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August 9, 2022

Aer Lingus response to CAP2365A: Economic regulation of Heathrow Airport Limited, H7 Final Proposal

Aer Lingus welcomes the opportunity to respond to your Economic regulation of Heathrow Airport Limited (HAL): H7 Final Proposal.

For the avoidance of doubt, we have seen the submission to you from our colleagues at British Airways and agree fully with their position. Consequently, we limit our response to a number of high-level comments.

The CAA's final proposal stating that charges should be no more than £24.50 in 2020 prices is higher than the evidence suggests it should be, despite being at the bottom of the range proposed in its initial proposal. We believe that the CAA has made a number of errors in coming to its decision, both methodological and in fact. In terms of methodology, rather than starting from a zero baseline and assessing what an efficient company would need, the CAA has been content to use the 2022 holding cap of £29.20, as a baseline. This effectively builds HAL's inefficiencies into the control. We believe that rather than adopting an approach which assumed £29.20 was the efficient price and considering deviations, the question which the CAA should have posed itself is 'what would an efficient businesss require as a fair price over the H7 period.

The CAA continues to underestimate passenger demand, relying on a model developed by the Airport. The CAA substantially overprices risk within the cost of capital (WACC) and persists with the flawed introduction of a Traffic Risk Sharing mechanism. In addition we also have concerns about the CAA's decisions on opex and commercial revenue. Aer Lingus urges the CAA to further review the available evidence and reduce the price cap accordingly.

The purpose of economic regulation is to prevent the abuse of market power, and typically regulators do this by presenting the regulated entity with a structure that incentivises it to behave as if it was a competitive business. However, we do not believe that the CAA has properly accounted for the steps it has taken to insulate HAL from market shocks which effectively transfer risk from HAL's shareholders to the airlines and our passengers. The CAA has commented that the Traffic Risk Sharing (TRS) mechanism and new mechanisms for dealing with asymmetric shock effectively reduce HAL's exposure.

However, the CAA has not taken full account of the de-risking properties of the TRS. We draw the CAA's attention to the report for the airline community by the independent experts CEPA, which cites that had the CAA properly accounted for the TRS the WACC would be 68 basis points lower than currently proposed by the CAA. Furthermore, we believe that CAA granting HAL £300m in the RAB as compensation for lost business, clearly shows that HAL is an economic regulator that will act strongly to insulate HAL from any adverse demand shock.

With respect to the £300m uplift in the RAB, our understanding is that adjustments to the RAB should typically be made on the basis of an efficient investment. Aer Lingus submits that the CAA cannot just 'gift' HAL's investors money, and that HAL needs to demonstrate that the money has been used in an efficient way that is consistent with the CAA's primary duty. Given that it is the passenger who will ultimately be impacted by the £300m additional uplift, they have the right to insist that it is effectively spent. We urge the CAA to ensure that its unwarranted generosity to HAL in this regard results in benefits to our passengers rather than inflated dividends to HALs shareholders.

We also note that the CAA's historic approach to price regulation has been that HAL should bear both upside and downside volume risk within the control period. The introduction of the Traffic Risk Sharing mechanism for dealing with asymmetric shock effectively reduces HAL's exposure. Whilst it is clear that HAL continues to reap much of the benefits of upside risk, it is not the case that it bears downside risk as some sort of charitable venture. It is already compensated to take downside risk. This is because the CAA has taken account of downside risk when determining the WACC for HAL. So, HAL takes most of the upside risk and is compensated insofar as it takes the downside risk. The result of the CAA's final proposal rewards HAL twice for downside risk, once through the WACC and again through the Traffic Risk Sharing mechanism. This double charges airport users for risk. Arguably, the inclusion of the asymmetric allowance effectively adds a third layer of risk protection.

Prior to setting the H7 control the CAA's policy on unexpected and adverse shock was that it was dealt with by an adverse shock generator in the passenger forecasts and an uplift in the WACC. As the airline community has explained to the CAA, we are open to the further de-risking of HAL and the added bureaucracy and potentially perverse incentives those actions bring, if the benefits of such an approach pass fully to our passengers and not to HAL's shareholders. Given that the CAA has not fully passed on the benefits of HAL's de-risking to our customers, we question the value of such an approach. We urge the CAA to reconsider its position in light of its primary objective to further the interests of passengers rather than those of HAL's shareholders and to take proper account of the steps to de-risk HAL.

In short, we believe that the steps proposed and the actions of the CAA make HAL demonstrably less risky from an investors point of view than in Q6. Given this we cannot agree with the CAA that HAL's asset beta has actually increased.

Aer Lingus supports the CAA's decision not to add to the £300m increase in the RAB that it has already granted to HAL. We do not believe that any further upward adjustments are necessary. The purpose of economic regulation is to incentivise the monopolist to act as if it operated competitively. No commercially operated airline received a £300m bail out from its regulator to compensate it for the effects of Covid. The act of being regulated should not mean that HAL is treated differently to a commercial business. However, having decided on a RAB adjustment the CAA needs to follow through on the de-risking implications of such a move and it has done so. In short, we object in principle to the RAB adjustment and believe that the CAA has not fully accounted for it.

In terms of the CAA's final proposals for the WACC, we support the decision to reduce the WACC by some 140bp. However we note that this is largely due to changes in inflation. We believe that the CAA has erred in its proposals for the WACC and have not taken proper account of HAL's new, lower level of risk, erring in its decision on the cost of debt and in its calculations of an asset beta (specifically with respect to the post pandemic element). We note the reports commissioned by the airline community from the independent experts, CEPA and Alix partners, in this regard. The CEPA report suggests a real vanilla WACC of 2.69% if the CAA corrects only for its errors in the asset beta and lower if it corrects for its other errors. Alix partners suggest a real vanilla WACC of 2.37%.

The CAA has set its passenger forecasts too low, overly relying on the HAL model rather than undertaking independent analysis. The CAA recognises that forecasting in the current climate can be tricky. What is more reliable is actual behaviour and we are already seeing a heavy uptick in passenger demand. In particular the CAA traffic forecasts underestimate passenger demand in the early years of the forecast – which is exactly when actual booking data is likely to be most reliable.

We note that the CAA's reliance on HAL's model has led it to propose a passenger forecast that is at odds with both real world evidence and the forecasts of other bodies. The CAA suggests that passeneger volumes at Heathrow will not return to 2019 levels until 2025, which is 1-2 years slower than forecasts from IATA and ACI. We also note that if the CAA examines OAG data for May 2022, Heathrow passenger volumes for 2022 are estimated at around 65m – significantly higher than the CAA's estimate.We do not accept the CAA's argument that airline booking data may overestimate actual passengers because HAL may be too short staffed. If airlines can find the staff to fly the planes (and HAL argues that its opex costs are largely fixed and invariant to pax numbers) then surely HAL can too. HAL is effectively capping passenger volumes, and the CAA should not insulate HAL's management from its inability to manage its own staffing levels or give it an incentive to respond slowly to the demands of its customers. We remind the CAA that its duty is towards the passengers who cannot fly to Heathrow because of HAL's inefficiency as well as those who do.

Turning to the other building blocks, we have both specific and general comments around capex, opex and commercial revenues. Between the CAA's IP and FP all three building blocks have moved in HAL's favour. The CAA notes that in all three building blocks, HAL has provided little or no detail to explain why they want the increase, and in places, the CAA's FP decision are at odds with their own consultants. We are increasingly concerned at the signals that the CAA's decisions will send HAL and with the incentives for future behaviour that they imply. It appears that all HAL needs to do to get an increase in capex and opex and a decrease in commercial revenues is not to give the CAA the full information it needs to make an evidenced based decision. We are concerned that this sets a precedent for H7 implementation and future controls.

In terms of the capex programme, we agree with the CAA that the lack of meaningful information from HAL has made any assessment of capital spend for H7 extremely difficult. Like the airline community at Heathrow as a whole, we do not believe the overall level and make-up of the capital plan within the Final Proposals is justified but is instead based on a number of inconsistencies and lack of challenge on HAL. It is very concerning then that the CAA has allowed the capex program to increase from £2.4 billion in initial proposal to £3.6 billion in final proposal, without supporting evidence for the increase. A point that the CAA itself has acknowledged.

For example, when looking at the new UK security mandate and HAL's capex plans in relation to this, we believe that, based on presentations given by HAL, and our own operational knowledge, that the capex spend required is in the order of £50m, rather than the £1bn HAL propose. We also note that the investment should release significant opex savings, which we do not believe have been factored into the opex numbers. In HAL's proposals the documents are so heavily redacted that most of the key information is missing, making it impossible to for us to understand why HAL's estimated costs are so much greater than our assessment. We request that the CAA make an unredacted version available so that we may scrutinise the proposals properly

One of our key priorities for the upcoming period is for progress to be made in the development of a new baggage system for T2 to replace what is an increasingly obsolete and unreliable system. It is disappointing that HAL has continued to defer investment in a new baggage system to the point that substantial investment is required to prolong the archaic T1 system still used for T2 operations. Nevertheless, it is necessary to start investment in a new T2 system during H7, which might as a result be delivered by 2031 or 2032. The alternative of delivery in the late 2030's is not credible.

We also support the further automation of the passenger journey such as the further roll-out of self bag drop and self boarding gates together with further optimisation of the existing automation, for example adding payment to self bag drop). We believe this is the way to unlock capacity in T2 and to ease some of the operational challenges that are faced today.

We agree with the CAA that deferral of the T5 station fitout to align it with the latest Western Heavy Rail timelines is a sensible idea.

Finally, on net zero and the environment, Aer Lingus has always striven to be environmentally responsible. That is why Aer Lingus has already committed to introducing new fuel efficient, quieter aircraft into our fleet and retiring other older more inefficient aircraft. For example, our new Airbus 321NEOLR aircraft are 20% more fuel efficient than existing aircraft and produce 50% less engine noise than the A321CEO. We are actively introducing a range of other environmental measures, both at DUB at beyond.

We are equally demanding of our partners and so, in principle, we are supportive of work to enable Easterly Alternation.

We are also supportive, in principle of Menzies plans to switch to electric vehicles (EV) for ground handling. However, HAL's proposals for investment in EV charging and HV infrastructure will require careful scrutiny to ensure that investments are efficiently designed, undertaken and delivered.

For the avoidance of doubt we are supportive of HAL investing to better meet its environmental obligations. However, we are frustrated that HAL has provided almost no detail on its plans. For example, we note that there is circa £400m ear-marked for 'decarbonising heat' but that no detail has been provided on what this entails. Indeed, whilst we are supportive of a broader package of measures on environmemntal susutainability, we note that in the narrow context of the capex plan, HAL's investment needs to be efficient. More broadly however, we also note that there are other ways to deliver better environmental outcomes for our passengers (eg improving airfield efficiency, working with third parties and improving aircraft taxiing and holding times). These may deliver better outcomes and not incur costly HAL capex.
Taking account of the above, the airline community has assessed the average H7 price cap to be between £18.00 and £19.00 (at 2020 prices) as opposed to the CAA's decision of £24.50 (at 2020 prices).

Aer Lingus is available to discuss any of the issues raised and to engage further with the CAA on points of detail, should that be useful.

Yours sincerely,

Marta Drozdz
Airports Commercial Manager