulatory depreciation	£'m CPI-real 2020	929	916	870	888	902	4,504
Return on year average RAB	£'m CPI-real 2020	223	252	282	277	273	1,306
Revenue allowance for tax	£'m CPI-real 2020	-	-	-	-	-	-
Total revenue requirement	£'m CPI-real 2020	2,232	2,268	2,258	2,262	2,265	11,286
Non-aero (inc ORCs)	£'m CPI-real 2020	(1,242)	(1,321)	(1,347)	(1,402)	(1,434)	(6,745)
Non aero revenues bonus (+ve) / penalty (-ve)	£'m CPI-real 2020	-	-	-	-	-	-
Cargo revenue	£'m CPI-real 2020	(23)	(16)	(12)	(10)	(8)	(69)
Net revenue requirement	£'m CPI-real 2020	968	932	899	851	823	4,471
Passengers	m ppa	71.99	77.65	80.89	82.50	84.12	397.15
Unprofiled yield per pax	£'m CPI-real 2020/ passenger	13.44	12.00	11.11	10.31	9.78	11.26
Profiled yield per pax	£'m CPI-real 2020/ passenger	11.14	11.19	11.28	11.39	11.50	11.30

Live Scenario		2022	2023	2024	2025	2026	Total
Opex	£'m CPI-real 2020	1,080	1,101	1,106	1,098	1,091	5,475
Opex bonus (+ve) / penalty (-ve)	£'m CPI-real 2020	-	-	-	-	-	-
Regulatory depreciation	£'m CPI-real 2020	929	916	870	888	902	4,504
Return on year average RAB	£'m CPI-real 2020	474	518	560	551	542	2,646
Revenue allowance for tax	£'m CPI-real 2020	-	-	-	-	-	-
Total revenue requirement	£'m CPI-real 2020	2,483	2,534	2,536	2,537	2,535	12,625
Non-aero (inc ORCs)	£'m CPI-real 2020	(1,242)	(1,321)	(1,347)	(1,402)	(1,434)	(6,745)
Non aero revenues bonus (+ve) / penalty (-ve)	£'m CPI-real 2020	-	-	-	-	-	-
Cargo revenue	£'m CPI-real 2020	(23)	(16)	(12)	(10)	(8)	(69)
Net revenue requirement	£'m CPI-real 2020	1,219	1,198	1,177	1,125	1,092	5,811
Passengers	m ppa	71.99	77.65	80.89	82.50	84.12	397.15
Unprofiled yield per pax	£'m CPI-real 2020/ passenger	16.93	15.43	14.55	13.63	12.98	14.63
Profiled yield per pax	£'m CPI-real 2020/ passenger	14.51	14.58	14.69	14.83	14.97	14.72