Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

Sent by email to: economicregulation@caa.co.uk

17th December 2021

Dear Sir/Madam

Response to CAP2265 Economic regulation of Heathrow Airport Ltd : Initial Proposals for H7

Thank you for the opportunity to respond to your latest consultation on the Initial Proposal for H7 ("CAP2265").

IAG fully supports British Airways' submission in full.

Our position can be summarised with the following:

Heathrow is already one of the world's most expensive airports. The proposals by the CAA range from the lower range increasing significantly by +25% whereas the upper range suggests an unprecedented increase of +75% and will have a significant bearing on consumers.

We maintain our strongly held position that H7 should see an overall fall in the level of aeronautical charge compared to current levels. Applying the analysis from both CAA and our independent consultants suggests a level significantly below the CAA's Initial Proposal.

The industry is in the recovery stage and the CAA need to reflect this in its approach to key elements of the settlement, notably passenger forecasting and the cost of capital.

Such findings are based on four particular errors in the Initial Proposals that the CAA must address before their Final Proposals:

1. 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 follow similar conclusions drawn by PA Consulting who have reviewed on behalf of the airline community. Where scenarios are to be used it would be logical and reasonable to select the CAA's advisors' mid-point with upper and lower quartile projections around that, given the level of evidence submitted and independent supporting analysis

2. The CAA's proposal is based on an outdated passenger forecast which does not reflect latest industry analysis, such as those published by Eurocontrol STATFOR, IATA and ACI – all of which point to a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. Analysis by the Airline Community suggests the current CAA estimate to be in the range of circa 58m passengers lower than industry consensus across H7 with traffic expected to recover to 2019 levels at Heathrow by 2024

3. 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 which sets out a more appropriate range and is submitted as part of the IATA / AOC response

4. The approach the CAA has taken appears to have placed undue weight on short-term financeability considerations and tends towards HAL's position in asserting that consumers alone should bear the cost of Covid. 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 (Covid) risk allowance and 1.07% shock factor to passenger forecasts, all of which ultimately over-compensates HAL and should be dismissed by the CAA

We encourage the CAA to set out stronger safeguards and measures in H7; ensuring greater transparency and engagement from HAL and the ability for the CAA to intervene, in particular areas that directly affect airlines and consumers

Financial Matters and Risk

We do not support the CAA's Traffic Risk Sharing (TRS) in the form proposed by the CAA in its Initial Proposals as

1. There has not been a corresponding appropriate reduction in the WACC – despite the proposed TRS significantly reducing HAL's volume risk – we estimate the reduction should reduce the WACC to very close to the level of the water and electricity companies

2. The TRS structure proposed 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 at LHR by 2023 (as set out further in IATA/AOC response to Passenger Forecasting) and that HAL will have a significant cash advantage given the additional revenue will not be returned to consumers until H8

We remain opposed to the CAA's decision on to grant Heathrow a £300m 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.

We believe the airline alternate proposals as calculated by British Airways are fully financeable.

Passenger forecasting

Omicron should not dissuade any arguments on passenger forecasting and we support the recommendations made by Skylark to the CAA, which should ultimately result in the CAA performing their own modelling to determine the price control

Operating costs, Commercial revenue and Other Regulated Charges

Support the recommendations made by CEPA / Taylor Airey to the CAA

Capital Plan and Incentives

The capital plan is still too high-level to sufficiently comment on in detail but we agree with the approach the CAA has taken in rejecting HAL's inflated plan with a focus on what is required in H7; noting the CAA's mid-point of £2.4bn being broadly in line with that suggested by the airline community of £2.2bn

We are broadly supportive of the ex-ante capital efficiency incentive proposal being proposed by the CAA with the specific details to be worked through with the airline community between now and Final Proposals

We also highlight that improvements are required within the current governance process, particularly on the definition and reconciliation of benefits and cost assurances

Outcome Based Regulation

We will be responding to the CAA's Working Paper in January.

Other Topics

We are disappointed with the outcome of the CAA's assessment on expansion costs; any re-start in the future must have tighter controls in place before any further expenditure is incurred by HAL

Yours sincerely,

Colin Betteridge
Head of Regulation and User Charges
IAG