Civil Aviation Authority
Mr. Paul Smith
Westferry Circus
Canary Wharf
London EH14 4HD

Sent to: economicregulation@caa.co.uk

16th November 2021

Dear Paul,

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

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

Summary:

- 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. Fundamentally, this cannot be furthering the interests of consumers even on an interim basis.

- The CAA's "range" for 2022 prices is skewed in favour of HAL's RBP and fails to sufficiently consider detailed analysis carried out by the CAA's own advisors on Opex and Commercial Revenues.

- The suggested price cap of £29.50 is based on an outdated passenger forecast – which has been recognised by the CAA. The passenger forecast should be updated based on recent trends – particularly with the removal of travel restrictions. Consumers flying in 2022 should be protected against un-necessarily inflated charges.

- With Opex & Commercial Revenues correctly adjusted, and a more realistic and up to date passenger forecast, a more appropriate 'mid-point' for 2022 charges is £19.39. We would note that this lower range is financeable.

- The CAA's H7 process has been suboptimal leading to significant delays in reaching a final settlement with no price cap agreed for 1st January 2022. We support the CAA in following the full process and in the interim would strongly support the use the existing level of charges following the precedence set during Q5 and Q6.

- 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 high cost of debt and exaggerated asset betas. These are further areas we will respond on for the full H7 consultation.

- We strongly urge the CAA to roll over the existing level of charges for the annual charges for 2022, following the precedence set during Q5 and Q6. That level of charge will further the interests of consumers, reduce the risk of overcharging consumers, ensure Heathrow remains a global hub and that HAL will be financeable.

Heathrow is already the most expensive airport in the world.

Heathrow's total charges were 44% greater than the next most expensive European hub airport in 2020, and the CAA's proposed charges could raise this gap to 83% in 2022.

Shorthaul operators have raised concerns with the Heathrow Airport Operators Committee (AOC) that the proposed charges are making them more uncompetitive with the LCC carriers operating out of Stansted, Luton and Gatwick. Overtime this will likely result in less capacity being operated into Heathrow. Internally Air France and KLM are studying options to change fleet deployment. This could result in lower capacity on our routes to and from London Heathrow (**confidential information**). Air France is planning index 70 and KLM index 86 of 2019 levels in the UK.

UK based consumers and UK based airlines are disproportionately impacted by these charges, as they have few alternate options, particularly for longhaul flights, given Heathrow's market power, as recognised by the CAA.

The fact that UK consumers have to pay so much more than other European travellers going through an airport appears to support a monopoly which the CAA is meant to be controlling.

How does this support the message of the UK being open for business and post Brexit we are more competitive?

These charges will lead to airlines considering alternative transfer routings, either at other European, USA or Middle East hubs. The charges will lead to a reduction in Heathrow's ability to operate as an effective global hub and offer consumers and businesses an extensive range of international destinations and frequencies.

The CAA's "range" for 2022 prices is skewed in favour of HAL's RBP

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

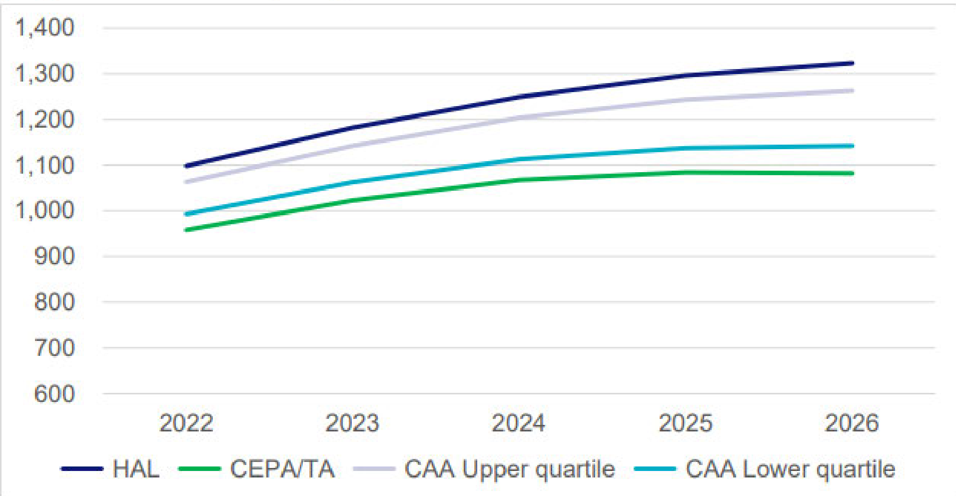
The below graphic taken from the CAP 2265B illustrates that the CAA have estimated Opex in a range between the independent consultants (CEPA/TA) and HAL's RBP Update 1 cost estimates for H7. We simply do not agree with this approach. The CEPA/TA Opex projection is significantly lower than HAL's due to:

CEPA/TA recommending 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.

We agree with all CEPA/TA recommendations, they are sensible and logically presented with supporting evidence. It is not appropriate for the CAA to treat CEPA/TA's opex 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/TA line as the mid-point with upper quartile and lower quartile projections around that.

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

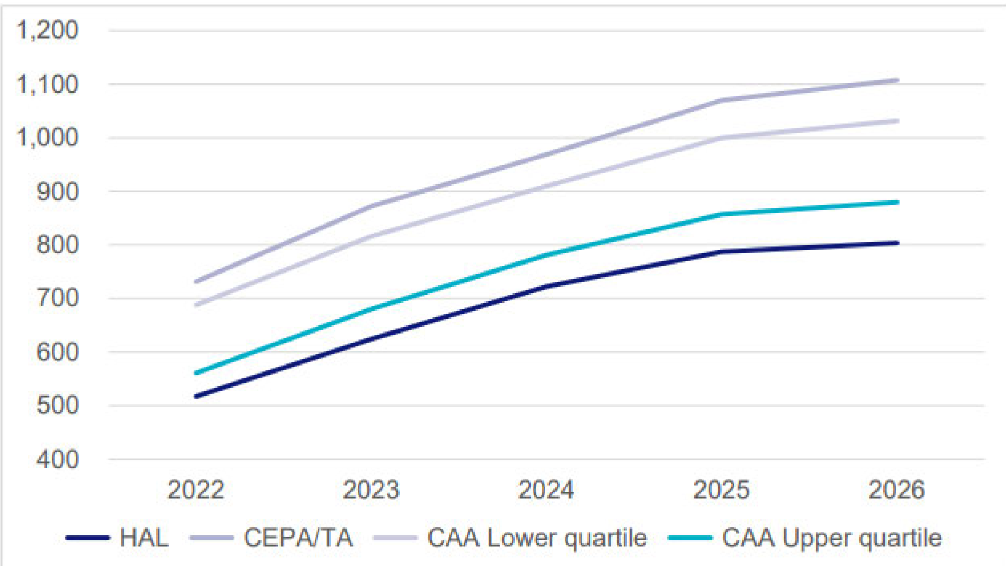
The below graphic taken from the CAP 2265B illustrates that the CAA have estimated Commercial Revenues in a range between the independent consultants (CEPA/TA) and HAL's RBP Update 1 commercial revenue estimates for H7. We simply do not agree with this approach. The CEPA/TA Opex projection is significantly higher than HAL's due to:

CEPA/TA recommending that:

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

We agree with all CEPA/TA recommendations, they are sensible and logically presented with supporting evidence. It is not appropriate for the CAA to treat CEPA/TA'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/TA line as the mid-point with upper quartile and lower quartile projections around that.

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

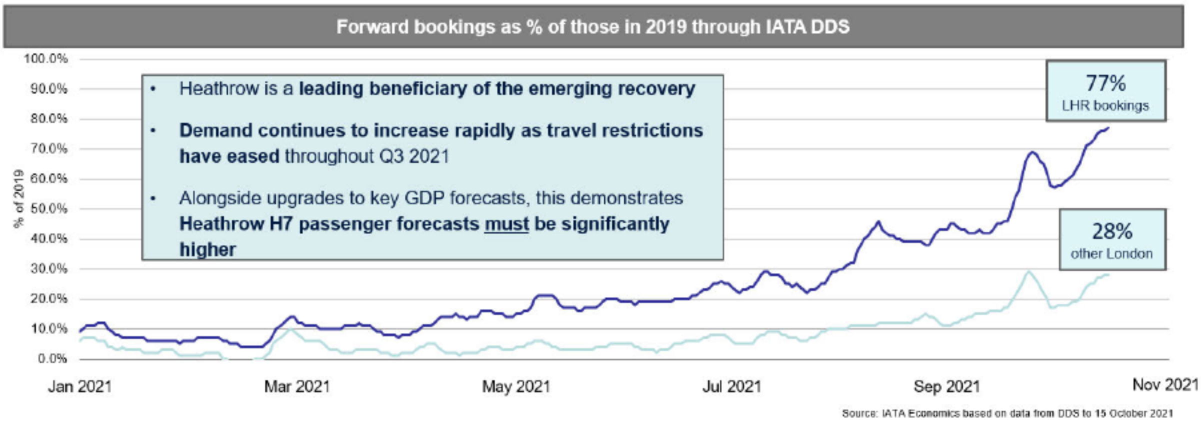


Source: HAL updated RBP, CEPA/Taylor Airey analysis and CAA ranges

The suggested price cap of £29.50 is based on an outdated passenger forecast.

The passenger forecast should be updated based on recent trends – particularly with the removal of travel restrictions. The CAA's passenger forecast was made in April 2021, since then the UK has lifted nearly all Travel Restrictions, and this has had a significant impact on passenger growth.

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.



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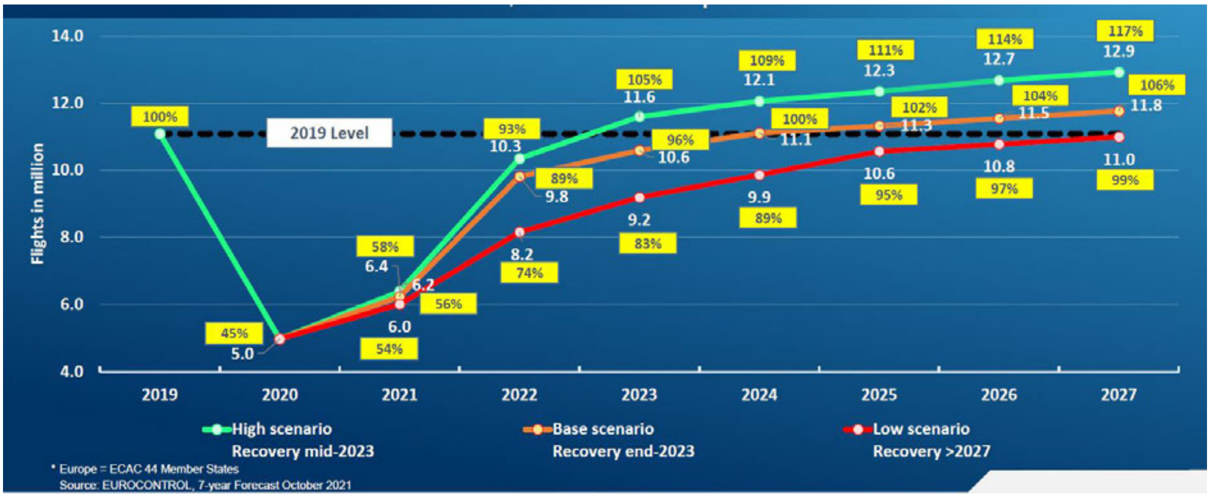
Finally we also refer the CAA to Eurocontrol's recently updated movement forecast from October 2021 (see below) which shows the Eurocontrol Base Scenario is forecasting ATMs to recover to 89% of their 2019 levels by 2022 and 100% of their 2019 levels by 2024.

We would urge the CAA to update their forecast in the light of the lifting of the UK's travel restrictions and to take account of the evidence we have presented that passenger traffic in both 2022 and H7 will be significantly higher than that forecast in the CAA's Initial Proposals. Consumers flying in 2022 should be protected against un-necessarily inflated charges – which could occur if the CAA maintains its current passenger forecast for 2022 and H7.



Source: Eurocontrol October 2021

We would also note that we 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.

Implications of no decision on 2022 charges.

We would highlight again to the CAA the issues that face airlines and consumers due to the delay in setting a final price cap for 2022 annual charges. As the CAA is aware consumers are already booking flights for travel in 2022 and airlines do not have a firm decision on which to base PSC's for 2022. If the CAA persists with the proposed price cap the there is a significant risk of over recovery of revenue by HAL in 2022 and of consumers being over charged.

In summary we strongly urge the CAA to roll over the existing level of charges for the annual charges for 2022, following the precedence set during Q5 and Q6. As demonstrated above, that level of charges will further the interests of consumers, reduce the risk of over-charging consumers in 2022, ensure Heathrow remains a global hub and that HAL will be financeable.

Yours sincerely,

Fahmi Mahjoub

General Manager Air France KLM Great Britain & Ireland