Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

cc: economicregulation@caa.co.uk

17th November 2021

Dear Paul,

Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – 2022 Charges Consultation

1. INTRODUCTION

1.1 Thank you for the opportunity to provide our comments on the Economic regulation of Heathrow Airport Limited ("**HAL**"): H7 Initial Proposals – 2022 Charges Consultation Documents.

1.2 This letter constitutes the response of Virgin Atlantic Airways ("**VAA**") and Delta Air Lines ("**Delta**") to the proposals of the Civil Aviation Authority (the "**CAA**") to introduce an interim or holding cap for HAL's airport charges for 2022. The CAA's proposals for the interim cap rely entirely on the CAA's proposals for the full H7 period. In particular, the proposals for 2022 are simply the mid-point of the CAA's provisional range for HAL's price cap for the full H7 period. In that sense, the matters on which consultees are asked to respond in relation to the 2022 charge are at least as broad as those which consultees will need to consider when responding to the full H7 consultation (for which responses have been requested by 17th December 2021).

1.3 As you are aware, consultees have only been provided with a very short window in which to provide their response to the proposals for 2022. In these circumstances, it has not been possible for us to respond to these proposals as comprehensively (or with as much supporting evidence) as we would wish. On that basis, you will appreciate that the matters set out in this response necessarily represent our preliminary submissions as to the CAA's proposals. We expect our analysis of the CAA's proposals to continue to develop over the coming weeks (and, in particular, in advance of the deadline for responding to the H7 consultation in a month's time given the significant overlap of the issues raised). We would also, of course, be pleased to address any questions that the CAA may have in relation to this response.

1.4 We recognise the practical difficulties faced by the CAA in complying with its statutory duties in circumstances where the current price control for HAL expires on 31st December 2021. In that regard, we agree that interim arrangements are needed to ensure that the interests of consumers are protected in the period before the H7 modifications come into effect (which we understand to be intended for July/August 2022).

1.5 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.[1]

1.6 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.[2]

1.7 This is in a context where the Covid-19 pandemic has had a devastating effect on all UK airlines, including VAA. As the CAA is well aware, the shutdown of aviation worldwide led to a near-total reduction in VAA's passenger numbers. VAA operated only a skeleton network between 23rd March 2020 and 20th July 2020. VAA has been particularly affected because 70% of its routes are across the Atlantic, which had effectively been closed off for 20 months.

1.8 [redacted] In complete contrast, HAL's shareholders have not provided any financial support by way of permanent equity. No airline has been able to pass the costs of the pandemic onto its customers and it would be unlawful for the CAA to allow the regulatory framework to be used to guarantee substantial shareholder returns.

1.9 In order to comply with its statutory duties (and in particular in order to consider fully the matters to which it must have regard), the CAA must take

---

1 See section 1(1), (3)(c), (3)(g) and (4) of the Civil Aviation Act 2012 in particular.

2 Index 2020: LHR = 100, FRA = 69; index 2022: LHR = 132, FRA = 72 (charge moves £23.56 to £19.36 to the proposed £29.50, which is uplifted from 2020 prices by the ONS RPI price index (Aug 2019 to Aug 2020: 293.3/291.7 and Aug 2020 to Aug 2021: 307.4 to 293.3) https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/chaw/mm23.

a detailed, logical approach to the analysis of the building blocks which are used to construct the price control for HAL. It is not sufficient for the CAA to simply seek to find the middle ground in its determinations between the positions put forward by the airlines and the airport operator. In this regard, the fact that HAL has not used a bottom-up method to create its business plans means that the CAA cannot simply rely on those proposals. It must instead ensure that it acts in accordance with its duties and on a principled basis in seeking to set the next 12 months and five year pricing settlements respectively, on behalf of consumers.

1.10 This consultation response outlines our position that the CAA's approach to defining a 2022 holding cap of £29.50 is fundamentally flawed. The flaws that we have so far identified include:

1.10.1 a failure properly to take into account the CAA's own independent analysis when calculating the building blocks of operational expenditure and commercial revenue (see section 5);

1.10.2 a failure to use available up to date passenger forecasts (see section 6); and

1.10.3 a failure properly to calculate the appropriate weighted average cost of capital ("**WACC**") (see section 7).

1.11 Given these significant flaws and failures in the CAA's approach, proceeding with the introduction of a holding price cap at the level proposed would be unlawful. Accordingly, only a significantly lower cap would be defensible (and indeed lawful). As we explain below, we consider that an appropriate interim cap would be £19.39.

1.12 The question of an appropriate price cap, including any holding cap of short duration, raises matters of detailed empirical evidence and analysis. As explained above, this response reflects VAA's position and supporting evidence which it has been able to put together in the limited time available for consultees to respond to the CAA's Initial Proposals. We also note that there was a delay in the provision of some relevant information by the CAA. In particular, the CAA only provided its Price Control Model on 26th October 2021 (i.e. after the publication of the consultation on the Initial Proposals), which further narrowed the time which we had to provide our response.

1.13 In order to assist the CAA as far as possible, we have provided in this response some information which is confidential, particularly in relation to data around passenger forecasts. This information is commercially sensitive and should be treated as strictly confidential by the CAA. We therefore consider that an unredacted version of this letter should not be disclosed in the event of any request made under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004, or otherwise. In the event that the CAA does receive such a disclosure request, VAA would expect to be informed in good time before any decision is made on disclosure and to be provided with an opportunity to make representations.

1.14 In the following sections we:

1.14.1 summarise our response to the 2022 charges consultation (see section 2);

1.14.2 explain the impact that the proposed charge would have on consumers and VAA (see section 3);

1.14.3 explain in more detail the flaws which we have identified and the concerns which we have about the CAA's proposed approach (see sections 4 to 7); and

1.14.4 conclude by explaining the action the CAA should take instead in relation to the 2022 interim charges.

2. SUMMARY OF OUR CONSULTATION RESPONSE

2.1 Heathrow is already by far the most expensive airport in the world. The CAA's proposal for 2022 would see an increase in charges of over 50%, an unprecedented level of increase which will exacerbate this even further. It is self-evident that such an increase, even on an interim basis, cannot be furthering the interests of consumers.

2.2 As a result of the delay in the CAA's H7 process, as at mid-November 2021, there remains no clarity as to the price cap which will be in place (if any) on 1st January 2022. This delay has prejudiced the interests of all stakeholders in the process. It remains, however, of the utmost importance that the CAA follows the full statutory process for H7.

2.3 We agree with the CAA that it is abundantly clear that it must put in place a licence condition to regulate HAL's prices in 2022, in order to protect airlines and in turn consumers from HAL's substantial market power and in order to comply with its statutory functions.

2.4 As we explain below, an appropriate 'mid-point' for 2022 charges is £19.39. This figure reflects the following issues with the CAA's proposals:

2.4.1 <u>First</u>, the CAA's 'range' for 2022 prices fails sufficiently to reflect the detailed independent analysis carried out by the CAA's own advisors on operational expenditure ("**Opex**") and Commercial Revenues. Instead, these building blocks are skewed in favour of HAL's Revised Business Plan ("**RBP**") (which is inflated). It is inexplicable and unlawful for the CAA, without good reason, to rely so heavily on HAL's RBP (which is not independent) compared to the independent analysis the CAA commissioned itself (and which considered the HAL RBP figures as part of its analysis).

2.4.2 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,[3] 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.

2.5 As the proposed figure of £19.39 would not amount to an adjustment in the return on capital, and there will also be a materially positive increase in passenger numbers, this lower figure would ensure that HAL remains financeable: a matter to which the CAA must have regard.[4] We discuss HAL's financeability further in paragraphs 7.8 and 7.9 below.

2.6 When calculating this figure of £19.39, we have not proposed any amendments to the WACC. That is because, in the time available to respond to this consultation, we have not been able to address this issue fully. We expect to be in a position to do so by the time that the full H7 consultation concludes (in mid-December 2021). However, we observe that the proposed pre-tax WACC of 4.4% to 7.1% represents a significant return for HAL shareholders at the expense of consumers with an assumed, inappropriately high cost of debt and exaggerated asset betas.

2.7 We, therefore, strongly urge the CAA to substantially revise down the level of the 2022 cap to the lower level of £19.39. This level of charge will further the interests of consumers, reduce the risk of overcharging consumers, preserve Heathrow's position as a global hub and ensure that HAL will be financeable.

2.8 In the alternative, VAA would be content for the CAA to roll over the existing level of charges for 2022, following the precedents set during Q5 and Q6. On those occasions, the CAA rolled over the existing terms of the price control in circumstances where additional time was required to carry out the next price control in an effective manner.[5]

---

3 See our letter to the CAA of 4th November 2021.

4 See section 1(3)(a) of the Civil Aviation Act 2012.

5 See the particular one-year extensions adopted by the CAA in relation to Q5 in March 2011 (https://webarchive.nationalarchives.gov.uk/ukgwa/20140605063645/https:/www.caa.co.uk/default.aspx?catid=78&pageid=14597) and Q6 in December 2016. (https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/Files/Q6ExtensionModification.pdf).

2.9 Finally, we note that the consultation envisages that the final H7 price control would include a correction factor that would automatically adjust revenue in the later years of the H7 price control for any under or over recovery of revenue against the level to be specified in the 2022 interim price cap.[6] We reserve all of our rights in relation to this proposal. We do not see how the proposed correction factor is an adequate solution to the incorrect calculation of the interim cap, when the errors in the Opex, Commercial Revenues and passenger forecasts are already apparent and can be remedied now by the CAA when making its final determination of the interim cap. Such a correction factor simply leads to unnecessary uncertainty for us and consumers and fails to protect those consumers who have been overcharged. It will also fail to remedy the harm to consumers who will be deterred from flying from Heathrow due to an erroneous significant increase in airport charges, and will have a negative impact on the airline industry at a critical juncture in its recovery from the pandemic.

3. THE IMPACT ON CONSUMERS AND VAA IF THE INITIAL PROPOSALS ARE IMPLEMENTED

3.1 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.

3.2 Should the CAA opt to impose a £29.50 price cap from the 1st January 2022 in its determination from this consultation process, we foresee that the following issues will arise:

3.2.1 [redacted] This follows from the fact that, in the absence of certainty over 2022 airport charges, IATA's systems have continued to record 2022 airport charges applicable to all airlines flying from Heathrow as being equal to 2021 charges. VAA has no ability to amend the charges filed with IATA, as VAA is not the relevant dominant carrier. This leaves VAA with the commercially unattractive choice between either: (1) continuing to assume 2022 charges will match 2021 charges and risk undercharging customers; (2) increasing the overall price of its 2022

[6] Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary P.24 (81).

[7] **Confidential**

tickets to account for the risk that 2022 charges increase but by doing so risk losing ticket sales to competitors who do not adopt the same strategy; or (3) passing any increase onto customers who have already purchased their tickets. [redacted]

3.2.2 Conversely, HAL will be allowed to charge airlines the newly inflated MAY figure regardless of whether the customer has been charged the 52% higher rate or not.

3.2.3 Some consumers will have little option but to pay the overinflated MAY in 2022 due to the monopoly status of Heathrow. However, the overinflated MAY will also deter many consumers from flying from Heathrow in the first place. This reduction in traffic will have consequences for consumers, airlines, HAL and jobs at a critical point in the industry's recovery from the pandemic.

3.2.4 Transfer passengers, rather than connecting through Heathrow, may elect to transfer through alternative European Hubs that are already significantly cheaper to fly from than Heathrow. By their nature, transfer passengers can be more price sensitive than point-to-point travellers and any increase in charges may influence their journey selection.

3.3 The above points are very clearly to the detriment of the consumer.

4. ERRORS IN CALCULATING THE RELEVANT BUILDING BLOCKS

The CAA has made some fundamental errors when calculating the building blocks, which have significantly skewed the final figures in the Initial Proposals. These errors can be categorised as follows: (1) a failure properly to take into account the CAA's own independent analysis when calculating the building blocks of Opex and Commercial Revenue; (2) a failure to use up-to-date passenger forecasts; and (3) a failure properly to calculate the appropriate WACC. As outlined below, in the limited time available for this response we have focussed on categories (1) and (2). VAA reserves its right to refine its position in relation to all categories, and in particular the WACC, in its response to the H7 consultation.

5. FAILURE PROPERLY TO TAKE INTO ACCOUNT ITS OWN INDEPENDENT ANALYSIS WHEN CALCULATING THE RELEVANT BUILDING BLOCKS.

Fundamental errors when calculating the Opex

5.1 The CAA has made fundamental errors in how it has calculated Opex as a material building block in the settlement of HAL's MAY. As part of the airline response to the 'Way Forward' consultation, we supported the use of independent third party specialists in helping the CAA determine an appropriate Opex figure for its settlement calculations.

5.2 However, although the CAA engaged the independent third party, CEPA/Taylor Airey, to carry out a study of HAL's Opex, it has chosen to only partly regard these findings without any apparent reasoning for this approach. Instead of taking full account of this independent and expert input, the CAA has created a set of entirely arbitrary tramlines between HAL's Opex figures (which are not a robust basis on which to base a decision) and the CAA's own commissioned independent advisors' analysis from which to determine the MAY. Additionally, the CAA has failed to take into account the alternative business plan Opex proposal presented by our airline, in conjunction with the London Airport Consultative Committee, in relation to any determination. This alternative business plan Opex was presented to the CAA on 2nd March 2021, in response to HAL's RBP which was published in December 2020. In the circumstances, the CAA's approach simply cannot be justified.

5.3 The CAA outlined in its Initial Proposals document that the CEPA/Taylor Airey analysis identifies a significant difference between HAL's Opex forecasts and its own. It states, "*Over the five years of the H7 period, CEPA/Taylor Airey project that HAL's opex would be £801m lower than HAL's forecast, a difference of around 13%*".[8] At Section 4.30 of the Initial Proposals document, the CAA explains the rationale and reasoning behind the differences in the CEPA/Taylor Airey analysis and HAL's. There are well-founded reasons as to why the CEPA/Taylor Airey analysis differs from that of HAL's, and yet the CAA has failed to provide any explanation as to why the independent review has not been fully accepted over HAL's RBP figures.

5.4 We fully support the independent findings of CEPA/Taylor Airey and agree with all of their recommendations; they are sensible and logically presented with supporting evidence. It is not appropriate for the CAA to treat CEPA/Taylor Airey's Opex projections in the same light as HAL's and to therefore select scenarios between the two competing projections without providing a proper reason for such approach. If scenarios are to be used, it would be logical to select the CEPA/Taylor Airey line as the mid-point with upper quartile and lower quartile projections around that, given that those findings are derived from independent third party specialists which have been commissioned by the CAA for the very purpose of determining those figures. There is no explanation from the CAA as to why it should not set the MAY figure for 2022 based on the independent analysis it commissioned. We provide below an alternative (and lawful) approach to setting a MAY figure for 2022 that only takes into consideration the CEPA/Taylor Airey analysis,

8 Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 1: Overall approach and building blocks P.49 (4.29).

which is the only rational and proportionate option for the CAA in setting a MAY.

5.5 One final point on Opex is that consumers are bearing too much of a burden in relation to HAL's pension deficit repair costs. The CAA, in its final proposal assessment, must review HAL's approach to reducing these costs to ensure they are truly efficient as there is little value being transferred to consumers in this area.

Fundamental errors when calculating the Commercial Revenues

5.6 As with Opex above, the CAA has failed to take fully into account the detailed analysis provided by CEPA/Taylor Airey in its report on Commercial Revenues, preferring to compromise on a set of arbitrary tramlines that anchors the range to HAL's non-independent forecasts.

5.7 It is clear that, as an independent report, the CEPA/Taylor Airey report objectively analyses the evidence before it and makes clear where it has agreed with HAL's evidence, outlining where it has based aspects of its report on those assumptions. However, it has also critically analysed HAL's assumptions and tested those conclusions. For example, the CAA outlines in its Initial Proposals document that the CEPA/Taylor Airey analysis identifies a significant difference between HAL's Commercial Revenue forecasts and its own. It states, "*The difference between CEPA/Taylor Airey and HAL … £1,016 million or 30%*". The stretch target identified is wholly justifiable and makes up for the pessimistic assumptions in HAL's model where HAL clearly has no incentive to suggest any innovative new commercial revenue opportunities at this stage in the H7 process.

5.8 In the circumstances, it is not appropriate for the CAA to give as much credibility to HAL's figures as it has done to its own independent analysis which CEPA/Taylor Airey have highlighted.

5.9 For these reasons, VAA fully supports the independent analysis carried out by CEPA/Taylor Airey as commissioned by the CAA for that very purpose, and we agree with all its recommendations; they are sensible and logically presented with supporting evidence. It is not appropriate for the CAA to treat CEPA/Taylor Airey's commercial revenue projections in the same light as HAL's and to therefore select scenarios between the two competing projections. If scenarios are to be used, it would be logical to select the CEPA/Taylor Airey line as the mid-point with upper quartile and lower quartile projections around that.

5.10 The only feasible set of figures that the CAA can credibly use to help determine a MAY for 2022 and a broader settlement for the H7 period is its own independent analysis carried out by CEPA/Taylor Airey. The approach to Commercial Revenues outlined in the Initial Proposals by the CAA inexplicably fails to properly take into account this report that the CAA itself commissioned and does not appear to be founded on a rational or proportionate basis.

Effect of properly using independent analysis only on 2022 MAY to the Opex and Commercial Revenue building blocks

5.11 The calculation used by the CAA in the Initial Proposals to identify the 'range' for the 2022 MAY provided equal weighting to both HAL's RBP and the CAA's own independent analysis of Opex and Commercial Revenues by CEPA/Taylor Airey.

5.12 For the reasons given above, this calculation is fundamentally flawed, is not sufficiently independent and therefore does not survive scrutiny. 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 MAY for 2022.

5.13 The diagram below outlines the difference in the two ranges with all other building blocks remaining equal:

5.13.1 The CAA's range using a mix of HAL and CEPA/Taylor Airey analysis.

5.13.2 VAA's submission on the correct range using solely CEPA/Taylor Airey analysis.

Fig. 1

5.14 **Therefore, if the CAA was to properly take into account its own third party analysis, rather than the 2022 MAY being pegged to HAL's biased Opex and Commercial Revenue figures, then the more accurate mid-point for Opex would not be £29.50 as contained in the Initial Proposals. Instead, the true mid-point, using only independent analysis (but subject to the further points made below), should be £23.91.**

6. ERRORS IN APPLYING THE CORRECT PASSENGER FORECAST DATA

Fundamental errors in relation to the date used to determine the passenger forecast

6.1 As the CAA quite rightly identifies in its opening remarks in Chapter 2 – Passenger forecasts of the Initial Proposals, having a suitable forecast of passenger volumes is pivotal in achieving the ultimate proper pricing calculation and the effects that has on consumers. The CAA states, "*Developing appropriate forecasts of passenger numbers is a key step in* *allowing us to properly consider our primary statutory duty to further the interests of consumers when establishing allowances for operating costs, capex and commercial revenues that are efficient and deliver value for money.*"[9]

6.2 VAA completely supports the position identified above and clearly it is in our and the consumers' primary interests to ensure that the passenger forecast is as accurate as it can be, given its fundamental impact on the pricing calculation. As the Initial Proposals acknowledge, "*The underlying forecasts of passenger numbers is vital to setting an appropriate price control*".[10]

6.3 We appreciate that, through the uncertainty of the pandemic, predicting passenger volumes has been difficult, largely driven by the UK Government's restrictions on travel, such as the traffic light system, and testing regime. However, these restrictions have now largely been lifted, the testing process on arrival has now been simplified and multiple markets are now open to British travellers, most notably the USA which opened on the 8th November 2021.

6.4 By its own admission, the passenger forecast used by the CAA is severely outdated.

6.5 For example, the CAA itself states, "*these forecasts were produced some time ago and before the recent government announcements on the lessening of travel restrictions.*"[11]

6.6 For such a crucial building block to be knowingly inaccurate at the time of publishing the Initial Proposals is impossible to comprehend, particularly as it relates to 2022 charges. It is also contrary to the CAA's own consultation materials; we do not agree that the Initial Proposals reflect the "*best information currently available on how we should further the interests of consumers and discharge [the CAA's] other statutory duties*."[12]

6.7 Indeed, even by the time the Initial Proposals were published by the CAA, better information relevant to passenger forecasting was readily available. This included, by way of example only, four further months of updated passenger figures from HAL, significant developments in relation to global travel restrictions (not least the removal of the UK's "traffic light system"[13] and the recommencement of travel to the USA for British passengers which is of particular significance to VAA). Since the consultation commenced, even more data has become available which illustrates the inaccurate and unreliable nature of the passenger forecasts relied upon by the CAA, as we explain below.

---

[9] Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary P.17 (2.3).
[10] Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary P.17 (2.2).
[11] Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary P.7 (5).
[12] Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Summary P.24 (82).
[13] Which was announced on 17th September 2021 and came into force on 4th October 2021.

6.8 The CAA indicated orally at the meeting between the airline community and the CAA on the 20th October 2021 that, because there will be a true-up mechanism part way through 2022, there would be little reason to revise the £29.50 price cap as airlines and consumers would ultimately be made whole. However, the true-up process that only serves as a significant cash advance to HAL is not an acceptable substitution to agreeing a suitable forecast from the commencement of the period, particularly where it is already apparent from the outset that the forecasts being used to found the current calculations are already out of date. Moreover, it is not in the interests of those consumers that fly during 2022 from Heathrow.

6.9 On that basis, the CAA needs to radically review the passenger forecasts allowing for recent changes in travel restrictions, the opening of markets, the relaxation of testing procedures and take in account real data directly from airlines and Eurocontrol about exactly what numbers of passengers are truly expected to fly from Heathrow in 2022.

6.10 The evidence provided below should inform the CAA of how VAA is gearing up for coping with far more passengers than the CAA's current forecasts would suggest VAA would be carrying. **Where noted, this information is provided commercially in confidence and should be kept strictly confidential within the CAA. It should in no circumstances be shared outside the CAA or published, without VAA's prior written consent.**

6.11 Since the publishing of the underlying passenger forecast, the market dynamics have changed, due to the easing of travel restrictions into key markets for Heathrow, namely Europe, Canada and the USA.

6.12 [redacted]

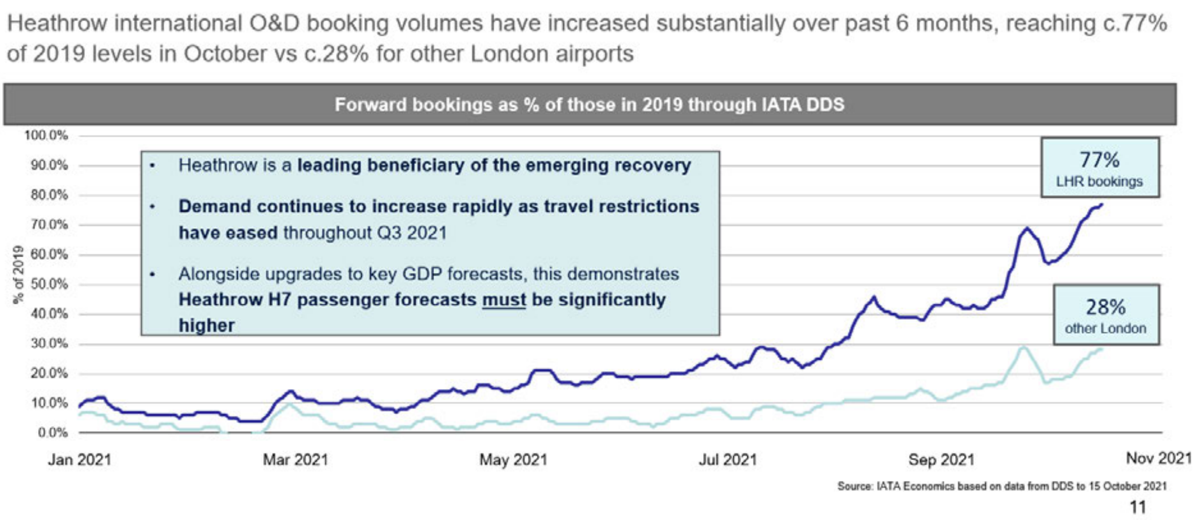
[redacted]

[redacted]

[redacted]

6.14 This confidence is also reflected in increasing numbers of bookings for all Heathrow flying in the IATA DDS bookings that have reached 77% of 2019 levels (refer to graph 3), clearly much higher than the CAA envisioned at 56.1% of 2019 levels.

<u>Graph 3:</u>



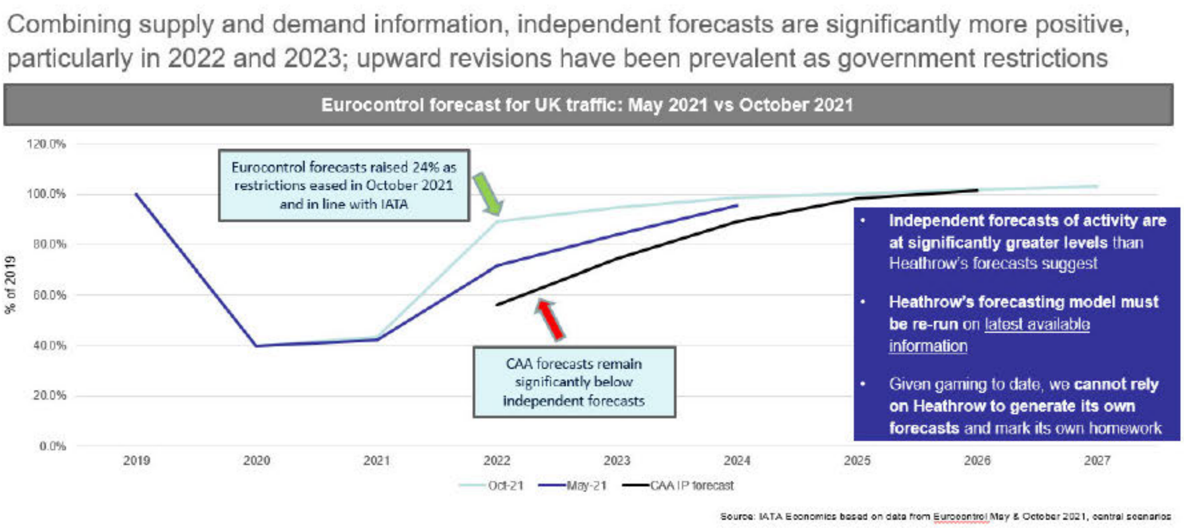
[redacted] [redacted]

6.16 Industry forecasts for UK traffic foresee an earlier recovery trajectory than envisioned by the CAA. Eurocontrol forecasts a recovery to 2019 levels in 2024 having recently upgraded the 2022 forecast to 88.9% of 2019 levels (refer to graph 4).

Table 1.

M passenger per year	2022	2023	2024	2025	2026	Total
CAA mid	45.62	60.21	71.99	79.37	82.00	**339.19**
% 2019 (80.88m)	*56.1%*	*74.4%*	*89.0%*	*98.1%*	*101.4%*	*n/a*
Airline forecast	72.0	77.7	80.9	82.5	84.1	**397.2**
% 2019 (80.88m)	*89.0%*	*96.0%*	*100%*	*102%*	*104%*	*n/a*

Graph 4



6.17 Additionally, HAL has recently told the airline community at operational readiness meetings in November 2021 that in December 2021, they will be back to 36-38 aircraft departures per hour between the hours of 0600 – 1100. The declared runway capacity is 38 movements per hour demonstrating that traffic is already bouncing back, providing greater levels of assurance that higher forecasts should be expected.

6.18 Based on these insights, key airlines support a forecast of 72m passengers in 2022 with a return to 2019 passenger numbers in 2024.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

6.21 By applying a more up-to-date forecast, such as that supplied by IATA based on Eurocontrol forecasts in October 2021 compared to the CAA's forecast (derived from HAL's forecast created in April 2021), a far lower range is apparent.

6.22 Clearly, the fact that the CAA has failed to create its own model to forecast passenger numbers has hindered its ability to keep an up-to-date forecast taking into account recent market dynamics. We maintain that had the CAA developed its own Heathrow forecast, it would not have fundamentally failed in its obligations to consumers by publishing a forecast in the Initial Proposals that is based on HAL's own spring 2021 figures. Furthermore, airlines have been unable to scrutinise HAL's forecasting methodology leading to questions about the integrity of the entire forecasting process.

Effect of applying more up-to-date passenger forecasts on 2022 MAY

6.23 The data above confirms that the forecasts relied upon by the CAA to determine its Initial Proposals are unduly pessimistic as to passenger numbers and growth in 2022 (and beyond). We do not consider the existing forecasts to be an appropriate (or indeed lawful) basis on which to make a determination about charges for 2022.

6.24 Because of the material nature of the passenger forecast on the yield calculation, it is imperative that the CAA uses the most up-to-date set of figures available to it at the point at which it is expected to make a determination. On publication of CAP2265, it is evident that the CAA has failed to do that, yet still planned on implementing a price cap at £29.50, regardless of the known inaccuracy of the passenger forecast.

6.25 The CAA should adopt the recommendations made by Skylark, the CAA's own independent consultants tasked to review the HAL forecast, on the basis that:

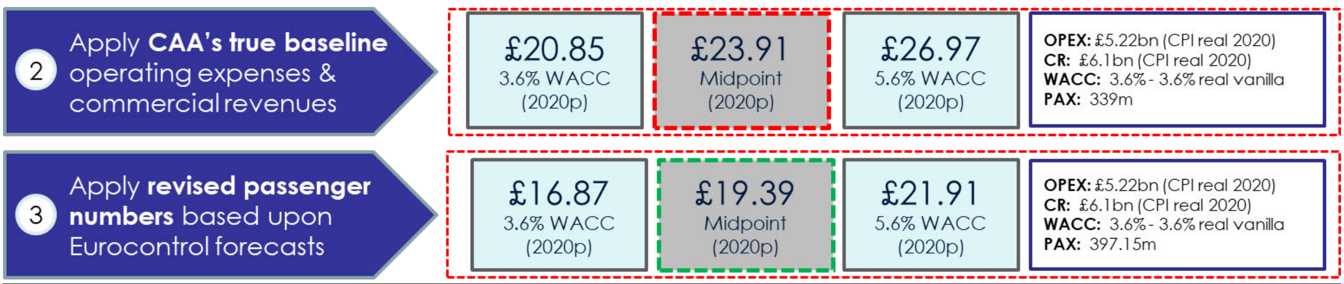
6.25.1 a more up-to-date GDP forecast was used;

6.25.2 there is little evidence to support a permanent shift in business behaviour based on the supporting evidence provided by HAL, and the CAA should consider forecasts underpinned by GDP growth to be a more appropriate mechanism to capture any potential changes in business activity; and

6.25.3 the use of the overlay Decay Function model potentially leads to an underestimate of traffic recovery, which the CAA could challenge further.

6.26 In the following diagram, Number 2 represents the new baseline range the CAA should apply once the CAA's advisors' true reflection of Opex and Commercial Revenues have been applied, as previously outlined above. Number 3 demonstrates the effect on the range taking into account the correct, re-adjusted Opex and Commercial Revenue forecasts outlined previously, and the newly applied airline forecast of 72m passengers for 2022. All other building blocks remain as per the Initial Proposals.

Fig. 2



6.27 The outcome of applying a re-adjusted Opex and Commercial Revenue figure and an up-to-date passenger forecast delivers a mid-point MAY of

£19.39. This new MAY figure is just £0.03 more than the MAY currently being charged in 2021 which we know is completely financeable.

7. ERRORS IN THE APPROACH TO THE WACC

7.1 The CAA has made several errors in judgment in determining the WACC as described in the Initial Proposals. However, given the limited time available, and in circumstances where much of our focus has necessarily been on correcting for Opex and Commercial Revenue mis-calculations and applying a more up-to-date passenger forecast reflecting the current 2022 flying programme, forward bookings, and recent changes in travel restrictions, we are not able to fully address at this stage the errors made in relation to the WACC.

7.2 In the circumstances, we are not proposing a change in the WACC as part of the calculations for the 2022 holding cap in this consultation submission. We will instead continue with our analysis of the WACC as promptly as possible and expect to provide you with our evidenced submissions on or before the 17th December 2021 (as part of our response to the H7 consultation).

7.3 The WACC is a crucial building block in the final determination which will have long-term consequences for the whole of H7 (including the charges in 2022). It is therefore regrettable that we have been afforded insufficient time in this consultation to provide you with our submissions in relation to the WACC.

7.4 Nevertheless, on the basis of full disclosure and to assist the CAA in preparing for the full H7 consultation, we will provide a summary of the errors we have identified in the CAA's WACC calculation to date. For the avoidance of doubt, this represents VAA's preliminary submissions and is subject to and without prejudice to any further information or refinements to the position that may be put forward by VAA in its response to the H7 consultation. The current preliminary summary of errors include, but are not limited to, the following:

7.4.1 The extent to which the balance of risk has shifted from HAL and onto VAA and other airlines is not sufficiently reflected in the calculation.

7.4.2 Despite the risk re-allocation, there is an over-compensation in the asset beta component which, as proposed, would see a 30% increase compared to Q6.

7.4.3 There is an inflated cost of debt, 123bps above HAL's plan and 319bps above debt investor statements.

7.4.4 The changes in calculation methodology are not supported by evidence and certainly not reflected in other sectors.

7.5 Since the CAA has made errors in its judgment in determining the WACC, the WACC should be significantly reduced. For instance, using CEPA's independent analysis of WACC as part of the airline community's engagement, VAA's current Vanilla WACC assessment is in the range of 1.9% to 2.8%. Applying an appropriate WACC has the ability to reduce further the mid-point, once the CAA has corrected for bias in its Opex and Commercial Revenue forecasts and applied an up-to-date passenger forecast.

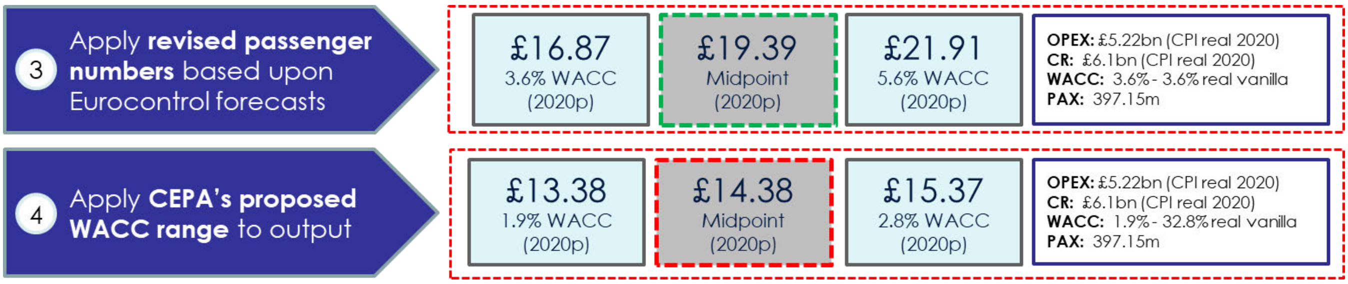
<u>VAA's preliminary submissions on the effect of applying VAA (CEPA) WACC assessment on 2022 MAY</u>

7.6 Following the logic of previous sections, once a correction for Opex and Commercial Revenues has been applied, and a more realistic passenger forecast has been reflected in the calculation of the range, we could consider the effect of a more suitable WACC. The Vanilla WACC applied under point 2 in the diagram below (as calculated by CEPA on behalf of the airline community), meets with VAA's assessment correcting for the balance of risk, re-profiles the asset betas, applies a more appropriate cost of debt and re-adjusts to historical comparators:

7.6.1 VAA's range following a correction for Opex and Commercial Revenue and an appropriate passenger forecast applied; and

7.6.2 VAA's range following a correction for Opex and Commercial Revenue and an appropriate passenger forecast applied, plus a revised WACC taken into account.

<u>Fig. 3</u>



7.7 In summary, once several of the building blocks have been re-assessed in line with the deficiencies of the CAA's approach, as outlined above, the new mid-point becomes £14.38. However, as we are not in a position to factor WACC into our consultation response at this time, our proposal remains a revision in MAY to £19.39. However, the unreliability of the proposed WACC evidenced above provides a further reason why the CAA should adopt a principled and substantiated approach, in line with the MAY that we have proposed.

<u>HAL's Financeability</u>

7.8 In making its determinations, the CAA must have regard to the need to secure that the national entity is able to finance its provision of airport operation services. VAA's proposal outlined in this submission will not financially expose the notional company (or, indeed, HAL itself) because the charges will be substantially the same as those currently experienced through 2021. Clearly, both structures remain financeable at that rate.

7.9 In HAL's most recent investor report, it outlines how financially secure it remains. It states, "*We have the financial strength, with £4.1bn of cash, to be able to come through until the market recovers*."[14]

8. THE CORRECT MAY FIGURE

8.1 We have outlined above why the MAY that was put forward in the Initial Proposals is fundamentally flawed. In particular, the approach taken to the Opex, Commercial Revenues and passenger forecasts fails properly to have regard to the independent analysis and up-to-date relevant information. We have explained why new building blocks should be used which would lead to a new MAY of £19.39.

8.2 As noted above, in the alternative, VAA considers that it would also be acceptable to roll over the current price control forward for a further year from 1st January 2022 as an interim arrangement whilst the CAA undergoes the H7 process. The MAY under the current price control is only £0.03 less than VAA's new MAY, and therefore similarly would still be consistent with the methodology which the CAA is seeking to apply for 2022 (if that methodology is applied correctly).

8.3 It would not be rational or lawful for the CAA to select a higher number, in view of the conclusions of the highly qualified external consultants commissioned by the CAA itself, the requirement to have regard to the latest passenger forecasts, and the exposure this would create for consumers who are buying ticket prices for 2022 already. Nor could the choice of such a number be justified by any true-up mechanism which simply lends itself to an unnecessarily uncertain position for both airlines and consumers in circumstances where the CAA's delay in consulting has already created significant uncertainty and has had an adverse commercial impact on our business.

8.4 A licence modification that "differs significantly" from the licence modification originally consulted upon may trigger the requirement for a new consultation, further to section 22(7) of the Civil Aviation Act 2012.

8.5 A licence modification set at £19.39 or rolling over at the existing level of £19.36 would not "differ significantly" from the licence modification originally consulted upon. The test under section 22(7) exists in order to protect consultees from decisions outside the scope of what they could be expected to have in mind. Given the history of the matter, £19.39 or rolling over at the existing level of £19.36 should be well within consultees' expectations, simply correcting for manifest errors to the methodology set out in the consultation that the CAA is seeking to apply and on which it has invited comment. Either option could not fairly be said to have taken any party to the consultation

---

14 Heathrow (SP) Limited RESULTS FOR THE 9 MONTHS ENDED 30TH SEPTEMBER 2021.

by surprise, or significantly to have affected the points that consultees would wish to make in response.[15]

8.6 For the above reasons, the only defensible and lawful approach to the interim price control would be for the CAA to adopt a MAY of £19.39 or alternatively to roll the current price control forward for a further year, without involving an additional consultation.

Yours sincerely,

Corneel Koster
Chief Customer and Operating Officer, Virgin Atlantic

And on behalf of Delta Air Lines

[15] For the avoidance of doubt, we do not consider there to be any question that a licence modification within the range described in the CAA's Initial Proposals (i.e. £24.50 - £34.40) could be described as differing significantly from the modification consulted upon. We note in particular the reference to "[w]e are consulting on a range of charges" at page 15 of the H7 Initial Proposals – Summary.