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Civil Aviation Authority
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9th August 2022

**Re: Response to Economic Regulation of Heathrow – CAP2365 H7 Final Proposals**

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

This submission is made jointly by the London (Heathrow) Airline Consultative Committee ("LACC"); Heathrow Airline Operators Committee ("AOC") and International Air Transport Association ("IATA"), collectively referred as (the "Airline Community"); and is supported by Airlines UK and the Board of Airline Representatives in the UK. It 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 broken our response across four sections including supporting documentation, as follows:

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

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

C. Other Matters for Consideration: This section addresses other new, key points raised within the Final Proposals not covered under Section B on which the Airline Community comment. This broadly follows the structure within the consultation documents; and

D. Appendices and Annexes:
   a. Appendix 1 – Breakdown of Airline Community calculations as to the proposed level of charge
   b. Annex 1 – CEPA: H7 Final Proposal WACC Analysis.
   c. Annex 2 – Airline feedback to CAA: "Timely Delivery on Departing Baggage"

This submission focuses on new evidence or developments within the Final Proposals. Previous Airline Community responses, including positions and comments within, still stand unless updated herein. These should be read alongside and are hereby incorporated into this response, particularly the Airline Community consultation responses to CAA Initial Proposals[1] as well as presentations made to the CAA Board[2], referred herein as ("Previous Submissions").

## A. Summary, Context and General Comments

### A.1 Summary

As set out in Previous Submissions, Heathrow is already one of the world's most expensive airports. Whilst noting the downward trend of charges in the Final Proposals, it must be seen in the context of a significant rise in 2022; views and the impacts of which, particularly for consumers, have been shared through our Previous Submissions. As set out below, the proposed charge still, in our view, ultimately remains above the level it should be.

At the Initial Proposals stage, the Airline Community used the CAA's PCM model and, based on analysis from both CAA and the Airline Communities' independent consultants, calculated a level of charge between £11.30 - £14.72 (2022 pricing) – the full analysis of which can be found in the Airline Community's response to the Initial Proposals[3].

In addressing key issues set out within the Final Proposals and taking into account updated information since the Initial Proposals, we believe the evidence shows the level to be no more than [redacted][4] on average across H7.

Such findings are as per the rationale and evidence set out in Sections B and C of this response; and summarised in Appendix 1, but are largely based on addressing four fundamental errors we have identified within the Final Proposals:

1. **Traffic Forecast:** Whilst the CAA's Final Proposals have seen an upward recalibration in the passenger forecast, we note compelling evidence, including both actual data as well as more recent updates to forecasts on which the CAA have relied upon, of a stronger recovery and greater passenger forecast total than the Final Proposals suggest. In particular, we note that the CAA's Final Proposals suggests: (i) a 'near-term' view that does not reflect actual figures being seen; and (ii) a view on recovering to 2019 levels (which the CAA does not expect until 2025), that continues to be contradicted by wider industry analysis. Based on new evidence since Initial Proposals, the Airline Community have reviewed our own forecast and believe that the current CAA total (Mid-case) figure to still be in the range of circa 36m passengers lower than the evidence suggests it should be. The Airline Community forecast this figure should be 396.1m across the period.

   We note the CAA's have committed to reviewing the passenger forecast where evidence shows retaining the proposals as set out in the Final Proposal would create a significant bias[5]. Given the evidence set out further within this response we believe this bar has been reached and a review of the CAA's forecast is clearly warranted.

[1] Airline Community responses to: CAA CAP2265 (Initial Proposals); CAA CAP2274 (OBR Working Paper); and CAA CAP2275 (H7 License Modifications)
[2] Joint Airline CEO meeting with CAA Board re H7, 4th May 2022
[3] CAA CAP2265: H7 Initial Proposals
[4] NB: The Airline Community are working with the CAA to finalise calibration within the CAA's PCM and CTA's model for operating costs and commercial revenue, the conclusion of which may adjust this figure within a range of tolerance; the Airline Community will further update the CAA upon its conclusion.
[5] Paras 108 and 109, CAA CAP2365A: H7 Final Proposals

2. **Cost of Capital:** Despite movement towards the lower range of the proposed cost of capital, we note that this has largely been driven by inflationary factors. As evidenced by the work undertaken on behalf of the Airline Community by CEPA ("CEPA Report"), included as Annex 1, further adjustments are still required. The CEPA Report demonstrates *at the very least* and by just addressing the main areas of difference between CEPA and the CAA, a return of 2.48% (real vanilla WACC) would be more appropriate. When correcting for additional factors including those raised by AlixPartners on behalf of a number of airlines, such expert opinion closely calibrates at 2.37%, and which the Airline Community have therefore used in our own analysis.

3. **The balance of Risk:** The CAA has significantly shifted the balance of risk for the H7 regulatory framework. Notably, the CAA has:

    - introduced the symmetric Traffic Risk Sharing ("TRS") mechanism;
    - continued with a 'shock factor' to traffic forecasts;
    - aimed up on the WACC to address 'welfare effects'; and
    - introduced an allowance for asymmetric risk

    Each of these features positively skews the expected outcome for HAL and, in our view, has been applied incorrectly and in a manner not in keeping with the CAA's primary interest to consumers and efficient pricing.

    In addition to the comments on traffic forecasting and WACC set out above and Section B of this response, the **Airline Community note in relation to TRS that**, in its current form:

    (i) whilst the risk transfer has now been accounted for in the WACC, a further downgrade is still required; and

    (ii) it leads to both an asymmetric variance between the under and over forecast scenarios; and also has a significant risk from mis-calibration to HAL's benefit in the outer band (105%).

    **In terms of the inclusion of an asymmetric risk allowance,** given the other risk mitigation measures already in place, an additional allowance to address a negative asymmetry is clearly neither required nor justified. Historically the CAA has also not included any adjustment on the WACC for asymmetry so, as well as this not evidentially being in the consumers' interest, it also creates concerns around regulatory predictability and stability.

    In order to closer reflect the actual balance of risk between HAL and consumers, the CAA should in both our, and experts' opinion, address the issues raised within this response on TRS and remove the unnecessary and unjustified asymmetric risk allowance.

4. **The RAB adjustment:** Finally, we note the CAA are seeking to implement the £300m RAB Adjustment through the H7 License, as set out within the Final Proposals. The Airline Community continues to strongly contest this. Whilst it may have seemed reasonable and proportionate at the time, notwithstanding other issues, HAL's subsequent failings to provide sufficient capacity to meet returning demand despite warnings of such has clearly impacted airlines and consumers and therefore must be removed.

In addition to the above, we also note that positions taken on Outcome Based Regulation ("OBR") have in our view, shown a lack of operational understanding that underpin consumer outcomes with airline evidence ignored or not sufficiently considered. This also appears to have led to a lack of sufficient challenge on targets and measures and will, in our view, ensure poorer consumer outcomes than should otherwise be the case. This is exampled by the CAA proposing consumers now pay HAL a bonus for meeting the same level of performance in departures and transfers security that they experienced during Q6.

Notwithstanding the above and other points described further within this response, we are broadly supportive and welcome the inclusion of several aspects within the Final Proposals which we think will provide for better outcomes for consumers. Notwithstanding and without prejudice to more detailed comments within, this includes the introduction of ex-ante and Delivery Obligations to capital incentives, although further work is required for the capital plan; movement to a marginal cost base approach for Other Regulated Charges ("ORCs"); and commitments to review and enhance governance arrangements in conjunction with airlines, as well as seeking greater reporting requirements on HAL.

Full details on these, and other key points, are set out further within this response with the offer of further discussion, as required.

We firmly believe that both the new evidence and observations set out within this response shows a need for further adjustments in advance of the CAA's final determination but by reflecting and correcting for the points raised, will ensure a better outcome for consumers.

## A.2 Context and General Comments

The Airline Community have consistently found and stated to the CAA that the H7 process to date has been problematic.

In particular, we would note HAL's continued failings in producing sufficient plans and information as clearly required and expected by the CAA; full details on which are set out in our Previous Submissions and with further examples within this response.

Despite this, the CAA appear to have ultimately relied upon much of this information in reaching certain positions; and in some cases, going further towards HAL than their own independent advice suggest. We note this particularly in relation to assessment and allocation of aspects of the operating costs, commercial revenues and the capital plan, as described further in Section C of this response, and where in many cases airlines and the Airline Community have not had visibility of such information.

In addition, there remains an ongoing concern that the 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 and which appear to have had undue influence. For example, setting a passenger forecast which continues to appear particularly pessimistic when compared to broader industry analysis, or inclusion of unjustified asymmetric risk allowance. The effect of this appears to create a layering of measures and assessments that, as set out in Section B, compound to create a higher level of charge.

Notwithstanding addressing the particular points set out further within this response, the Airline Community believe that, given the on-going challenges and behaviours faced, as well as some of the outcomes proposed within the Final Proposal, that a review of the regulatory process and framework is required for H8, particularly in relation to the promotion of competition of airport ownership and operation. We look forward to engaging further on this with the CAA in due course.

## B. The Level of Charge Proposed by the CAA remains Incorrect

Despite the welcome movement to the lower end of the CAA's initial range, the Airline Community believe the CAA has made several errors in a number of key aspects of the regulatory building blocks which ultimately results in an incorrect level of charge being recommended within the Final Proposals. In particular:

### B.1 Passenger Forecast

We fully concur with the CAA's assessment that developing *"appropriate forecasts of passenger numbers is a fundamental step in allowing [the CAA] to properly discharge [its] statutory duties, including furthering the interests of consumers[6]"*

It is therefore a fundamental concern to the Airline Community that, despite the revision upwards since the CAA's Initial Proposals, the CAA's passenger forecast is based on outdated information; continues to lag significantly behind wider industry views, despite the CAA's comments that the recovery profile remained central to its decision[7]; and has taken an overly cautious approach, with limited visibility to airlines on the drivers that sit behind this.

We note however the CAA's comments within the Final Proposals for a further review of evidence on the passenger forecast[8] and provide the following evidence which, when taken into account, should support the CAA in concluding on a more appropriate level.

#### B.1.1 Clear Evidence of an Improved Industry Outlook

Despite the upgrade to the forecast for Heathrow issued in the Final Proposals, the recovery profile over the regulatory period still looks very slow in comparison other industry forecasts and given the developments in key drivers of passenger traffic for the UK generally. The IATA / Tourism Economics forecast for the UK O-D market updated in May 2022 points to a recovery of passenger volumes to pre-crisis levels in 2023. The recovery profile of ACI Europe's forecast for the region was brought forward by one year to 2024 in their May 2022 update[9].

[6] Para 1.2, CAA CAP2365
[7] Para 1.24, CAA CAP236
[8] Para 49, CAA CAP2365
[9] https://www.aci-europe.org/downloads/resources/Airport%20Traffic%20Forecast%202022%20Scenarios%20%202022-2026%20Outlook%20-%20May%202022.pdf

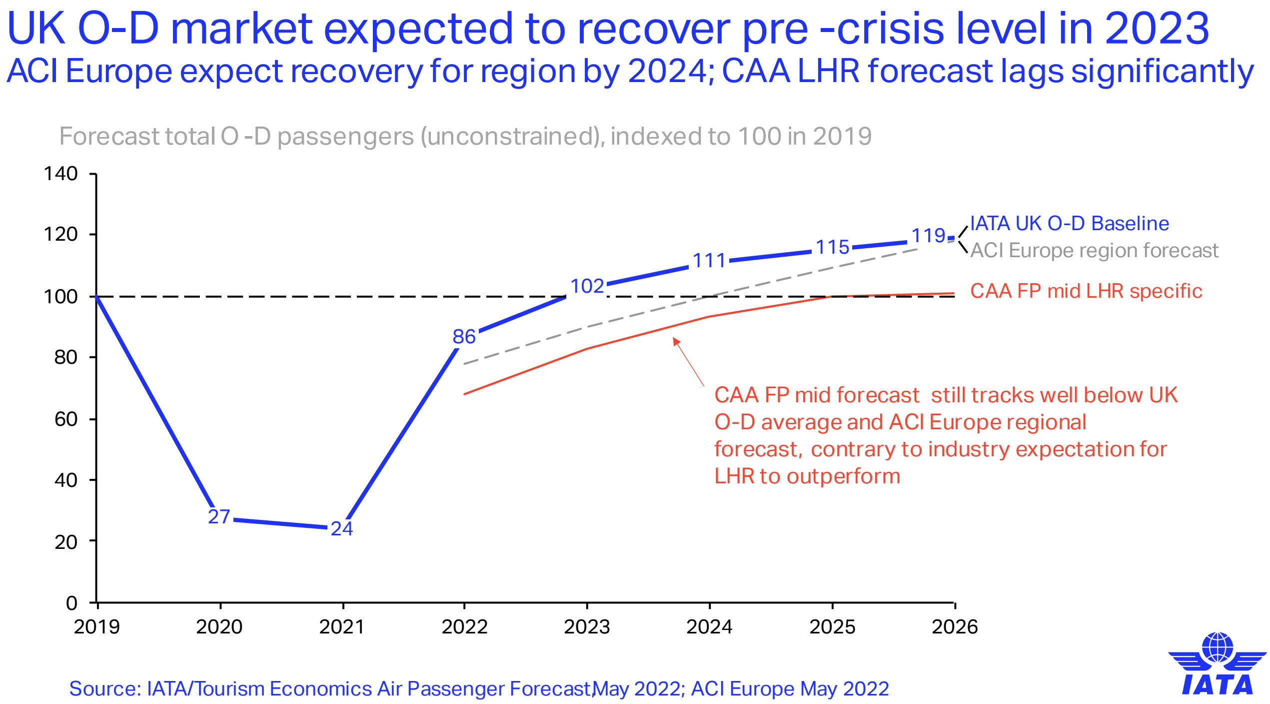



**Chart B.1**

Firstly, we note that the CAA Final Proposal Mid-case forecast indicates a recovery to pre-crisis levels for Heathrow by 2025 which is 1-2 years slower than the IATA and ACI comparators. This is at odds with the developments in key drivers of traffic for the UK and the evidence of Heathrow's relative resilience, as outlined in Chart B.2 below.

Notwithstanding the massive impact of Covid-19, according to the IMF[10]:

- the UK economy is expected to be around 2.3% larger in 2023 compared with 2019 measured by real (constant price) GDP;
- per capita incomes are expected to be 0.3% higher measured by real GDP per capita;
- the unemployment rate is forecast to remain relatively low at 4.6% compared with 3.8% in 2019; and
- population is likely to be 1.3 million persons higher, moving above 68 million.

All of these factors are supportive of a strong recovery in air passenger demand approaching pre-crisis levels in 2023 rather than the gradual and protracted recovery indicated by the CAA FP mid scenario.

Moreover, as documented in Figure 9 of the Airline Community Response to H7 Initial Proposals (reproduced as Chart B1.2 below), Heathrow has proven to be relatively resilient to shocks in the past. During the Great Financial Crisis of 2008-9, the impact on traffic at LHR was less pronounced than for other large UK airports.

[10] World Economic Outlook database, April 2022

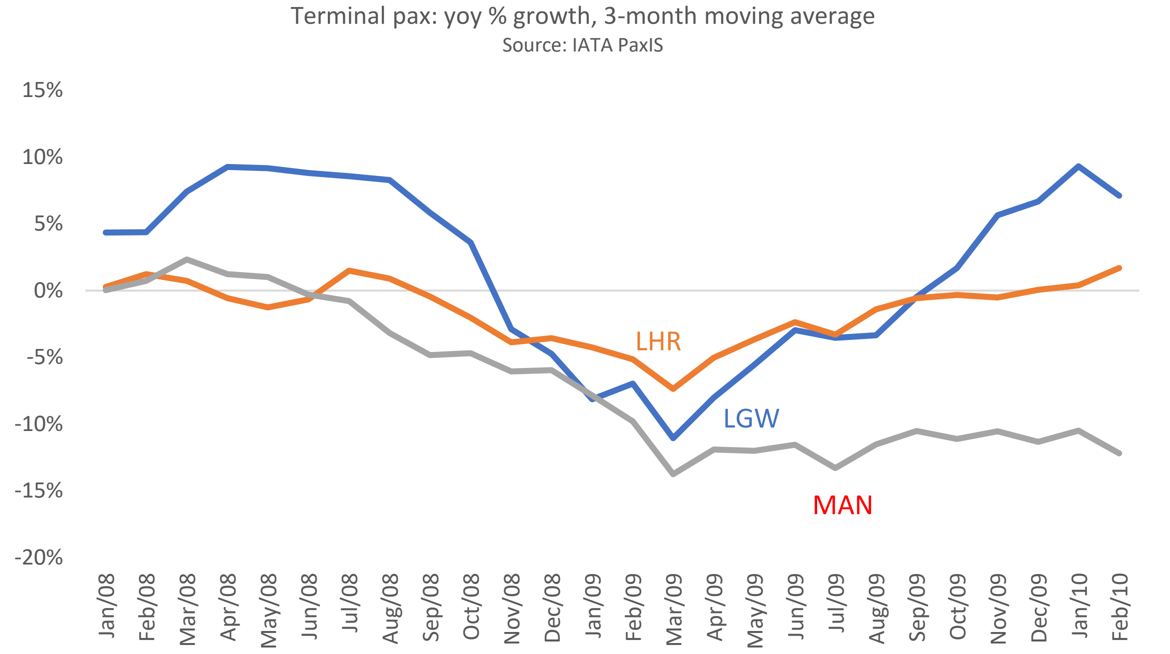



**Chart B.2**

Evidence of this resilience is also apparent when looking at the relative pace of recovery out of the COVID pandemic. According to CAA data[11] for the 12-month period from June 2021 to May 2022, Heathrow handled 45% of 2019 passenger volumes, well ahead of the 33% for Gatwick and above a number of other large UK airports-. This supports the industry expectation of a recovery for Heathrow that is in advance of, not lagging behind, the UK market on average.

The CAA also lists a number of traffic forecasts produced by external bodies in the Final Proposals Traffic Forecasting section. We would note that two of these external forecasts, ICAO and ACI Europe have recently been updated since the CAA's deliberations on the forecast within the Final Proposals. As further set out below in Chart B.3 and B.4, the update reflects a more optimistic outlook for when traffic will recover to 2019 levels. We would also note an additional forecast not used by the CAA in its Final Proposals, from the USA's Federal Aviation Authority (FAA) and shown as Chart B1.5 also supports a full recovery in traffic by 2024 or earlier.

**ICAO Forecast**

The ICAO Economic Impact Analysis (ICAO Effects of Novel Coronavirus (COVID-19) on Civil Aviation: Economic Impact Analysis) was updated on the 22nd June 2022. Under all 4 scenarios the forecast now shows European passenger numbers exceeding 2019 levels by July 2022.

[11] https://www.caa.co.uk/data-and-analysis/uk-aviation-market/airports/uk-airport-data/uk-airport-data-2022/

ICAO UNITING AVIATION

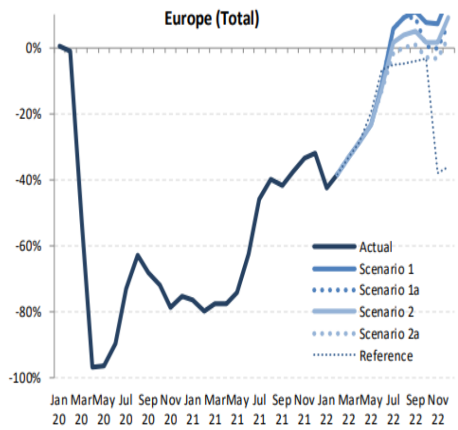
## Passenger number

Passenger Number (thousand) - Europe International + Domestic

| Year | 2019 | 2020 | | | | | | 2021 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Month | Actual | Baseline | Estimated | Compared to 2019 | | Compared to Baseline | | Baseline | Estimated | Compared to 2019 | | Compared to 2020 | | Compared to Baseline | |
| | a | b | c | c-a | c/a-1 | c-b | c/b-1 | d | e | e-a | e/a-1 | e-c | e/a-1 | e-d | e/d-1 |
| January | **77,528** | 78,142 | **77,947** | 419 | 0.5% | -194 | -0.2% | 78,303 | **18,151** | -59,378 | -76.6% | -59,797 | -76.7% | -60,153 | -76.8% |
| February | **72,688** | 76,133 | **71,811** | -877 | -1.2% | -4,321 | -5.7% | 77,812 | **14,517** | -58,171 | -80.0% | -57,295 | -79.8% | -63,295 | -81.3% |
| March | **84,599** | 87,314 | **39,896** | -44,703 | -52.8% | -47,418 | -54.3% | 87,682 | **18,941** | -65,658 | -77.6% | -20,955 | -52.5% | -68,741 | -78.4% |
| April | **95,133** | 97,681 | **2,722** | -92,411 | -97.1% | -94,960 | -97.2% | 99,610 | **21,103** | -74,030 | -77.8% | 18,382 | 675.4% | -78,507 | -78.8% |
| May | **102,510** | 103,573 | **3,687** | -98,823 | -96.4% | -99,886 | -96.4% | 104,019 | **26,153** | -76,357 | -74.5% | 22,466 | 609.3% | -77,866 | -74.9% |
| June | **111,993** | 115,558 | **11,632** | -100,361 | -89.6% | -103,926 | -89.9% | 118,917 | **41,832** | -70,161 | -62.6% | 30,200 | 259.6% | -77,085 | -64.8% |
| July | **120,122** | 123,394 | **32,249** | -87,873 | -73.2% | -91,145 | -73.9% | 126,815 | **65,013** | -55,109 | -45.9% | 32,764 | 101.6% | -61,802 | -48.7% |
| August | **120,473** | 123,186 | **44,802** | -75,671 | -62.8% | -78,384 | -63.6% | 126,079 | **72,353** | -48,120 | -39.9% | 27,551 | 61.5% | -53,726 | -42.6% |
| September | **110,385** | 112,804 | **35,154** | -75,231 | -68.2% | -77,650 | -68.8% | 115,240 | **64,110** | -46,275 | -41.9% | 28,955 | 82.4% | -51,130 | -44.4% |
| October | **103,338** | 103,716 | **28,723** | -74,615 | -72.2% | -74,993 | -72.3% | 104,254 | **64,410** | -38,928 | -37.7% | 35,687 | 124.2% | -39,844 | -38.2% |
| November | **80,932** | 81,118 | **17,054** | -63,878 | -78.9% | -64,064 | -79.0% | 81,471 | **53,887** | -27,045 | -33.4% | 36,833 | 216.0% | -27,584 | -33.9% |
| December | **81,864** | 83,909 | **20,031** | -61,833 | -75.5% | -63,878 | -76.1% | 85,949 | **55,674** | -26,190 | -32.0% | 35,642 | 177.9% | -30,276 | -35.2% |
| **1Q** | **234,816** | 241,589 | **189,655** | -45,161 | -19.2% | -51,934 | -21.5% | 243,798 | **51,609** | -183,207 | -78.0% | -138,046 | -72.8% | -192,189 | -78.8% |
| **2Q** | **309,636** | 316,812 | **18,041** | -291,595 | -94.2% | -298,771 | -94.3% | 322,547 | **89,088** | -220,548 | -71.2% | 71,047 | 393.8% | -233,458 | -72.4% |
| **3Q** | **350,980** | 359,384 | **112,205** | -238,774 | -68.0% | -247,179 | -68.8% | 368,134 | **201,475** | -149,504 | -42.6% | 89,270 | 79.6% | -166,659 | -45.3% |
| **4Q** | **266,133** | 268,743 | **65,807** | -200,326 | -75.3% | -202,936 | -75.5% | 271,674 | **173,970** | -92,163 | -34.6% | 108,163 | 164.4% | -97,704 | -36.0% |
| **Total** | **1,161,564** | 1,186,528 | **385,708** | -775,856 | -66.8% | -800,820 | -67.5% | 1,206,153 | **516,142** | -645,422 | -55.6% | 130,434 | 33.8% | -690,010 | -57.2% |

Passenger Number (thousand) - Europe International + Domestic

| Year | 2022 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Month | Baseline | Scenario 1 | Scenario 1a | Scenario 2 | Scenario 2a | Reference | Compared to 2019 | | Compared to 2021 | | Compared to Baseline | |
| | f | g | | | | - | g-a | g/a-1 | g-e | g/e-1 | g-f | f/g-1 |
| January | 79,228 | **44,593** | **44,593** | **44,593** | **44,593** | **44,593** | -32,935 | -42.5% | 26,443 | 145.7% | -34,635 | -43.7% |
| February | 80,615 | **44,635** | **44,635** | **44,635** | **44,635** | **44,635** | -28,053 | -38.6% | 30,119 | 207.5% | -35,979 | -44.6% |
| March | 89,326 | **56,537** | **56,537** | **56,537** | **56,537** | **56,537** | -28,062 | -33.2% | 37,596 | 198.5% | -32,789 | -36.7% |
| April | 102,617 | **67,825** | **67,825** | **67,825** | **67,825** | **67,825** | -27,308 | -28.7% | 46,722 | 221.4% | -34,792 | -33.9% |
| May | 105,516 | **78,419** | **78,419** | **78,419** | **78,419** | **82,380** | -24,091 to -24,091 | -23.5% to -23.5% | 52,265 to 52,265 | 199.8% to 199.8% | -27,097 to -27,097 | -25.7% to -25.7% |
| June | 123,579 | **99,407** | **99,407** | **98,193** | **97,395** | **104,267** | -14,598 to -12,586 | -13.0% to -11.2% | 55,563 to 57,575 | 132.8% to 137.6% | -26,184 to -24,172 | -21.2% to -19.6% |
| July | 131,471 | **127,148** | **127,148** | **121,868** | **118,034** | **113,923** | -2,087 to 7,027 | -1.7% to 5.8% | 53,022 to 62,136 | 81.6% to 95.6% | -13,437 to -4,323 | -10.2% to -3.3% |
| August | 130,153 | **131,674** | **131,674** | **124,997** | **120,662** | **114,854** | 189 to 11,201 | 0.2% to 9.3% | 48,309 to 59,321 | 66.8% to 82.0% | -9,491 to 1,520 | -7.3% to 1.2% |
| September | 118,772 | **122,746** | **120,361** | **116,068** | **111,436** | **105,879** | 1,051 to 12,361 | 1.0% to 11.2% | 47,327 to 58,637 | 73.8% to 91.5% | -7,336 to 3,974 | -6.2% to 3.3% |
| October | 105,680 | **111,129** | **103,969** | **104,973** | **100,134** | **99,773** | -3,203 to 7,791 | -3.1% to 7.5% | 35,725 to 46,719 | 55.5% to 72.5% | -5,545 to 5,449 | -5.2% to 5.2% |
| November | 82,463 | **86,861** | **80,672** | **82,137** | **78,170** | **50,192** | -2,762 to 5,930 | -3.4% to 7.3% | 24,283 to 32,975 | 45.1% to 61.2% | -4,293 to 4,398 | -5.2% to 5.3% |
| December | 88,798 | **94,376** | **87,857** | **89,227** | **84,510** | **52,393** | 2,646 to 12,512 | 3.2% to 15.3% | 28,836 to 38,702 | 51.8% to 69.5% | -4,288 to 5,577 | -4.8% to 6.3% |
| **1Q** | 249,169 | **145,766** | **145,766** | **145,766** | **145,766** | **145,766** | -89,050 to -89,050 | -37.9% to -37.9% | 94,157 to 94,157 | 182.4% to 182.4% | -103,403 to -103,403 | -41.5% to -41.5% |
| **2Q** | 331,712 | **245,651** | **245,651** | **244,437** | **243,639** | **254,472** | -65,997 to -63,985 | -21.3% to -20.7% | 154,550 to 156,563 | 173.5% to 175.7% | -88,073 to -86,060 | -26.6% to -25.9% |
| **3Q** | 380,397 | **381,568** | **379,183** | **362,933** | **350,133** | **334,656** | -847 to 30,588 | -0.2% to 8.7% | 148,657 to 180,093 | 73.8% to 89.4% | -30,264 to 1,171 | -8.0% to 0.3% |
| **4Q** | 276,941 | **292,366** | **272,497** | **276,336** | **262,814** | **202,358** | -3,319 to 26,233 | -1.2% to 9.9% | 88,844 to 118,396 | 51.1% to 68.1% | -14,127 to 15,425 | -5.1% to 5.6% |
| **Total** | 1,238,219 | **1,065,351** | **1,043,097** | **1,029,472** | **1,002,351** | **937,251** | -159,213 to -96,213 | -13.7% to -8.3% | 486,209 to 549,209 | 94.2% to 106.4% | -235,868 to -172,868 | -19.0% to -14.0% |




**Source**: ICAO estimates 76

**Chart B.3**[12]

[12] Reference: https://www.icao.int/sustainability/Documents/Covid-19/ICAO_coronavirus_Econ_Impact.pdf

**ACI- Europe Forecast**

The ACI Europe forecast was also updated recently and now shows a full recovery for European airport traffic to 2019 levels by 2024 – a year earlier than the previous forecast utilised by the CAA in its Final Proposals.

ACI Europe AIRPORT TRAFFIC FORECAST 2022 Scenarios & 2022-2026 Outlook May 2022

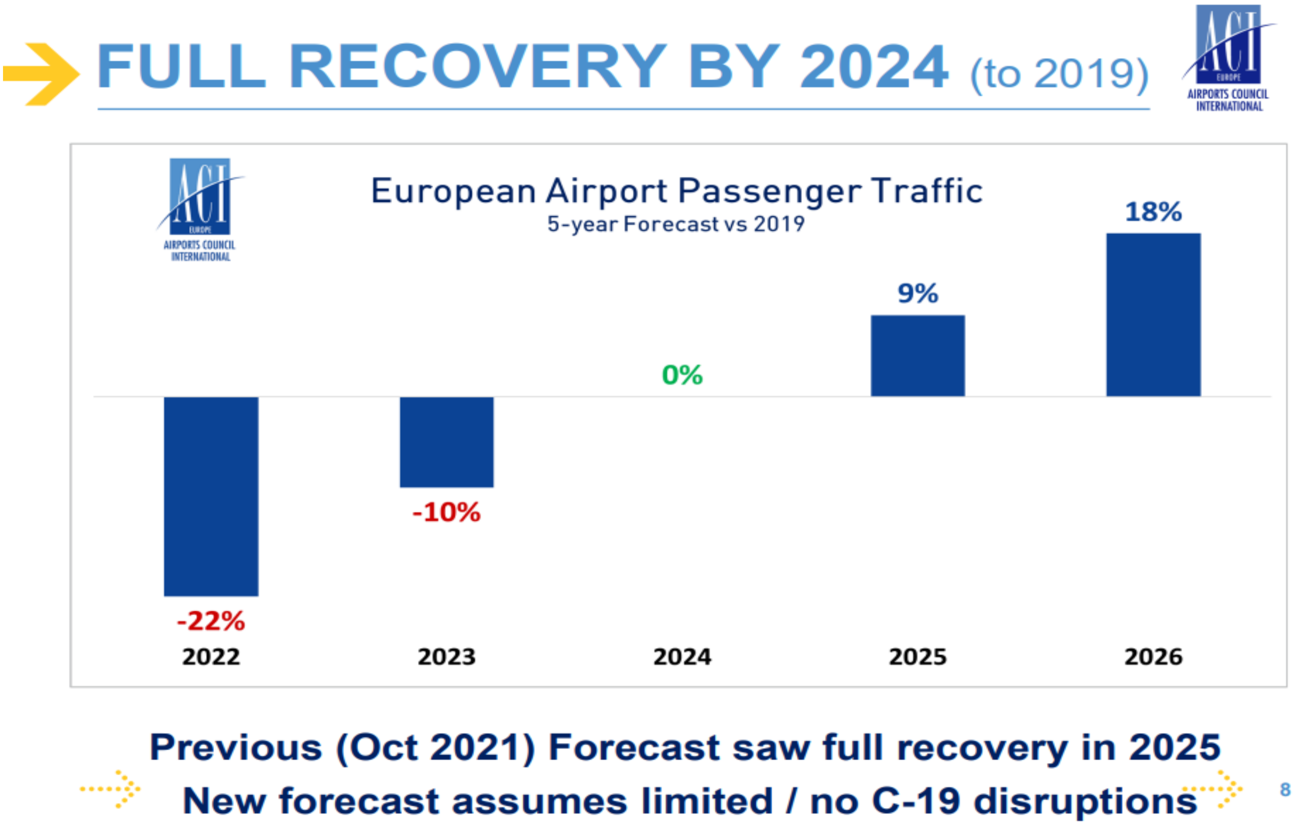



**Chart B.4**[13]

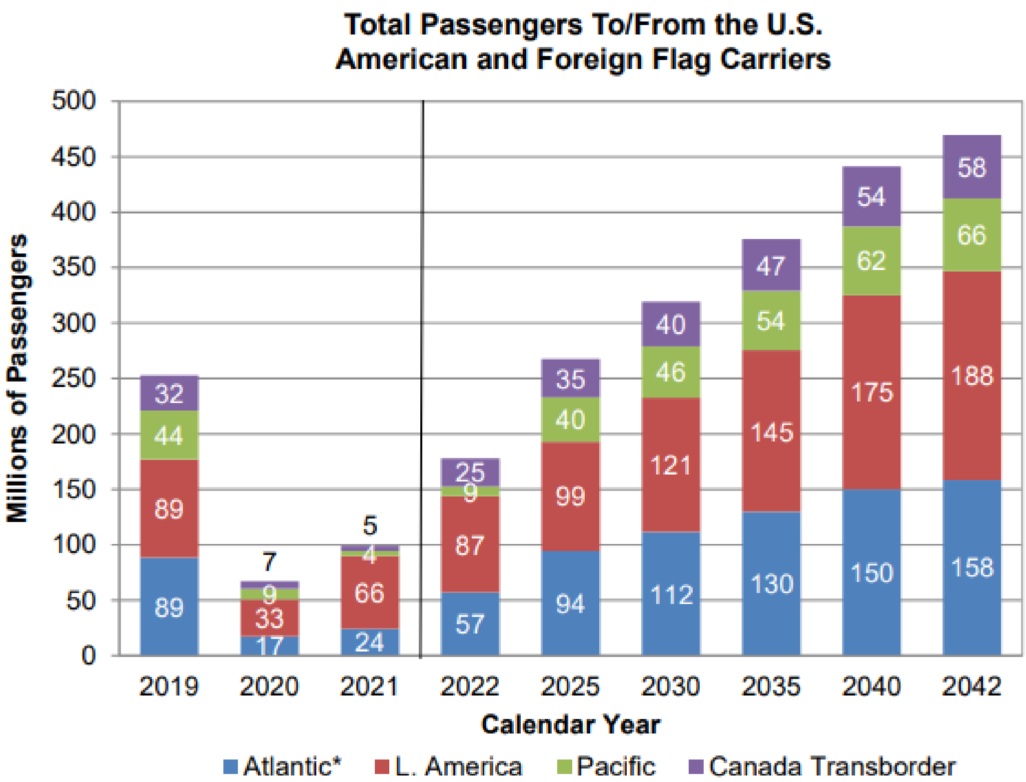
[13] Reference: https://www.aci-europe.org/economic-forecasts.html

**FAA Total Passengers forecast**

During our research we also discovered a recently released airline traffic forecast by the USA's Federal Aviation Authority (FAA). This forecast is for international traffic to and from the U.S and again forecasts airline traffic recovering to 2019 levels before 2025. (With the exception of the Pacific – U.S traffic).

FAA 28 June 2022 – Illustrating Total passengers on international markets (except for the Pacific) will have exceeded 2019 passenger numbers by 2025…ie full recovery in 2024 or earlier.

FAA Aerospace Forecast Fiscal Years 2022–2042




Source: US Customs & Border Protection data processed and released by Department of Commerce; data also received from Transport Canada
* Per past practice, the Mid-East region and Africa are included in the Atlantic category.

**Chart B1.5**[14]

### B.1.2 Updated Airline Community Forecast for H7

As part of our assessment on the appropriate level for the passenger forecast, the Airline Community have supported Virgin Atlantic in their undertaking of a 'bottom up' review of a Heathrow forecast, the output of which correlates closer to actual and industry forecasted data and is fully endorsed. It has also been used as the forecast, as set out below, for our own adjustment to the level of charge.

[14] Reference: https://www.faa.gov/dataresearch/aviation/faa-aerospace-forecast-fy-2022-2042

| | 2022 | 2023 | 2024 | 2025 | 2026 | Total |
|---|---|---|---|---|---|---|
| Passengers (m/pa) | 65 | 80.4 | 82 | 83.6 | 85 | 396.1 |
| % of 2019 | 85% | 99% | 101% | 103% | 105% | |

Full details are provided in the response from Virgin Atlantic but have been summarised below:

**LHR Passenger Forecast for 2022 and Q1 2023**

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[15] DIIO Capacity Data July 2022

[16] HAL reports / traffic statistics July 2022 and DIIO Capacity Data July 2022

[17] DIIO Capacity Data July 2022

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

**Passenger forecasts from 2023 onwards**

Recovery prospects

Despite the amendments to the forecast for LHR issued in the CAA's Final Proposals, the recovery profile projected by the CAA over the regulatory period still looks very slow in comparison to other industry forecasts and given the developments in key drivers of passenger traffic for the UK generally. The IATA / Tourism Economics forecast for the UK O-D market updated in May 2022 points to a recovery of passenger volumes to pre-crisis levels in 2023. The recovery profile of ACI Europe's forecast for the region was brought forward by one year to 2024 in their May 2022 update.19

Forecast for 2023 onwards

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[19] https://www.aci-europe.org/downloads/resources/Airport%20Traffic%20Forecast%202022%20Scenarios%20%202022-2026%20Outlook%20-%20May%202022.pdf

[20] Oxford Economics UK Air Travel Demand Growth Forecast, [May 22]

### B.1.3 Errors in the CAA's approach to Passenger Forecasting

In addition to the further evidence as set out in this Section B.1, the Airline Community remain particularly concerned on the on-going reliance of HAL's model (which the CAA correctly note) the Airline Community have not had access to.

Our previous challenges on the shock factor still stands, particularly given specific references to potential headwinds which again produce an undue bearing. It is worth reiterating that the CAA's justification of a shock factor is to account for any such risks that *might* arise during the regulatory period – by taking regard of these *risks* now is likely to be a 'double count'. Dealing with these headwinds in particular, we would point to our comments under B1.1 with regards to the comparison of 2019 and the latest economic expectations for 2023

We note the CAA's own concerns on the passenger forecast within the Final Proposal and think it is entirely right that this is an area in particular the CAA have remained open to receive further evidence on.

### B.1.4 Passenger Forecasting Conclusion

Given the above, we believe there is strong evidence highlighting ongoing errors and judgements in both the CAA's approach to the near, and longer, term forecasts that materially underestimate the expected level of passenger volumes likely to travel through Heathrow during H7. With input from the Airline Community and other airline resource, the Airline Community's updated assessment shows correcting for the latest available information the CAA's forecast should be uplifted.

## B.2 WACC

Throughout this process, CEPA have provided expert advice and support to the Airline Community on the WACC, the analysis of which was presented as part of our Previous Submissions. CEPA have subsequently undertaken a review of the Final Proposals, the findings of which are attached as Annex 1 (CEPA Report)

The CEPA Report sets out why, in their expert opinion, whilst the real vanilla WACC has fallen by c.140bps from Initial Proposals to Final Proposals, this is primarily driven by a change in inflation and there are a number of issues that CEPA consider are unresolved. In addition, it notes the Final Proposals have created new issues and areas where the commentary is at odds with the parameter estimates chosen.

In reviewing the CEPA Report and in further analysis undertaken on behalf of some of our airline members, we believe the CAA have erred in their judgement. We agree with the findings within the CEPA Report including the overarching theme that the CAA's approach has further areas that must be addressed as, currently, the CAA proposals do not appropriately reflect the risk HAL is exposed to.

The CEPA Report notes that just correcting the issues on asset beta, would suggest a level *of at least* 2.48% (real, Vanilla). Correcting for additional factors outside asset beta, this would be lower still. Indeed, we note AlixPartners have, on behalf of a number of member airlines, undertaken their own analysis, the details of which are provided within individual airline response(s). Such expert opinion suggests a similar figure of 2.37%, which the Airline Community have used as our base WACC figure.

## B.3 Misalignment of risk measures

The CAA has significantly shifted the balance of risk by for the H7 regulatory framework. Notably, the CAA has:

- introduced the symmetric Traffic Risk Sharing ("TRS") mechanism;
- continued to use a 'shock factor' to traffic forecasts;
- aimed up on the WACC to address 'welfare effects'; and
- introduced an allowance for asymmetric risk

Each of these features positively skews the expected outcome for HAL and, in our view, has been applied incorrectly and in a manner not in keeping with the CAA's primary interest to consumers and efficient pricing.

In addition to the comments on traffic forecasting and WACC set out within this response, the Airline Community note the following issues on two key elements to the CAA's approach to balancing risk.

### B.3.1 Traffic Risk Sharing

The Airline Community have consistently stated that any support for Traffic Risk Sharing ("TRS") would be subject to an appropriate reduction on the WACC. Whilst noting the CAA have now partially corrected for this error we believe, based on further analysis undertaken by AlixPartners on behalf of some airline members and submitted as part of their responses to the CAA, there is further opportunity for a downward adjustment to the WACC.

In addition to the above, the Airline Community also have deep concerns on the proposed structure, and the extent to which the CAA have considered the impacts of TRS on consumers and airlines. Two primary matters in relation to this being:

1) Whilst the CAA have set the TRS symmetrically between the 'over' and 'under' scenarios, the reality is this is not the case, not least where HAL have, and recently shown, a significant degree of influence in capping capacity. As such there are unintended 'incentives' that need to be addressed by reflecting this imbalance.

2) The CAA have also moved the outer band to 105%. In the event of such a downside event, which, given HAL has a capacity cap which is expected to be reached within H7 yet no such downward limitation; such a level provides no incentive on HAL to look for cost efficiencies or facilitate traffic growth at a time most needed. In order to address this concern and potential damaging impact to consumers, the CAA should review the level, and need altogether, for such a banding.

Further evidence of the materiality of these issues is provided through some member airline responses based on the work undertaken by their expert consultant, Alix Partners, on which we strongly support the CAA's consideration of.

### B.3.2 Asymmetric Risk

We continue to disagree with the CAA's inclusion of the asymmetric risk allowance. While we agree that the CAPM is a mean-variance model that assumes symmetrical distribution of outcomes, the

CAA has not demonstrated that an asymmetry exists for Heathrow Airport under the H7 regulatory framework.

For the H7 regulatory framework, the CAA has:

- introduced the TRS mechanism;
- included a 'shock factor' to traffic forecasts to address potential risks; and
- aims up on the WACC to address 'welfare effects'[21] e.g. the CAA do not ascribe a given value to this impact.

Each of these features positively skews the expected outcomes for Heathrow. An additional allowance to address a negative asymmetry for Heathrow is clearly not required. Historically, the CAA has not included any adjustment on the WACC for asymmetry, so this creates concerns around regulatory predictability and stability.

The asymmetric risk allowance is premised on two central assumptions that do not hold in practice:

1) All risks excluding pandemic risks are symmetric.

2) That the CAA would take no action/ would take symmetric action in a given price control.

For this first assumption, we consider that risks excluding the pandemic are likely to be positively skewed for HAL. The CAA has ignored relevant upside risks in their assessment and have demonstrated that their calibration of individual building blocks is above the central case. For example:

- The upwards bias on WACC from welfare effects.
- Conservative (i.e., upward-biased estimates) on regulatory building blocks, including opex, commercial revenues and the WACC.
- There may be other potential long-term upside risks, or option value held by HAL, for example, technological progress or the ability to expand on an existing site.
- HAL may also have informational asymmetry advantages over the regulator that allow it to make higher returns; this is a phenomenon that has been observed across regulated sectors since privatisation.

The CAA numbers are also premised on no further action to address a pandemic event. We consider that this is unlikely in practice. The CAA permitted a RAB adjustment in relation to the current price control, above and beyond what was set out in regulation. The largest impacts from the asymmetric risk allowance are when a pandemic hits at the start of a price control. This is also the time where a regulator is most likely to step in and change regulatory arrangements. In the most extreme case, where traffic went to zero in the first year of the price control, would the CAA make an explicit absolute statement that it would not step-in, as the pandemic risk is being covered ex-ante by this asymmetric risk allowance? If HAL are given the allowance and the regulator steps in to increase revenues, consumers are compensating HAL multiple times.

The CAA's framing of the problem is akin to an insurance premium, in estimating the magnitude of the risk and the expected probability. However, pandemic risks are typically not considered to be insurable by the industry. If insurance experts cannot provide this, it is unclear why the CAA considers that their approach is appropriate.

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[21] This is offset by asymmetry on the WACC parameters, so we do not have a value for this.

We have previously set out our views on the assumed magnitude of the shocks, including that the size of the traffic shock, duration of the pandemic and frequency of the pandemic are all overly generous to Heathrow. This leads to the allowance being set too high.

The CAA has therefore mistakenly applied an allowance that should not exist given incorrect assumptions. Even if the assumptions were to hold, the allowance is excessive.

### B.3.3 Misalignment of risk mitigation measures Conclusion

Given the above, the Airline Community strongly believe that it is in the consumers' best interest to remove the unrequired asymmetric risk allowance, as per the Airline Community assessment in Appendix 1; and address the issues raised in relation to the proposals for TRS.

## B.4 RAB Adjustment

Whilst noting the CAA's statement that "*The April 2021 RAB Adjustment Decision was intended to be our [CAA] final decision*[22]" it is also correct in further stating that this will be introduced via the license modifications being proposed for H7. It is therefore appropriate for the Airline Community to firstly reiterate our opposition to the adjustment.

Whilst we do not disagree with the CAA's stated view that rating agencies put weight to the stability and supportiveness of the regulatory framework[23], it is worth reiterating that the CAA themselves set out an expectation that this decision could be under review with the possibility of a downward adjustment[24]. Given this clear condition, we believe it reasonable that any such removal would not have an impact on credit rating views on the notional entity, on which such decisions are assessed against by the CAA.

Whilst references made by the CAA relate to expectations on ensuring capacity met demand in 2021, we are firmly of the view the CAA's intent was not to lock in on specific dates, but fundamentally that HAL was appropriately prepared for when demand did return. Indeed, in the last CAA consultation there are clear references to the high degree of uncertainty with forecasts at the time[25]

Notwithstanding the above comment, the Airline Community would highlight in any case the need for early investment, particularly the re-opening of Terminal 4, was raised with HAL in 2021, most notably by the AOC to meet forecasted demand[26]. This was rebutted by HAL, the details of which having previously been shared with the CAA[27]. Notwithstanding other pressures, such inaction directly led to capacity challenges and an unnecessary failure to sufficiently meet demand returning with negative consequences for airlines and consumers.

[22] Para 10.61, CAA CAP2365
[23] Para 10.77, CAA CAP2365
[24] Para 4.22, CAA CAP2140
[25] Para 4.21, CAA CAP2140
[26] Letter from Nigel Wicking (Heathrow AOC Ltd) to John Holland-Kaye (HAL), "*LHR 2022 Capacity Plans*", dated 30th November 2021
[27] Letter from Nigel Wicking (Heathrow AOC Ltd) to Sir Stephan Hillier (CAA), "*HAL's late re-opening of capacity in 2022 causing consumer harm*", dated 6th April 2022

It is imperative that the CAA conclude on its proposed review which we firmly believe warrants the removal of the proposed £300m RAB adjustment, as the Airline Community have done in our own assessment.

## B.5 Conclusion

In determining a correct level of charge the Airline Community have made several evidenced based adjustments as described within this Section B, as well as some specific adjustments set out further in Section C of this response.. we believe leads to a financeable profiled yield no more than £[redacted][28], on average across H7.

The summary details of the adjustments made are summarised in Appendix 1. The Arline Community would also note that the adjustments made are, in our view, conservative judgements that are:

1) focussed on either new evidence since the Initial Proposals and / or where the Final Proposals have updated; and

2) there are errors or inconsistencies that have a material bearing; and

Unless explicitly stated herein, preclusion of an adjustments does not:

1) diminish any comments on any other particular issue raised within this response, or previously provided as part of our Previous Submission not included in the Airline Community assessment; nor

2) does it imply any acceptance with the CAA's response to any previous point raised.

[28] NB: The Airline Community are working with the CAA to finalise calibration within the CAA's PCM and CTA's model for operating costs and commercial revenue, the conclusion of which may adjust this figure within a range of tolerance; we will further update the CAA upon its conclusion

## C. Other Matters by Building Block

### C.2 Outcome Based Regulation

The Airline Community have written extensively on its views and positions of the development of the OBR framework. In the interest of brevity, we note these previous comments still stand and have looked to focus on new or specific issues within the Final Proposals, as set out further in this Section C.2.

Our overarching view is that the Final Proposals have shown a lack of operational understanding that underpin consumer outcomes with airline evidence ignored or not sufficiently considered. This also appears to have led to a lack of sufficient challenge on targets and measures and will, in our view, ensure poorer consumer outcomes than should otherwise be the case. This is exampled by the CAA proposing consumers now pay HAL a bonus for meeting the same level of performance in security that they experienced during Q6.

We strongly urge the CAA to address these matters if not now, then as part of the mid-term review; the scope and path towards which we believe needs further development over the coming months.

#### C.2.1 Baggage

It is categorically in the consumer's interest that HAL should be **financially** incentivised for 'Timely Delivery from Departing Baggage System'. We justified this position in detail in our paper dated 25th April 2022 "Airline response to HAL's proposal that this be a reputational measure" and this paper is also attached as Annex 2[29]

Instead, we present further analysis below, showing that although the majority of passengers travel with their bags, there are still a significant number of passengers who do not.

Taking 2019 as a busy but 'normal' year of operation, the overall missed bag ratio was [redacted] per 1,000 pax. This means that nearly [redacted]m passengers flew without their bags. Note that the current missed bag ratio is [redacted] per 1000 pax. This would equate to nearly [redacted]m missed bags at 2019 passenger levels.

HAL need to be held accountable by the OBR scheme for delivering bags to the airlines' baggage handlers in time for passengers to travel with their bags. HAL's own analysis has shown that a significant number of "in system baggage failures" do occur. The below analysis by [redacted] presented to airlines by HAL details that:

[29] Airline presentation to the CAA, "Timely delivery of departing baggage", dated 21st April 2022

[redacted]

**Chart C.1 [Confidential]**

In 2021 (a very low volume year for departing bags due to COVID-19), there were [redacted] missed bags (“Not Loaded Bags”) of which [redacted] were classified under in-system categories, of which [redacted] were attributable to incidents and the system.

Factoring up to a normal 2019 level year this would equate to ~[redacted] bags not travelling with their passenger due to issues with HAL’s baggage system. Equally, some of the “out of System Categories” shown in the complex graphic above could actually be caused by poor system performance or HAL’s baggage operations. These would be picked up by the Timely Delivery measure and further investigation will demonstrate the magnitude of these categories.

This is very poor customer service from a system costing circa £500m per terminal. Repatriating these bags to passengers would have cost airlines of the order of £4.0m in 2019 and there would be further passenger compensation costs to be paid on top of this estimate.

**Impact of the failure of HAL’s baggage system in an exceptional year**

In an exceptional year such as 2022 when there have been multiple baggage system incidents the number of bags not travelling with their passenger due to baggage system failures could reach significantly more than the [redacted] estimated above.

Chart C.2 below illustrates the increased missed bags both direct (blue shaded) and transfer (beige shaded) that have occurred in 2022. There is an overall increase that can be seen as a trend upwards, but there have also been a number of major incidents – that can be seen as spikes in missed bags in April, May, June and July 2022 in each of T2, T3 and T5.

[redacted]

**Chart C.2 [Confidential]**

**Baggage Conclusion:**

The above analysis has shown that although the vast majority of passengers travel with their bags there are still a significant number of passengers who do not and as such it should be in the consumers interest to provide a financial incentive for HAL to improve this performance area.

CAA states that the distinction between reputational and financial incentives should be made based on "the degree of control that HAL is likely to have over specific aspects of service quality". If we reasonably allow for defined exceptions, the in-system performance for the vast majority of bags is **totally** within HAL's control. Non-timely delivery from the system directly causes a negative consumer outcome.

### C.2.2 Check-In Measures

We are pleased that the Final Proposals confirm the implementation of a new financially incentivised measure for 'Availability of Check-in Infrastructure'[30]. However, we are extremely disappointed that this new measure will not include baggage input belts within its scope. There is no explanation as to why this fundamental element of the check-in product is excluded, other than it addresses HAL's concerns. We assume these concerns are those as articulated in the Frontier Economics review, commissioned by HAL in December 2021.

Analysing these concerns in the source document, there is no direct reference to baggage input belts being part of the measure. There are general concerns stated about the overall measure (e.g. not fully within HAL's control; being prescriptive about the output rather than the outcome), but the Final Proposals reject these concerns and confirm that the measure will be implemented.

We urge the CAA to reconsider the inclusion of baggage input belts within the scope of this measure. We believe it is extremely important to do so for the following reasons:

[30] Para 3.49, CAA CAP2365

- Of all elements of the check-in product, the baggage input belts are fully in HAL's control. They are a piece of airport infrastructure, installed and maintained by HAL. There is no interaction with airlines systems or software.
- They are a relatively simple piece of hardware, for which the airline agent's interaction is also simple (i.e. pressing a button to send the bag into the baggage system).
- They are arguably the most tangible piece of check-in infrastructure in the eyes of the consumer, who sees the baggage input belt as the initial vehicle through which their bags are despatched to their flight.
- There are regular belt failures, which cause operational issues and consumer anxiety. If a passenger's bag cannot be injected at the desk at which they check in due to a failed belt, it is a poor experience and concerning for the passenger who is asked to move their bag to another belt/desk.
- If a failed belt is not fixed quickly (and this is often the case), check-in capacity is reduced because the desk is taken out of service. This creates a consumer impact at peak times (when all desks are normally needed) and resulting operational difficulties.
- The baggage input belts are in effect the first key gateway to the most fundamental of consumer outcomes: "a predictable and reliable journey" (or alternatively "my flight will depart on time together with my checked baggage", the outcome suggested/preferred by the airline community).
- HAL already has detailed data on baggage belt failures within its engineering fault reporting system; faults are always reported immediately by airline staff because the belts are so fundamental to the check-in operation and airlines are powerless to fix faults given HAL's ownership of the infrastructure.

### C.2.3 Automated measurement method for passenger security queues

We are surprised and disappointed that there is little reference to this important aspect of OBR in the Final Proposals. Moreover, licence modifications in the Final Proposals mean that HAL's licence now has no reference whatsoever to automated measurement of security queues. This is a worrying step-back from the licence condition imposed on HAL for Q6, whereby HAL were compelled to introduce an automated per passenger method to measure security queues. Equally, the licence modifications shown in the Initial Proposals showed a holding section under section 3(b), which at least mentioned the potential installation of automatic queue measurement.

This is even more worrying when there is now an automated queue measurement and monitoring system (QMM) installed and operating at LHR already (T2 immigration). Unlike in Q6, where work was still being done to find and choose a system, we now have a system available

The proposed H7 licence simply compels HAL to develop and consult on amendments to the service quality regime, one of which could presumably be an automated queue measurement system. There is no obligation for HAL to implement such a system, nor to do any work on its scoping and development. This is disappointing and weakens a previously positive and reasonable regulatory position, which would have enabled an improved consumer outcome. Every passenger matters, yet the current manual queue measurement system cannot show airlines the queue time for an individual passenger. The richness of data that is potentially available through an automated system would not only enable robust assessment of HAL's security performance minute-by-minute, but would give HAL's operational management invaluable insight into their security operation and more easily drive continuous improvement.

We acknowledge that automated queue measurement is listed as a change that will be considered in the OBR Framework mid-term review. Until more work is done, we are concerned that the promise of this review has little regulatory weight and HAL will therefore have no **compulsion** to progress further with QMM in H7.

As it stands therefore, the lack of an H7 licence obligation could very well mean that there is no automated queue measurement system in place in 2027, some 14 years after the CAA was compelling HAL, via the license, to implement such a system. The Airline Community ask the CAA what consultation and evidence has been undertaken to have moved away from such a position?

Equally, the capital plan as presented in the Final Proposals has removed the budget line for QMM. This previously sat under the Efficient Airport programme (hence its demise), but in any case the Airline Community has proposed that it should sit within the Regulated Security programme  It is a small amount of spend in the context of the £825m budget for Regulated Security and naturally falls under the auspices of that programme. We urge the CAA to specify this as a component of the Regulated Security budget within the Final Decision.

As well as the budgetary reference as suggested above, we also urge the CAA to incorporate the following licence modification in its Final Decision, which probably most fittingly sits as a new clause under Draft licence modification to Schedule 1, paragraph 3.18. For simplicity, we have proposed the following text but rely on the CAA's expertise to craft this appropriately:

- *The Licensee shall continue to develop an Automated method of data collection to measure Security Queue Time for passengers and shall implement this method at each search area in accordance with the governance arrangements required under Condition F1.1(a)(iv).*

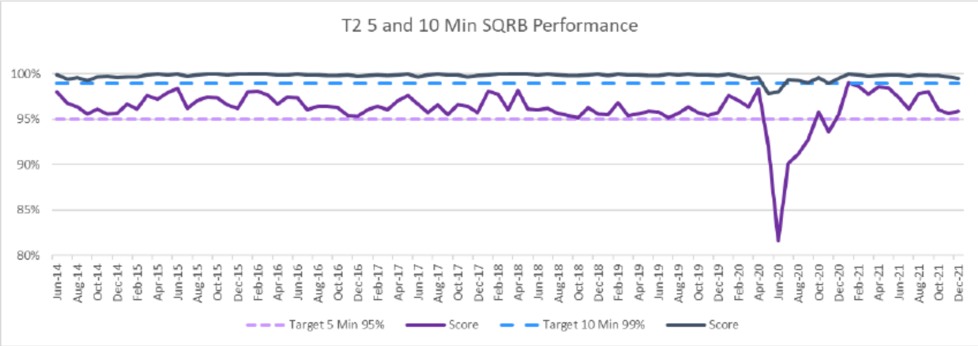
(Note that this proposed text is also shown in section C.8 below in our comments on licence conditions).

We believe that this modification would obligate HAL to progress with the  important process of system development but enable the timing and phasing of implementation to be discussed and agreed appropriately with airlines and the Airline Community  under the usual governance arrangements, and as was done so in Q6. This would have the benefit of enabling a fuller understanding of how the technology would best be implemented as part of the security transformation work.

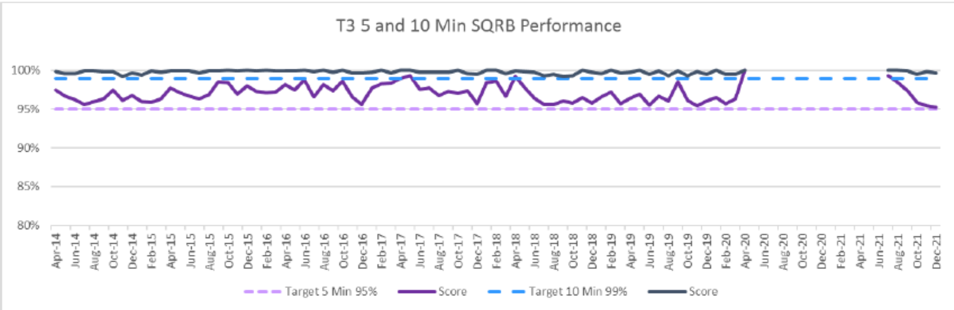
### C.2.4 General Targets Comments

**OBR Targets for Security performance**

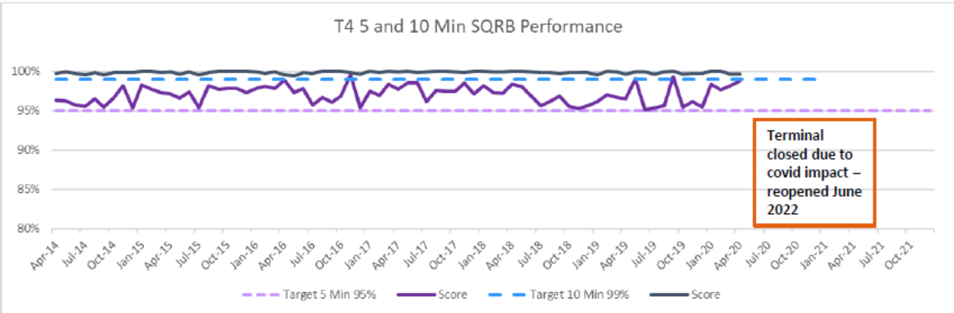
The below charts (collectively Chart C.3) are the performance data presented by Arcadis in their report to the CAA on whether the 5mi and 10 min security performance targets are achievable in H7. On reviewing the past performance Arcadis state that HAL have consistently exceeded the targets across Q6 (see below data to support this).  Arcadis then conclude that the targets, if unchanged, are achievable in H7.  The airline community understand that the CAA have some trepidation in setting higher targets across H7 as they believe there may be some disruption risk on roll out of the new security equipment.  The airline community strongly disagree with this assessment and have already made that point in our response to the IP's.




- As can be seen to the left, HAL has consistently exceeded the 95% and 99% target in every month in T2 except for around Q2/Q3 2020 when there was a significant period of failure. Given this is during the pandemic period and is arguably an isolated incident this should not have any material bearing on the proposed measure.




- As can be seen in the two charts to the left, HAL has consistently exceeded the 95% and 99% target in every month since April 2014.
- Whilst it is recognised HAL will resource to the current targets, the historic performance suggests the target as proposed by both HAL and the IP is achievable.



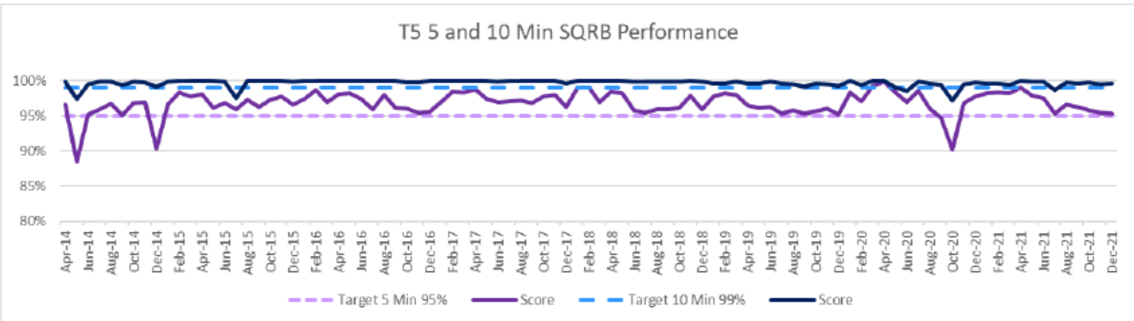




**Chart C.3 (collectively)**

**OBR Bonus targets for Security performance and cleanliness**

Notwithstanding our existing and repeated objections to the CAA paying any bonuses to HAL and without prejudice to that position we would make the following statements on the proposed H7 Bonus structure:

Security Bonus targets

The Airline Community completely disagree with the CAA's approach to setting bonus targets for H7 for security Central Search, 5 and 10 minute standards. The CAA have set the below targets:

**Table 3.3 Proposed bonuses**

| Measure | Maximum bonus (% of airport charges revenues) | Lower performance threshold | Upper performance threshold |
|---|---|---|---|
| Cleanliness | 0.36 | 4.35 | 4.65 |
| Wayfinding | 0.36 | 4.40 | 4.70 |
| Security queue time – central search (queues < 5 minutes) | 0.54 | 97.0 | 99.0 |
| Security queue time – transfer search (queues < 10 minutes) | 0.18 | 97.0 | 99.0 |

These standards of between 97% and 99% for both 5 and 10 minute performance at Central Search are just not sufficient to stretch HAL, do not represent exceptional performance and should not be set as the bonus standard for H7. As can be seen from the Arcadis reports, HAL have met or exceeded these standards across the whole of Q6. These bonus standards will result in the consumer paying bonuses to HAL across the whole of H7 for standards of service that were no better than that experienced in Q6!

A much better bonus standard that could result in improved consistency of performance across H7 is one of:

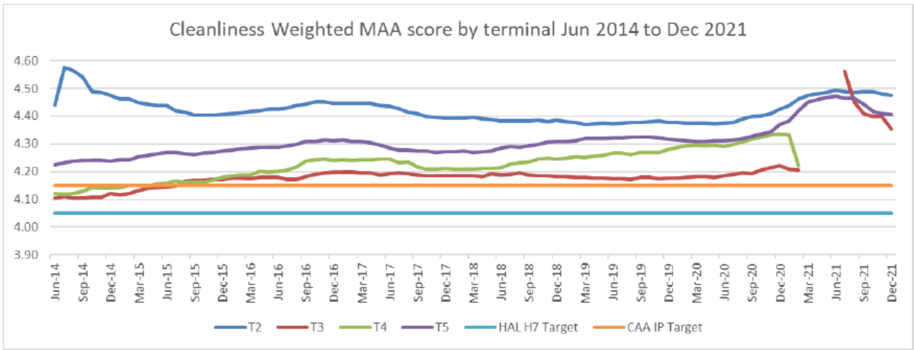
Central Search target of zero days in the month when queue time is over 5 mins more than 2 x 15 min periods in the day.

Transfer search target of zero days in the month when queue time is over 5 mins more than 2 x 15 min periods in the day.

Cleanliness Bonus Targets:

The Airline Community completely disagree with the CAA's approach to setting bonus targets for H7 for cleanliness.

The standards of between 4.35 and 4.65 are just not sufficient to stretch HAL in all terminals, do not represent exceptional performance and should not be set as the bonus standard for H7. As can be seen from the Arcadis reports, HAL have met or exceeded these standards across the whole of Q6 for T2. These bonus standards will result in the consumer paying bonuses to HAL for T2 across the whole of H7 for standards of service that were no better than that experienced in Q6.




Source: HAL data, Arcadis analysis - **It should be noted that due to Covid, reporting and sample sizes have been compromised, so as an example the T4 score in February 2021 is not considered reliable as the sample size in March 2020 was too small to be statistically relevant.**

- The target proposed by HAL at 4.05 would have been exceeded in each terminal in every month since Q2 2014 on an MAA basis suggesting this target is too low and therefore justifiably a subject for stretch for H7.
- When considering the IP target on a MAA basis, the IP target of 4.15 would have been exceeded every month since Q4 2015 across all terminals.
- T3 is the lowest performing terminal scoring between 4.15 to 4.20 for much of the period Q4 2015 to the period of the pandemic. Placing too much emphasis on the operational period during the pandemic should be avoided as it is likely to not be reflective of true performance levels.

Source: Arcadis report to CAA

The Airline Community would accept that the proposed bonus target levels are appropriate for T3, T4 and T5, but that a separate standard be set for T2 of 4.50-4.70.

### C.2.5 Mid-Term Review

**Important areas for mid-term review:**

If a mid-term review is to occur "before the half-way point of H7" – then it needs to occur in 2023 and addressed the following:

**Understand whether moving to daily performance measures is beneficial to the consumer**

To understand whether demand is driving security (and control post) performance, and therefore answer the question as to whether moving to a daily performance standard would drive an increase in Op Ex – or whether improved performance could be achieved at no extra cost by moving to a daily standard we need to analyse the data that is available. If we find that security and control post performance varies at the daily level when the same levels of demand are placed on the system, then performance variations are not being driven by external factors. We can therefore be confident that introducing a daily standard would incentivise the management team to produce a more consistent daily performance, at the same cost as today and to the overall benefit of consumers.

**Summary of evidence to date:**

HAL provided 2019 security performance data at the daily level – so eg; for T5 CSA we were given the number of 5 minute queue performance breaches and the number of 10 minute queue performance breaches on each day of 2019. From the BA data we also had the number of passengers entering T5 CSA in each hour for each day for 2019. ICF reported on their work with time series decomposition to investigate the correlations between the SQRB breaches and the number of passengers going through security. ICF showed that they had found no significant correlation between SQRB breaches and the number of passengers going through security. We then outlined how we should be analysing demand and SQRB performance at the 15 minute level to completely understand whether there is a correlation and we highlighted how this should be explored further as we conservatively estimated moving to daily performance targets could benefit ~ 600,000 consumers per year.

When the airline community requested that data from HAL we were told by HAL that *"At an overall level, the level of detail you are requesting is much more granular than we have ever provided to the Airline Community and includes a lot of detailed assumptions on issues such as resource planning. Many of these issues are our responsibility to manage within the bounds of service quality requirements and cost envelopes set by the CAA. Given this, we do not think it would be appropriate to share this level of detail."*

On receipt of the lower level data we are confident ICF can provide a revised report rapidly – which should then fully answer the question as to whether moving to a daily performance standard will require an increase in Op Ex and how many consumers are likely to experience improved levels of service.

In light of HAL's response we are requesting that the CAA instruct HAL to provide the below data within a CAA specified timeframe so that we can move forward on this issue in time to properly review it within the timeframes of the mid-term review.

The list of the data required is as below:

**Data required:**

For the whole of 2019:

<u>For each terminal (central search, staff search, transfer search),</u>

At a 15 minute level:

No. of trays per passenger, No. of trays, No. of images per passenger, No. of lanes open, No. of security staff, No. of passengers, No. of trays in check lane, Average queue time, ATP gate data to show the exact time each passenger passes through the ATP gate (anonymised)

<u>For each control post</u>

At a 15 minute level:

No. of trays per person, No. of trays, No. of images per person, No. of lanes open, No. of security staff, No. of people, No. of vehicles, No. of trays in check lane, Average queue time, Actual queue time for each vehicle (anonymised).

**Unbalanced approach to Mid-term review of Targets**

It is unclear why the CAA have chosen to state in the Final Proposals that it will review the OBR framework for any targets "that now appear unachievable for reasons outside of HAL's control" but in the opposite case "would not generally expect to make any adjustment if a target appears potentially too low". The Airline Community question how this in the best interests of the consumer and ask what evidence the CAA has that this approach is in the best interests of the consumer?

The Airline Community do not support this approach as in our view it is not in the best interests of the consumer and we have seen no evidence from the CAA to support it.

The Airline Community also note the need to develop a clear scope, timescales and necessary steps towards the Mid-Term review in order to avoid debate and / or missed opportunities at that time.

### C.2.6 Automated measurement of passenger security queues

Whilst we acknowledge that automated queue measurement is listed as a change that will be considered in the OBR Framework mid-term review, we are concerned that the promise of this review has little regulatory weight and HAL will have no **compulsion** to progress further with QMM in H7. HAL must be obligated by licence to continue working on automated measurement in advance of the mid-term review, at which point we would expect a timetable for implementation of the technology across all terminal search areas to be agreed and instigated. Section C.2.3 gives more details of our concerns and proposed approach.

## C.3 Operating Expenditure

### C.3.1 Approach and Assessment of Operating Expenditure

The Airline Community have been supportive of using independent consultants, in this case CEPA / Taylor Airey ("CTA"), to better understand actual operating expenditure requirements as well as setting stretching, but achievable, targets. We also note that the CAA have, correctly, moved on from its 'range' based approach.

Notwithstanding the above, we note the significant increase in operating expenditure the CAA have allowed for, notably under utilities and security (a combined total increase of circa £460m) and have two fundamental concerns:

(i) We note the CAA's comments that "CTA updated its analysis across all categories of opex since our [CAA] Initial Proposals, primarily based on new information from HAL[31]; however this has not been made available to the Airline Community. We are therefore not able to validate nor provide critical insight as we would have expected to be able to do so; and

(ii) The CAA have been clear that CTA have still had to make a "...*large number of assumptions of the detail of HAL's cost base*[32]*"* on which there has been minimal engagement with the Airline Community on

The CAA have applied an on-going efficiency and used the passenger forecast profiles of 2019 and 2025 (when the CAA forecast a return to such levels) as a proxy to triangulate its assessment of a benchmark in order to validate the position taken within the Final Proposal . We believe however that this characterisation is incorrect as, in real terms, this actually remains below those 2019 levels, and questions the validity of this assessment as the CAA describes within the Final Proposals[33].

Given the above, we therefore strongly encourage the CAA to revisit the level of challenge within the proposed level of operating expenditure.

### C.3.2 Security Costs and Future Transformation

As well as the more general points on efficiencies set out in C.3.1 above, the Airline Community note the specific removal of efficiency savings for security, totalling an increase of £331m. Whilst other

[31] Para 4.61, CAA CAP2365
[32] Para 4.62, CAA CAP2365
[33] Para 4.63 & 4.64, CAA CAP2365

benefits need to also be considered, this assessment raises serious concerns on the case for the 'transformative' elements of the Security Programme, to which the CAA have agreed to HAL's proposed total budget. A significant element of the benefit for this element was to provide operating efficiency savings but these no longer appear applicable in the CAA's H7 proposals.

Given the materiality we therefore believe this supports:

(i) a reinstatement of a security efficiency to ensure HAL are incentivised to seek security efficiencies during H7, and likewise are now not unduly 'rewarded' by bringing forward such elements (and therefore retain the benefit); and / or

(ii) a review of the specific security costs presented as part of the capital gateway lifecycle, with any such savings presented and agreed at G3 being returned to consumers by way of rebate into the charge.

Further comment on the Security Programme can also be found under the capital section of this response, C.5

### C.3.3 Business Rate Review

Whilst noting the situation with regards to business rates during H7[34], given the provisional £0.5bn expenditure over H7, the Airline Community are particularly concerned that the CAA's approach fails to properly incentivise HAL and is likely to be too subjective. The CAA's own assessment, and the Airline Community comments through Previous Submissions, of ex-post reviews highlights the challenges in assessing after the event and the CAA have suggested a very high bar with the caveat that a further review would be on the basis of "material concerns" and yet with no further qualification.

Given such concerns, the Airline Community would therefore suggest that airlines have the right to place their own experts within a governance framework that obligates HAL to update an agreed group on progress, impacts and strategy on a monthly basis with such airline representatives to any discussions with the VO. We believe this would strengthen the proposed approach

Notwithstanding the above, the CAA must make clear how the Airline Community will be made aware, and can input, into the review proposed by the CAA[35].

### C.3.4 Pension Arrangements

The Airline Community, and airlines, have raised through our Previous Submissions that consumers should not bear HAL's deficit repair costs

We note, and welcome, the CAA's comments that HAL's pension scheme is now in surplus[36] . That being the case, and taking onboard the above comments, we strongly believe that HAL must now remain fully liable for any future deficit and repair costs in line with other businesses. In order to ensure HAL are fully incentivised this must be an explicit within the CAA's final determination for H7.

Given the surplus situation, the Airline Community have removed the pension repair costs from our assessment of the level of charge.

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[34] Paras 4.67 – 4.69, CAA CAP2365

[35] Para 4.69. CAA CAP2365

[36] Para 4.70, CAA CAP2365

Notwithstanding the above, the CAA must make clear how the Airline Community will be made aware, and can input, into the proposed review set out by the CAA[37] .

#### C.3.5 PRS Costs

The Airline Community fully concur with the concerns raised by the CAA of HAL's conflation of passengers defined as "PRM" and those that may require additional services, who HAL has referred to as "PRS"[38]. The Airline Community are supportive of working with HAL in improving passenger services however, given the strict legal definition and requirements, it is important that a clear distinction remains.

### C.4 Commercial Revenues

#### C.4.1 Approach and Assessment of Commercial Revenues

As set out under C.3 (Operating Expenditure) above, the Airline Community have been supportive of using independent consultants, in this case CEPA / Taylor Airey ("CTA"), to better understand actual commercial revenue requirements as well as setting stretching, but achievable, targets. We also note that the CAA have, correctly, moved on from its 'range' based approach.

Notwithstanding the above, we note the significant downward adjustment the CAA have allowed for, and have two fundamental concerns:

(i) We note additional information has been provided by HAL to CTA and the CAA however this has not been made available to the Airline Community. We are therefore not able to validate nor provide critical insight as we would have expected to be able to do so;

(ii) The CAA have not taken account of all the evidence from CTA which would suggest a higher management stretch of up to 2% would be more appropriate[39] . This is further supported where we note a discrepancy in the assessment of the Terminal Drop Off Charge where the CAA have excluded this from any management stretch as it is deemed as a "non-controllable cost" by the CAA[40], yet the CAA have allowed HAL the ability to manage this revenue stream through setting of charges with only a requirement to 'consult' with other parties (covered further under C.4.2). Given the variation, the Airline Community have applied a conservative yet more challenging stretch of 1.5% in our assessment.

#### C.4.2 Terminal Drop Off Charge (TDOC)

In addition to the reference to TDOC in C.4.1 the Airline Community remain particularly concerned that the CAA are only seeking HAL to "notify" CAA or airlines of any price increases above 10%. The Airline Community have long been concerned on the possibility for significant price increases upon the conclusion of the H7 settlement, noting the CAA also has such concerns[41]. However, even with a risk share element, this in itself is unlikely to deter levels that could have implications to future traffic demand. Furthermore, unlike car park revenues where the entire risk / reward is with HAL, it

[37] Para 4.72, CAA CAP2365
[38] Para 4.73 & 4.74, CAA CAP2365
[39] Para 4.81, CAA CAP2365
[40] Para 5.36, CAA CAP2365
[41] Para 5.73 CAA CAP2365

is entirely appropriate for a requirement to seek any agreement from those sharing in the risk. We strongly note therefore that the requirement to seek agreement from airlines is incorporated into the final determination to address such concerns of potential abuse.

We would also note that, in our view, the CAA forecast of TDOC revenues is overly pessimistic. We have previously shared our forecast for 2022 with the CAA (Chart C that was based on current performance data shared by HAL on ratios such as the % of consumers paying the TDOC first time, vs those having to pay the PCN etc. We have developed the TDOC revenue forecast below based on the airline community's passenger forecast (assumptions are detailed in the table). All assumptions are taken from the HAL Surface Access Stakeholder Meetings, of which the CAA are an invited party, and reflect current TDOC performance. Over the H7 period our forecast is £87m higher than that of the CAA's forecast detailed in the Final Proposals, and we would urge the CAA to reconsider its TDOC revenue estimate[42].

[redacted]

**Chart C.4 [Confidential]**

[42] NB: This uplift is not included within the Airline Community assessment of the level of charge

## C.5 Assessment of Capital Expenditure and Capex Incentives

### C.5.1 Limited information from HAL and failure to address specific comments

The Airline Community fully concur with the CAA's assessment that the limited level of information has made the capital process difficult, summarised in the CAA's own words below, and there is a clear need for HAL to produce better quality plans going forward[43].

> *" Overall, we recognise the efforts of HAL's team to expand on its response to Initial Proposals through additional written submissions and a series of "deep dives" sessions. However, the information that HAL has provided frequently still falls short of our expectations"*[44]

In doing so however we also note on the need for clear consequences should HAL continue to fail in addressing this requirement from the CAA. To date and in our experience, this has not proven to be the case, and indeed, as set out below, the CAA have still progressed with much of what HAL have proposed, despite these clear failings.

The issues experienced to date only further enhance the need for the proposed changes to the governance and engagement framework, as set out further in this Section C.5

### C.5.2 Level and Make Up of the Capital Plan

We note the CAA's significant uplift since the Initial Proposals of the proposed capital plan. As set out further, the Airline Community does 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.

As set out in C.5.1 above, it is clear both Arcadis and the CAA have struggled to access meaningful information from HAL that sufficiently validates the figures with a high degree of confidence. It also appears, notwithstanding certain benchmarking activities, that Arcadis's, and subsequently the CAA's, assessment has been against the requirements or assumptions *HAL* have set out.

Furthermore, the CAA have subsequently accepted much of HAL's request despite guidance from its own independent analysis, or lack of explanation. By way of primary example:

- the CAA's consultant Arcadis in its report suggested a range for Asset Management and Compliance of between £1,375m and HAL's full request of £1,829m with the CAA settling on £1,715m with little explanation or rationale as to how the CAA has arrived at such a decision;

- Arcadis have not been able to review any of the costs associated with 'transformation' as part of the Security Programme but suggested in their report increasing the allowance "*some way*"[45]. Despite this lack of clarity, and as well as removal of incentives on security operating costs (one of the primary drivers of case for transformation and as set out further in C.3.2 above), the CAA have allocated the total amount requested by HAL; and

[43] Para 6.71, CAA CAP2365
[44] Para 6.46, CAA CAP2365
[45] Slide 37, Arcadis Annex Report, CAA CAP2365

- It is clear from the Arcadis and CAA assessment that much of the Carbon and Sustainability programme remains undefined and there are concerns on those sampled cost estimates that suggests a level higher than should otherwise be the case. Despite this the CAA have allocated the total amount requested by HAL.

Instead, the CAA's primary challenge on HAL's capital programme has, to a large extent, sought to challenge HAL by removing costs from the Efficient Airport and Commercial Revenue programme.

The Airline Community would highlight an inconsistency in application of guidance. Despite the comments on Carbon and Sustainability re a lack of definition, the CAA have taken a 'judgement call' over and above the Arcadis review and comments based on the importance they see consumers place on this. However, for the Efficient Airport programme, it appears the CAA have given no further consideration to such possible requirements above the Arcadis comments. This is despite evidence (as the CAA themselves have relied upon in reaching a conclusion on the Final Proposals) that show the operational improvements are ultimately important to consumers, for example, addressing issues that improve punctuality.

The Airline Community are frustrated that failings by HAL, as set out within the Final Proposals, has led to this outcome. This also highlights the challenges in both the H7 and 'within Q' process on the reliance on HAL, and their absolute ability, to prioritise expenditure.

For the avoidance of doubt, the Airline Community are supportive of sustainability initiatives that deliver evidenced based environmental benefits, such as improvements to Pre-Conditioned Air, and support a wider strategy and package of initiatives that address carbon and broader sustainability initiatives. However, it is also important to stress here that, in the context of the capital plan, such initiatives *may* be better with alternative delivery and charging models, such as working with third parties to deliver vehicle charging infrastructure and services. Likewise, a number of initiatives that provide operational enhancements are likely to have sustainability benefits as well. For example, improving airfield efficiency would, by its nature, reduce a number of metrics that would also have sustainability benefits such as reducing aircraft taxiing and holding times.

Focusing more broadly on the elements of the almost-eliminated Efficient Airports Programme, the Airline Community believe that it is essential to maintain some of the key projects within the H7 plan. Examples include parts of Passenger Process Automation and Airfield Optimisation. The former will provide significant consumer benefits; the latter will deliver significant operational improvements. We need to find an approach to prioritise the important projects which were previously listed within this Programme and work through the details to arrive a mutually acceptable plan, mindful of the overall capital envelope.

Another important project for which capital budget must be provisioned is QMM technology (Queue Measurement and Management) . Crucially, this will enable automated per passenger measurement of security queues, a project on which HAL and the airline community have already done a great deal of work. Although this project/budget previously sat under the Efficient Airport programme (hence its demise), the Airline Community has proposed that it should sit within the Regulated Security programme anyway. It is a small amount of spend in the context of the £825m budget for Regulated Security and naturally falls under the auspices of that programme. We urge the CAA to specify this as a component of the Regulated Security budget within its Final Decision.

Note that full details of our concerns and proposals about automated security measurement are articulated at section C.2.3.

Stepping back from the programme assessment, the CAA have also used the Q6 level of expenditure as validation for the overall level it has arrived at. We would question that conclusion, given: (i) the significant difference the CAA is suggesting in passenger volumes between Q6 and H7; and (ii) the ramp up challenges Arcadis and the CAA have also noted in the Final Proposals leading (and in the case of 2022, experiencing) into H7 as a result of the Covid pandemic and more general, construction pressures.

Whilst the capital governance process does allow for a degree of management of the capital expenditure, this does not discharge the CAA its duty to be confident in the level of expenditure, both by programme, and in totality, both forecasted and allowed for in H7.

In conclusion, the Airline Community remain concerned that the CAA's proposals not only have errors of judgement within but will be taken by HAL as 'pseudo approval' or specific endorsement of expenditure.

Even with the adjustment mechanisms in place, consumers will ultimately be paying for such decisions and we therefore believe it is necessary for the CAA to consider and be clear in its final determination on: (i) the degree of confidence, and therefore expectation, of such levels of expenditure; as well as (ii) how the changes to current governance arrangements, particularly with regards to the assessment of requirements and benefits (as set out further in C.5.8) might help better validate information and support decision making for HAL, airlines and the CAA.

Furthermore, and notwithstanding the comments above relating to the overall level, the Airline Community are strongly of the view on the need to review the overall prioritisation and initial allocation of the capital plan, *within the proposed level, excluding any marginal allowance increase* (as described for in Paras 7.126 & 7.127). For the avoidance of doubt, the Airline Community are not agreeable nor see any justification to addressing this simply through a further increase on the CAA's proposed level of capital.

### C.5.3 Uncertainty Mechanism

The Airline Community was open to the introduction of an 'uncertainty mechanism' that would allow for an agreed uplift to the capital plan later in H7, particularly given the ongoing uncertainties expressed by the CAA on passenger volumes. However, we believe, in setting the capital level as it has, the CAA has made an error of judgement and, in part, an inconsistent logic. In particular:

(i) the CAA's own assessment suggests levels above being proposed by HAL would not be deliverable[46] – though we note the CAA's plans begin to get close to HAL's initial ask;

(ii) there are still a number of challenges in assessing the true level of the required capital, particular the latter years of some programmes when utilising the uncertainty mechanism appears more appropriate; and

[46] Para 6.40, CAA CAP2365

(iii) that the CAA awarded most of what HAL has asked for and missed an opportunity to set a more challenging level initially that would also incentivise HAL to meet the CAA's requirement of providing better quality information in the future[47].

#### C.5.4 Coverage of Capex Incentives Ex-Ante

The Airline Community believe that, with the proposed enhancements within the governance arrangements including the introduction of Delivery Obligations, the approach and logic to ex-ante that the CAA has developed, as set out in Paras 7.88 – 7.92, can and should be applied to all projects that have yet to pass through G3. We agree that, by following the capital gateway process including approval at G3, HAL should have sufficient confidence and control to be held to account and that this is the same for all projects.

#### C.5.5 Incentive Rate

In relation to the incentive rate, the Airline Community believe the CAA's views set out in Para 7.41 (that rates are typically higher in other sectors and, whilst "*likely to influence HAL's behaviour*", the CAA are applying "caution") and 7.43 (that asymmetric rates are applied elsewhere are not appropriate) shows an over-degree of protection to HAL at the expense of the consumer, particularly where asymmetric risk is being proposed and justified by the CAA in other elements of the Final Proposal. This should be reconsidered now rather than at the next H8 price control period.

#### C.5.6 Delivery Obligations and Implementation

The Airline Community broadly concur and support the introduction of Delivery Obligations as proscribed within the Final Proposals.

We agree with the CAA's assessment that by setting Delivery Objectives at G3 (the timing of which is within HAL's control as part of their overall programme / project management) HAL must by this point have sufficient information and confidence to progress. This process is applied to all projects HAL undertake and therefore it is not reasonable or justified to treat projects differently. By assigning Delivery Obligations to the 'project' or 'tranche', this in our view, addresses any concerns.

As the CAA are aware, airline representatives have been working with HAL on the future structure of the capital governance, particularly where HAL are seeking to move to a 'programmatic approach'. During these discussions the Airline Community have been clear, and see workable, Delivery Obligations alongside and as part of the overall governance framework.

The area of greatest concern, and where we believe the CAA have not gone far enough, is on the definition of quality assessment which the CAA appear to have limited to delivery against 'requirements' as opposed to 'benefit realisation'.

We note the CAA's consideration of some of the Airline Community's previous concerns, particularly with regards to delivery of category level benefits (as described further in Paras7.114 and 7.115). It is disappointing that, whilst acknowledging this, it appears more a matter for the CAA in H8.

We believe that such commitments and incentives should be possible as part of the overall programme business case. We do not believe this requires a change to what the CAA are proposing but would welcome further discussion on this and the above 'quality assessment' point as part of the

[47] Para 6.71, CAA CAP2365

broader governance arrangements and think that this further supports a future formal review, as set out further in C.5.8

### C.5.7 Timing Incentives and Triggers

As set out in the Final Proposals the Airline Community are strongly supportive of triggers though had been open to reviewing timing incentives within H7. Through the CAA's development of the capital incentive framework, the CAA Airline Community have formally raised our concerns on the CAA's approach on timing incentives and triggers, particularly where a core element was being lost. We include the full text of our last written correspondence on the matter (set out in the Airline Community response to CAA CAA2265) but note this issue has continually been raised in our responses to CAA CAP2139 and CAA CAP1940

> "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."

Despite these concerns, the Final Proposals intends to remove triggers altogether, a step further than the Initial Proposals, without clearly addressing the Airline Community concerns, either by way of amending the approach to the 'timing incentive element' or justifying its exclusion.

The CAA's decision appears largely based on HAL's argument that new incentive arrangements "removes the need for, and potential double jeopardy to HAL, of also retaining triggers."[48]. The Airline Community disagrees with this assessment and believe it does not warrant the removal of triggers mechanism for three key reasons:

(1) By incorporating as part of the Delivery Obligations and applying a weighting against other criteria, this brings an element of 'trade-off' with other benefits. We do not disagree with this balance, but believe the underlying intention is more appropriate where timing is key to delivery of the *benefits* itself;

(2) The rebate HAL pays is on the *return it receives* for capital expenditure, not any overspend as would be the case being proposed; and

(3) the current ex-post review process shows a clear precedence and distinction between capex efficiency incentives, undertaken as part of the ex-post review, and payment of trigger rebates. By way of example, the CAA noted in CAP1996 that it would assess the efficiency of the Main Tunnel project upon its completion with no reference or link to the trigger rebates currently being made. We are not aware of any assessment undertaken by the CAA, nor argument made, that in the event capital expenditure is deemed to be inefficient and thereby removed, that this is offset by any trigger rebate payments that may have been made.

We note the CAA's continued reference to triggers within the Final Proposal as 'penalties' which was an issue formally raised by the Airline Community to the CAA in our response to CAA Consultation CAP1940. We reiterate our position here that trigger payments are 'rebates'. By way of support, we

[48] Para 7.59, CAA CAP2365

point the CAA to the governing document for triggers, “Q6 Capital Investment Triggers Handbook”, where they are described as such.

We remain concerned that continued referenced to ‘penalties’ by the CAA further evidences a misunderstanding in the role triggers play and believe this has had an undue bearing in the CAA’s decision to remove them altogether.

In summary, we: (i) do not believe the CAA has sufficiently considered nor responded to the concerns raised in the removal of triggers altogether; and (ii) would seek their reinstatement, as suggested within the Initial Proposals, for the reasons outlined previously and above.

We remain agreeable to explore further any required alleviation to address any outstanding concerns either HAL and / or the CAA may have.

### C.5.8 Enhanced governance and transparency

The Airline Community have made extensive comments on both issues with the current governance processes to be addressed, as well as changes required to meet the CAA’s new capital incentive framework; all of which remain valid and hereby incorporated including those set out in our response to CAA CAP1951. In summary these primarily focused on the need for improvements to:

- Ensure a sufficient level of definition and commitment to in the development of business cases, particularly in relation to benefits that HAL are accountable for delivering;
- The ability for airlines and the Airline Community to validate requirements, scope and associated costs proposed by HAL;
- Reporting and provision of information by HAL; and
- Engagement with procurement, including benchmarking activities.

In addition to the above we have also highlighted the need for a full review on the value and treatment of Leadership & Logistic and management of risk.

Whilst we look forward to working on the details further with the CAA and HAL over the summer, we would note here the CAA’s acknowledgement that under the CAA’s proposals the G3 will have an increased emphasis[49].

The Airline Community propose the enhancement of airlines utilising independent, expert support, particularly in relation to Bullets 1 and 2 above which are largely outside the remit of the IFS. We believe this could be funded within capital plan (as opposed to increasing) and that should also provide benefit and further confidence to the CAA in their own assessments.

Whilst current governance arrangements do not preclude the Airline Community utilising the support of third-party expertise, and there is precedence of such[50], the effectiveness is largely contingent upon HAL’s engagement and information provision.

Not only would the formalisation and implementation help the Airline Community, acting on behalf of the consumer, to make more informed judgements, it should also help HAL in both its own business case and solution development, as well as provide further assurances for the CAA. We

[49] Para 7.70, CAA CAP2365

[50] HAL funded a specialist ‘Fuel Infrastructure’ SME to support the Airline Community assessment of HAL’s future fuel farm plans under the Expansion Programme

welcome further discussion with both the CAA and HAL on this and welcome its inclusion in the CAA's final determination.

### C.5.9 Promoting Economy and Efficiency

We welcome the CAA have specifically commented upon promoting economy and efficiency as well as identifying some particular areas of possible concern[51]. We would propose that, rather than waiting for evidence to be found, as suggested by the CAA in Para 7.143 and 7.144, that the CAA *commits* to undertake such a review on the capital arrangements, as it did in Q6. This proactive approach should h. This would allow for not only the CAA assuring itself that consumer interests are being served, for instance that HAL are providing the level of savings information and acting upon it in future, as per CAA's expectations in 7.141, but also ensure any findings are addressed both within the rest of H7 as well as a better 'glide path' into H8.

We would particularly note the point raised on information transparency and the path into H8 given the issues of such within Q6 and the apparent challenges taken to implement the CAA's proposals for H7.

The Airline Community would be available to develop this detail with the CAA as part of the broader governance discussions.

### C.5.10 Implementation

Notwithstanding specific points raised elsewhere in C.5 to be addressed, the Airline Community concur with the CAA's rational logic and approach to implementation, including a 'go live' in 2022, as set out in Paras 7.145 – 7.147.

## C.6 Other Regulated Charges

### C.6.1 Marginal Cost Approach

We agree with the CAA that there are advantages to the consumer in setting ORC's on the basis of the marginal costs of the services provided. The benefits outlined in the Initial Proposals remain valid and the Airline Community continue to strongly support this approach for H7.

In addition, we continue to support the CAA's approach to add back the non-airline fixed costs and annuities relating to non-airline costs due to staff car parking, electricity and water. It is clearly unreasonable for the consumer to face a further cost of £90m via the Aero Charges over the period of H7 to finance these costs. We would also highlight that HAL already have systems in place that provided differentiated costs for ORC's (eg based on individual airlines pre notification rates for PRM's). We therefore do not believe that it would be a significant issue for HAL to implement this.

### C.6.2 Bus and Coach

In its Initial Proposals[52] the CAA stated that *"There may be some advantages to moving to commercial arrangements"… "however we note that airlines and other stakeholders have not had an*

[51] Para 7.141 & 7.142, CAA CAP2365
[52] Para 13.28, CAA CAP2365

*opportunity to provide a formal view on this proposal. We will, therefore, reserve our position on these matters until stakeholders have an opportunity to comment on HAL's proposals*".

The Airline Community would note that we have not had any details on HAL's proposals and have therefore not had any opportunity to comment on them, other than the previous comments made in the response to the Initial Proposals where we stated "*we would welcome the opportunity to comment further*" and we would want assurances that the impact on commercial revenues should be "*modelled consistently across all other building blocks*".

We would also note that there has been no written application from HAL to the CAA that has been made public to the airlines on this matter (either in the Initial Proposals or between the Initial Proposals and the CAA's release of its Final Proposals).

We would therefore express our opposition to the CAA deciding without consultation to support HAL's proposal to remove Bus and Coach services from the ORC framework.

### C.6.3 Reflection of Operating Cost and ORC Revenue Treatment

The Airline Community have been unable to validate but raise as a question to the CAA the assurance that changes to ORC revenues reflect the treatment for utility and PRM costs,

## C.7 License Implementation

The CAA have correctly set out the need for a correction factor to deal with the over-recovery of 2020 and 2021 charges[53] however, given the scale of the over-recovery, it is entirely inappropriate for this to be at HAL's discretion. Instead, it should be based on a joint agreement with airlines. Whilst going some way to address the shortfall, and we do concur that the application of RPI inflation and RPI real WACC is a more appropriate uplift mechanism for each year delay than the Treasury Bill discount rate, the CAA should look to amend this position to require HAL to consult and reach an agreement.

## C.8 License Conditions

We have a number of comments to make on the proposed changes to the Licence Conditions and list them below :

Conditions C2.2 and 2.3

We support the introduction of condition C2.2 and C2.3 which allow the CAA after a period of consultation to amend the cost allocation methodology outlined by HAL in September of each regulatory year. Clearly it is in the best interests of consumer to endure that the allocation methodology is reasonable and fair to all users of the services concerned.

Condition C2.4

We support the introduction of condition C2.4 which specifies that HAL shall facilitate and pay for an independent review of the cost allocation methodology reporting to the CAA. The airlines have requested a number of times that independent reviews be conducted during Q6 and to date HAL

[53] Para 14.17, CAA CAP2365

have not complied with these requests. Introducing this condition will provide additional protection for the consumer in ensuring that the cost allocation methodology used by HAL is fair and reasonable. We would also recommend that the independent review audit the cost allocation mechanisms used to ensure that the processes adopted to allocate the costs are robust, properly checked and not producing any significant errors.

Condition C2.5, C2.6 and C2.7

We support he amendment to this condition. It is important that cost and revenue transparency is enhanced in H7 so that users can ensure that the charges are reasonable, represent value for money and that the allocation methodology has been applied fairly and correctly. During Q6 the airlines have requested that HAL provide further detail on charges in a number of cost categories. It has been difficult to get agreement from HAL to provide those details and these amended conditions along the amended governance arrangements will provide clear guidance to HAL that these details should be provided.

Deletion of “or their representatives”

We note that the phrase “or their representatives” has been deleted from conditions C2.7, C2.8, and C2.12. We would request that this phrase is reinstated as without this phrase, authorised representative bodies (for example the Heathrow AOC, airlines’ alliances and IATA) would not be able to fully participate in the ORCG as representatives of some or all the airlines at LHR. Conditions C2.9, C2.10 and C2.11

We support the creation of a self-modification procedure for amending the list of specified facilities covered by ORC’s where there is written agreement between HAL and the Heathrow AOC. This is a sensible condition to include in the licence.

Condition C2.12

We do not support the removal of the “facilities for bus and coach operators” from the list of specified facilities (see section on **Treatment of Bus and Coach ORC services** above for our reasons why we oppose this change).

Condition F1.1

We support the amendment to this condition which requires HAL to seek agreement on governance arrangements for ORC’s. It is important to establish clear rules, processes and information requirements, including consultation requirements, to allow airlines and other parties to scrutinise, challenge and collaborate with HAL to drive efficient costs and appropriate service levels and to propose and, where relevant, agree amendments to ORC’s. In Q6 when airlines and HAL jointly renegotiated the baggage contract this collaboration worked to great effect. However that has not occurred on all Q6 ORC contract renegotiations and this condition will ensure that during H7 there is consistent collaboration between HAL and the airlines on ORC charges to ensure the most efficient outcome for consumers.

Section C11

We do not agree with the proposal to change the name of the SQRB scheme to the “MTI” scheme. The scheme is substantially the same as was utilised in Q6 with largely the same measures and structure. The SQRB scheme is known throughout the airport community, changing the name to “MTI” will cause unnecessary confusion for no real reason and to no gain. We recommend that the SQRB name is continued in H7.

Section C14

We do not agree with the new provision set out in Annex 3 to Schedule 1 that allows the CAA to make a binding decision on the application of a specific exclusion. The CAA has presented no evidence that this new provision is required. There is actually good evidence that this new provision is not required as there have been no instances during the whole of Q6 where it has been shown that the Heathrow AOC have made an unreasonable decision or an unjustified decision on exclusions.

Schedule 1, Section -3.18

We would recommend that an additional requirement is included in the section that defines how the defined method of data collection should be agreed locally. There should be a requirement that this is agreed on an annual basis or whenever the queue configuration is changed. It is likely that the configuration of security queue areas in particular will be changing regularly across the H7 period so it is important that these measurements are made correctly to an agreed standard.

As a separate point, we recommend the insertion of a new sub-paragraph here as follows: "*The Licensee shall continue to develop an Automated method of data collection to measure Security Queue Time for passengers and shall implement this method at each search area in accordance with the governance arrangements required under Condition F1.1(a)(iv).*

The rationale for this recommendation is shown in detail in section 3.2.3 above.

## D. Appendices and Annexes

### Appendix 1: PCM Calculations of the Airline Community Level of £[redacted]*

Current adjustments to CAA Figures:

(i) Removal of Pension Repair Costs (as noted in Section C.3)

(ii) 0.5% improvement in Commercial Revenues to reflect proposed Management Stretch (as noted in Section C.4)

(iii) Reversal of the £300m RAB adjustment; (as noted in Section B.4)

(iv) Removal of the Asymmetric Risk (as noted in Section B.3)

(v) Adjustment to the WACC to reflect the Airline Community 2.37% (as noted in Section B.2)

(vi) Adjustment to the Passenger Numbers to reflect the Airline Community assessment (as noted in Section B.1)

[redacted]

NB:

* This table is provided to support the statement for £[redacted]. The Airline Community are working with the CAA to finalise calibration within the CAA's PCM and CTA's model for operating costs and commercial revenue, the conclusion of which may adjust this figure within a range of tolerance; we will further update the CAA upon its conclusion.

** Other suggested changes within Sections B and C not referenced within Appendix 1 have not been included in this current assessment

### Annexes:

1. CEPA: H7 Final Proposal WACC Analysis.

2. Airline Feedback to CAA: "Timely Delivery on Departing Baggage"