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Virgin Atlantic Airways

**H7 Final Proposal – consultation response**

APPENDIX 1

VAA'S ADDITIONAL COMMENTS ON PASSENGER FORECASTING AND DATA SUPPLEMENT

1. **PASSENGER FORECASTING**

1.1 This Appendix 1 contains additional comments and data to support VAA's and Delta's joint response in relation to passenger forecasting, found at Section 2 that document. This Appendix 1 contains information which is confidential to VAA, such information to be removed from the version of this joint response submitted by Delta, and any version of the response intended to be shared publicly.

1.2 The CAA has raised concerns about extrapolating load factors into 2022 and 2023, stating that forward bookings were a small proportion of the year at the time of publication of its forecast.[1] The CAA has also raised concerns that airlines have not fulfilled their schedules as filed at the beginning of the year. However, many of the recent cancellations have been at HAL's request, and it should be noted that demand is extremely strong and driving yields across all cabins. For example, ██████████ ████████████████ with economy ████████████████████████ across the first six months of the year 2022 on average. This can be seen from ███████████.

Figure B - ██

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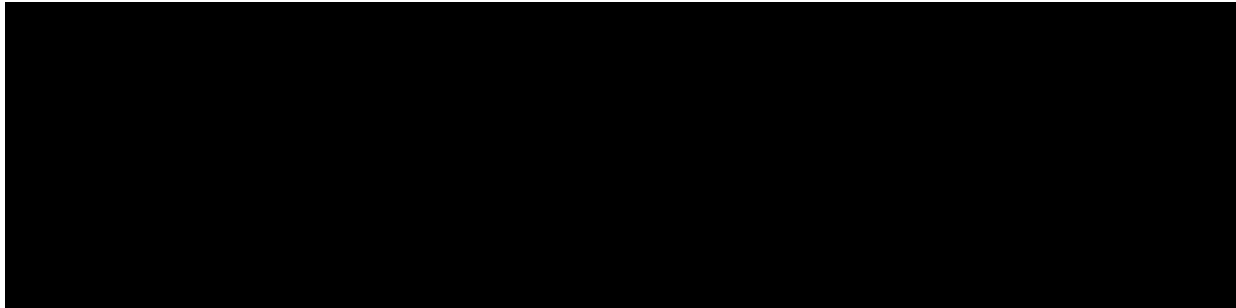
1.3 VAA have previously explained to the CAA's Forecasting team that airlines typically solve for load factor by amending fares. There is more than enough scope for carriers to appropriately manage their yields, by adjustments to fares, without experiencing detrimental impact to overall demand and passenger numbers at LHR. This was the case post-Global Financial Crisis, where passenger numbers at LHR dropped less than 2% in the four-year period from 2007 to 2010, unlike London Gatwick ("**LGW**") and Manchester Airport ("**MAN**") which experienced drops of 11% and 17% respectively across the same period. This suggests LHR is somewhat more shielded from the macro-economic environment of the wider UK owing to its geographical location close to central London, together with its high proportion of premium passengers and connecting traffic. This is supported by International Air Travel ("**IATA**") research (see **Figure C**).

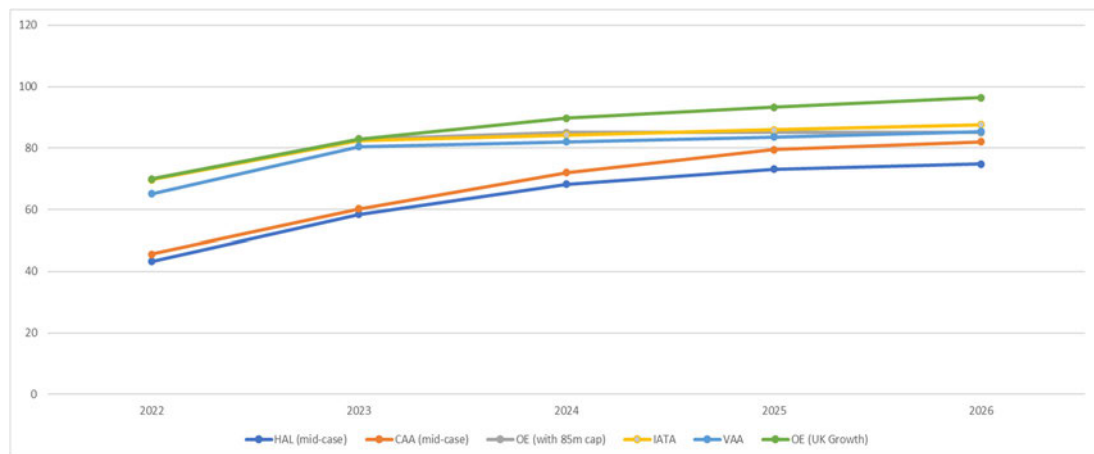[1] CAA's Final Proposals, Section 1, Chapter 1, page 14, paragraph 1.30.

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VAA's proposed forecast for 2022 and Q1 2023

General approach

1.4   As highlighted in paragraph 2.31 of the VAA consultation response, VAA proposes an alternative approach for the immediate/short term in 2022 and H1 2023. Given the data which is available for this period (e.g., on sale capacities) and the ability to devise accurate granular assumptions (e.g., as to seat load factors), a more bottom-up approach should be taken to this period. VAA has now undertaken this task and sets out the outcome of that exercise below.

1.5   In respect of the forecasting judgements applied by the CAA as to (1) 2022,[3] (2) 2023 to 2026[4] and (3) the combined period,[5] VAA considers that 2022 numbers will be constrained by the capacity that HAL will allow airlines to fly.

1.6   Based on understated 2022 numbers, the CAA recovery profile for 2023, 2024, 2025 and 2026 remains well below the external forecasts as shown in **Figure C** below.

1.7   **Figure C** and **Figure D** below show how VAA's LHR-wide forecast compares to other industry forecasts as well as the "Mid" case forecasts from HAL and CAA. It should be noted that by 2026 all forecasts, with the exception of that put forward by HAL (and excluding the Oxford Economics unconstrained UK growth forecast), are within 4% of VAA's forecast. This serves to further highlight HAL's overly pessimistic view on the whole H7 period and unwillingness to align with the industry consensus.

1.8   It is highly unlikely that by 2026 air travel demand will still be suppressed to the extent that HAL is suggesting. By way of illustration, HAL's forecasted annual passenger figure for 2026 is below the actual figure for 2005. For reference, the compound annual growth rate of total passenger traffic for LHR year on year was 1.28% between January 2005 and December 2019, a period which included a number of shock events such as the Global Financial Crisis and the Eyjafjallajökull eruption in 2010.

Figure C – Comparison of VAA and HAL alongside industry forecasts across 2022-2026 period by annual passenger figures[6]

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[3] CAA's Final Proposals, Section 1, Chapter 1, pages 24-25, paragraphs 1.63 to 1.69.

[4] CAA's Final Proposals, Section 1, Chapter 1, pages 25-26, paragraphs 1.70 to 1.76.

[5] CAA's Final Proposals, Section 1, Chapter 1, page 27, paragraphs 1.77 and 1.78.

[6] CAA's Final Proposals, Section 1, Chapter 1, page 8, Table 1.1 and page 14, Table 1.2, as compared to VAA's LHR-wide forecast.

Figure D – Annual forecasted passengers per the different forecasts [7]

	2022	2023	2024	2025	2026	H7
HAL (mid-case)	43.2	58.4	68.2	73.1	74.8	317.7
CAA (mid-case)	45.6	60.2	72	79.4	82	339.2
IATA	69.6	82.5	84.2	85.9	87.6	409.7
OE[8] (UK Growth)	69.9	82.9	89.7	93.3	96.4	432.2
OE (with 85m cap)	69.9	82.9	85	85	85	407.8
VAA forecast	65.1	80.4	82	83.6	85	396.1

<u>VAA's approach to LHR-wide traffic forecasting in the period from 2022 to 2023</u>

1.9   The following section summarises VAA's approach to LHR-wide traffic forecasting in the period from 2022 to 2023, whilst also highlighting concerns around the current methodologies and assumptions used by the CAA and HAL in their own annual passenger forecasts ahead of price setting for the H7 travel period.

1.10   VAA's approach to passenger forecasting is based on ███████████████ ███ ███ ███

1.11   In its own 2022 "Mid" passenger forecast, the CAA concluded that an upper bound of 74% of 2019 levels was to be used based on selecting a cap of 84% of 2019 in its 2023 forecast.[9] This analysis computes figures which are at odds to actual figures from June 2022, as outlined in VAA's forecasting approach above at paragraph 1.10. Even amongst staffing difficulties and other operational challenges, the load factor for June 2022 was ███ across all airlines departing LHR.

1.12   LHR's average load factor since 2005 stands at ███ and typically follows the same peak pattern throughout the calendar year. Q2 2022 (an average load factor of ███ [10] [11]) has been used as a baseline to forecast load factors for the remainder of 2022, applying a monthly weighting to map to historic patterns and a recovery rate factor based on 2022 vs 2021. As such, in VAA's forecast, the load factor across all LHR flights for 2022 is ███ (vs ███ in 2019[12] [13]).

1.13   In order to meet HAL's initial "Mid" passenger forecast for 2022 of 43.2 million passengers the load factor across all remaining flights would need to be ███. Load factors as low as this were only seen in April and May 2020 and are highly unlikely to be seen again. It is also highly likely that passenger numbers will far exceed HAL's "high" case of 52 million passengers. HAL's excessively pessimistic forecast demonstrates that assumptions being made are not congruent with the market (and not congruent with the need for complete rebasing of the forecast.) Similarly, a load factor of ███ is required across the remainder of the year to meet the CAA's initial forecast of 45.6 million passengers

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[7] CAA's Final Proposals, Section 1, Chapter 1, page 8, Table 1.1 and page 14, Table 1.2, as compared to VAA's LHR-wide forecast.

[8] Oxford Economics UK Air Travel Demand Growth Forecast, May 2022.

[9] Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework 1.67

[10] HAL reports/traffic statistics June 2022, https://www.heathrow.com/company/investor-centre/reports/traffic-statistics

[11] DIIO Capacity Data July 2022

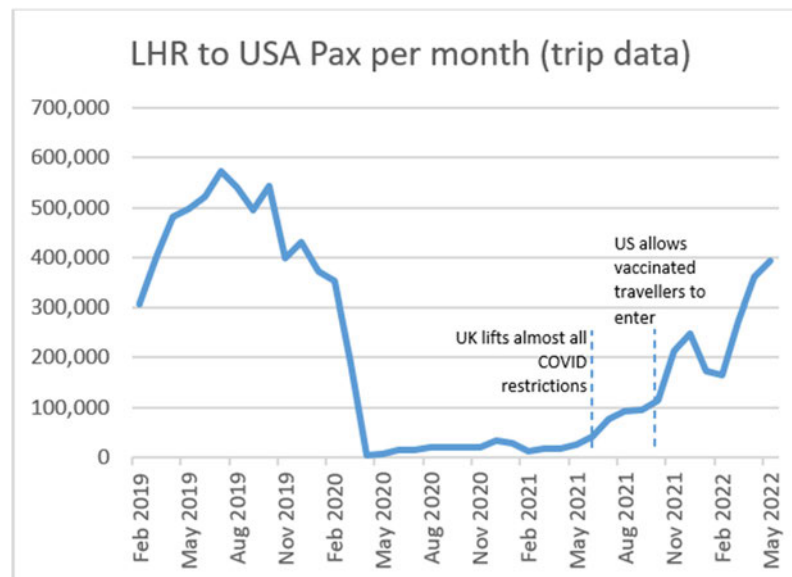[12] HAL reports/traffic statistics June 2022, https://www.heathrow.com/company/investor-centre/reports/traffic-statistics

[13] DIIO Capacity Data July 2022

per year for 2022.[14] Even HAL's revised forecast in Q1 2022 of 52.8 million passengers for the year appears to be unduly pessimistic based on data available as of July 2022.

1.14   On sale capacity for the remainder of 2022 has changed markedly over Q2 2022. This is owing to various market caps and external pressures. Applying forecasted load factors to on sale capacity as of May 2022 leads to a forecasted annual passenger figures of 65.1 million for 2022. Reductions in capacity as of July 2022 now equate to forecasted annual passenger figures of 61.9 million. The figures are based on applying forecasted load factors to on sale capacity as was in May 2022 versus on sale capacity as of July 2022.

1.15   On sale capacity for Q1 2023 currently stands ███████ than for Q1 2019.[15] We have seen in the case of the United States that demand recovers quickly after the lifting of travel restrictions. Travel restrictions have recently been removed in key markets such as Australia and Singapore, and the forecast assumes that in these markets demand will be at ███ of equivalent 2019 monthly levels within 3 months of restrictions being removed. In addition, more than 30% of passenger journeys to the United States from LHR begin at an airport other than LHR. A greater number of itineraries will be available as more countries continue to ease restrictions, which will further drive passenger demand.

Figure E – LHR to USA passengers per month (trip data)[16]

1.16   In VAA's LHR-wide forecast, the assumption has been made that available capacity to destinations in China and Hong Kong will remain constant as of July 2022. This is due to China and Hong Kong retaining significant Covid-19 restrictions, which include quarantining on arrival. Combined, China and Hong Kong only accounted for under 2% of available seat capacity at LHR in 2019. Similarly, routes to Russia and Ukraine were around just 0.6% of LHR overall 2019 capacity. Taking a cautious approach, the routes servicing these four locations (ie, China, Hong Kong, Russia and Ukraine) have been

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[14]HAL reports/traffic statistics June 2022, https://www.heathrow.com/company/investor-centre/reports/traffic-statistics; DIIO Capacity Data July 2022.

[15] DIIO Capacity Data July 2022

[16] Figure E - LHR to USA passengers per month (trip data) shows passenger trips between LHR and all US airports (direct and indirect) based on DDS data. The graph shows that in the absence of Covid-19 restrictions recovery happens swiftly noting the periods following the lifting of restrictions and post Omicron "scare".

left at current (highly reduced) levels for July 2022 in the passenger forecast for this exercise. This is likely to give conservative results, given that, for instance, Hong Kong announced shorter quarantine period, likely to result in increased passenger traffic. In addition, certain other route and carrier combinations which require Russian overflight rights have had no uplift applied in the 2022 and 2023 period.

1.17   For 2023, the forecast models annual passenger numbers at 80.4 million. As above, this assumes little to no change to capacity in markets affected by strict Covid-19 travel regulations as well as no change to markets and or routes affected by the Russia Ukraine conflict. In the event that China and Hong Kong remove a majority of travel restrictions in advance of the commencement of 2023 and assuming Chinese carriers maintain Russian overflight rights, the forecast gives annual passenger numbers of 81.1 million, which is slightly above 2019 levels.[17] This is extremely important, as currently, the CAA proposes that LHR will not recover to 2019 levels until 2025 at the earliest which is contrary to many industry forecasts.
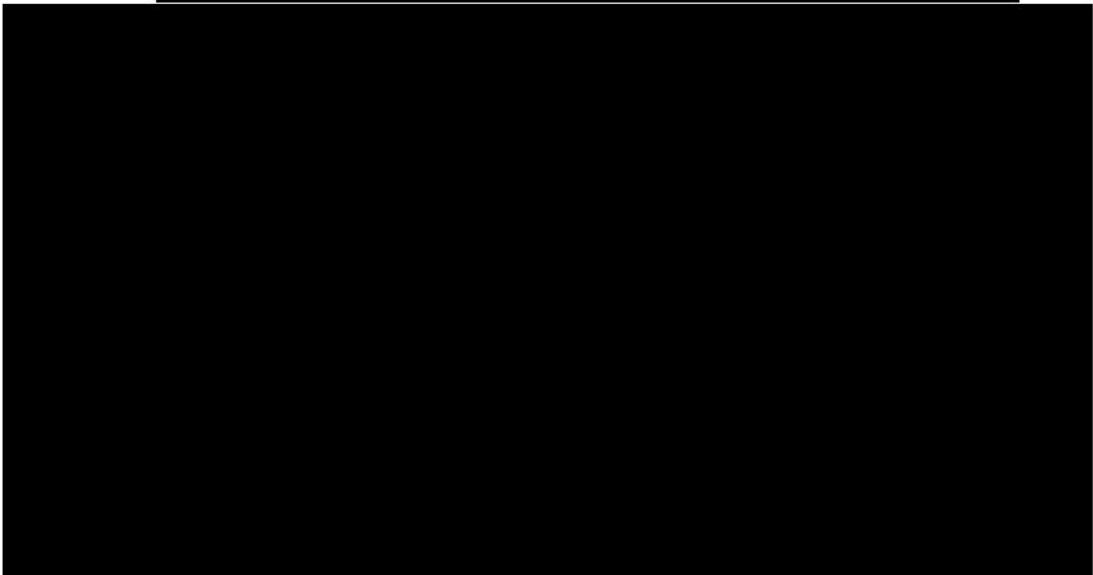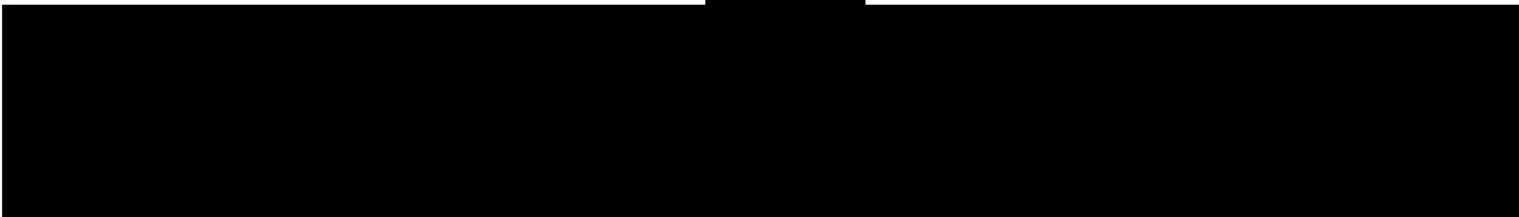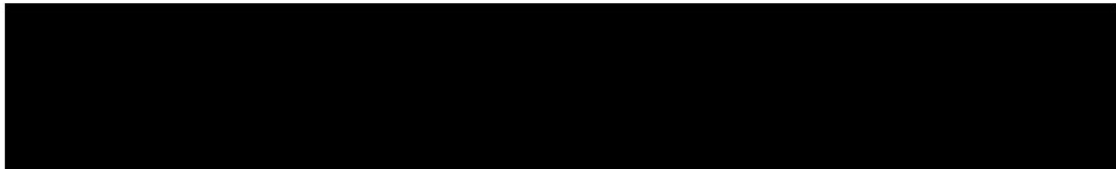
Figure F ████████████████████████████████████

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Figure G: ████████████████████████████████████

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1.18   ██

Figure H: ████████████

1.19 ██
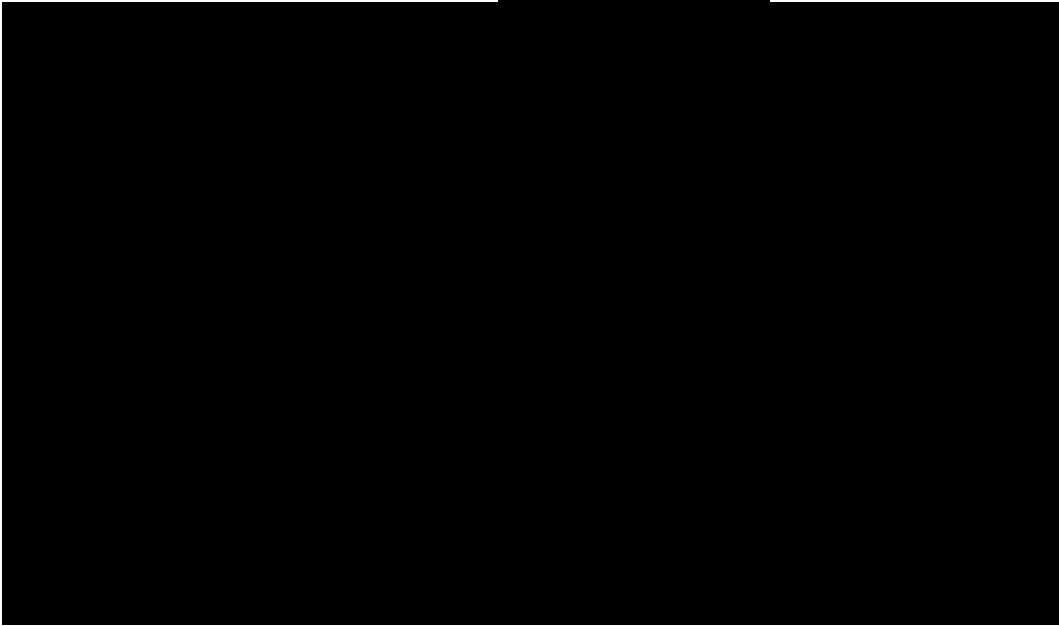
Figure I: ████████████

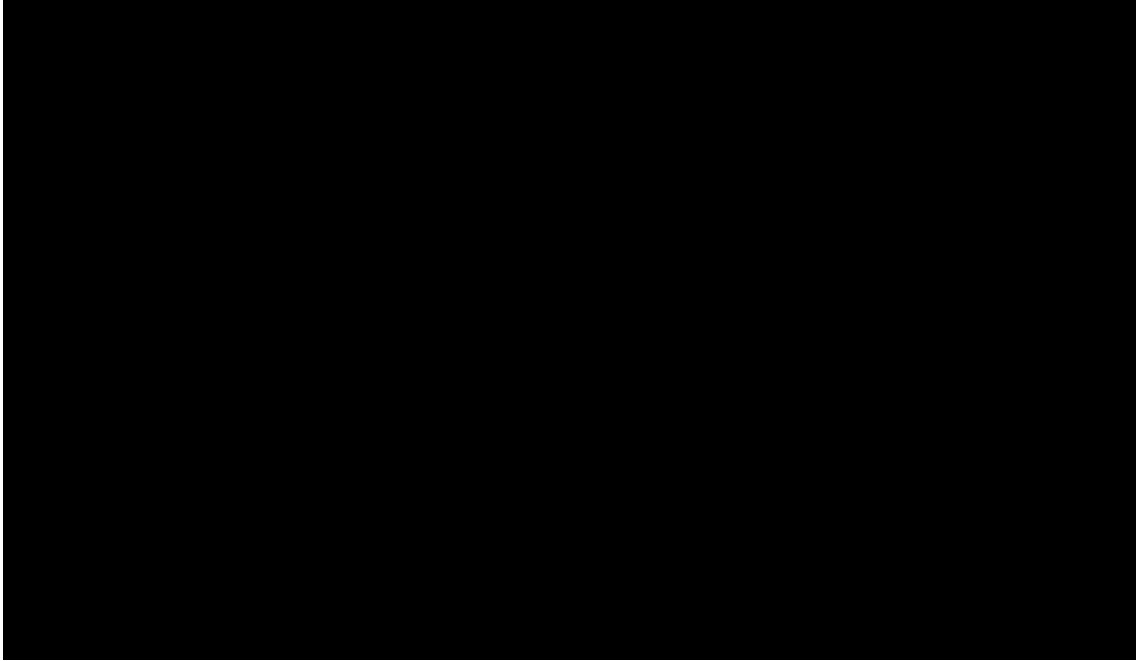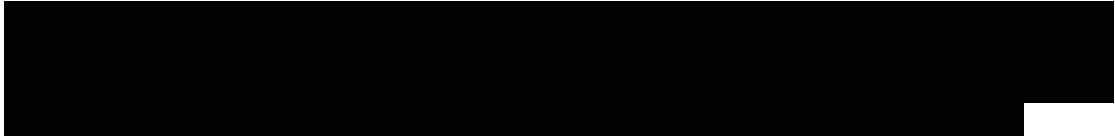[19] This graph plots proportion of passengers on the flight according to how many days before the flight they booked. It reflects the LHR route that VAA flew only in 2019 and 2022.

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1.22 ██
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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-pandemic 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.[20]

VAA's proposed forecast for 2023 onwards

1.23 In order to forecast passenger numbers from 2023 to end of the H7 period in 2026, passenger data from 2015 to 2019 was used as a growth baseline. The average year on year growth for this period was 2%.

1.24 Applying this static growth factor to VAA's 2023 forecast number produces an estimate of 85.3 million passengers in 2026. As has been the case throughout the consultation period, VAA and the wider airline community have been conscious of ensuring forecasting has been done robustly, using a combination of third-party, industry-recognised forecasts and data sets in combination with live "real world" data, and an appreciation of the current operational landscape. To this end, the forecast is capped at 85.0 million passengers in 2026 in line with HAL's current overall maximum terminal capacity.

1.25 It should be noted that VAA's pragmatic approach to forecasting yields passenger figures are in line with recognized external passenger forecasts.

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

Figure J - *UK Origin and Destination Market ("O-D")*

UK O-D market expected to recover pre -crisis level in 2023
ACI Europe expect recovery for region by 2024; CAA LHR forecast lags significantly

Source: IATA/Tourism Economics Air Passenger Forecast May 2022; ACI Europe May 2022
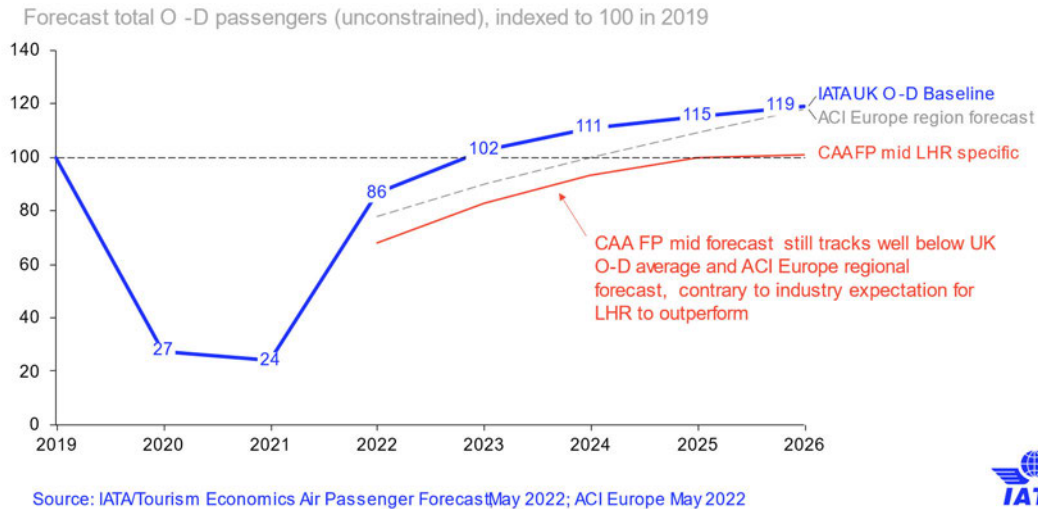
1.26   As **Figure J** shows, the IATA and ACI forecasts predict a return to 2019 traffic levels one to two years earlier than the current CAA forecast which (like that of HAL) indicates that a recovery to pre-pandemic levels for LHR will only occur by 2025. The key economic drivers of traffic for the UK below give reason to suggest that LHR's economic recovery will be quicker than both the CAA and HAL's forecasts suggest or allow. This is especially true as the 2022 starting point is materially higher than in the CAA forecast's starting point.

1.27   Notwithstanding the massive impact of Covid-19, according to the IMF:[21]

1.27.1   the UK economy is expected to be around 2.3% larger in 2023 compared with 2019 measured by real (constant price) GDP;

1.27.2   per capita incomes are expected to be 0.3% higher measured by real GDP per capita;

1.27.3   the unemployment rate is forecast to remain relatively low at 4.6% compared with 3.8% in 2019; and

1.27.4   population is likely to be 1.3 million persons higher, moving above 68 million.

1.28   All of these factors indicate that it would be more realistic to assume recovery in air passenger demand approaching pre-pandemic levels in 2023 rather than the gradual and protracted recovery indicated by the "mid" scenario in the CAA Final Proposals, only reaching 2019 levels in 2025.

1.29   Moreover, as documented in Figure 9 of the Airline Community Response to the H7 Initial Proposals (reproduced as **Figure K** below), LHR has proven to be relatively resilient to shocks in the past. During the Global Financial Crisis of 2008 – 2009, year on year

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[21] World Economic Outlook database, April 2022

negative fall in passenger numbers barely reached c. 5% at LHR, compared to c. 10% or more at LGW and MAN as shown in **Figure K**.

Figure K – (reproduced from Airline Community Response to H7 Initial Proposals)

Terminal pax: yoy % growth, 3-month moving average
Source: IATA PaxIS
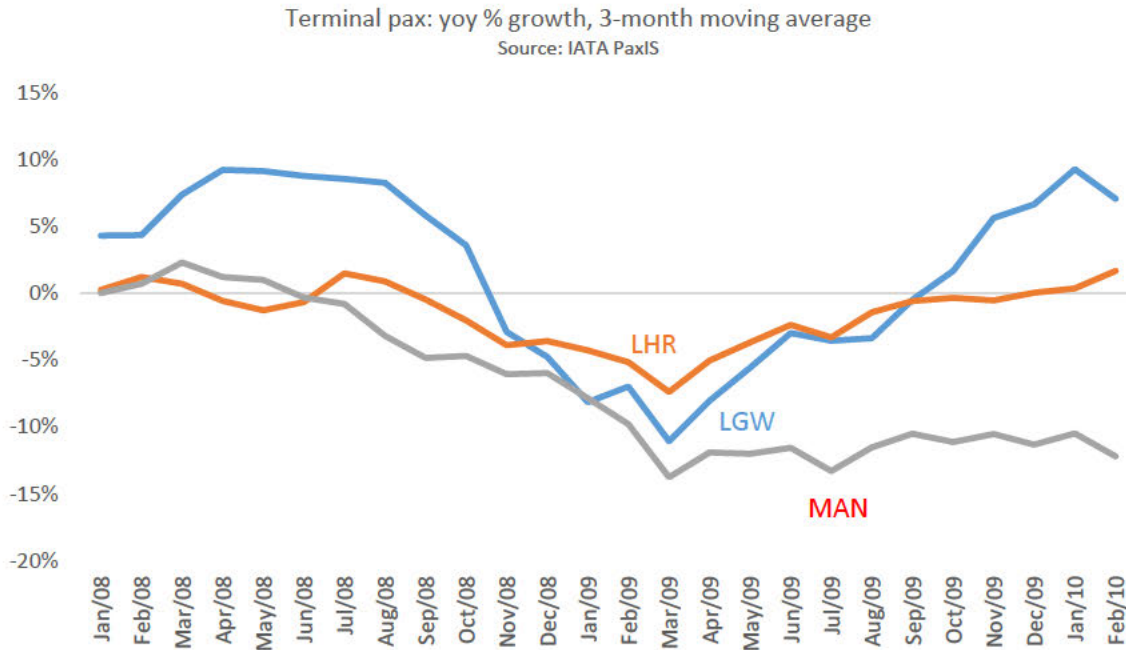
1.30   Evidence of this resilience is also apparent when looking at the relative pace of recovery out of the Covid-19 pandemic. It is worthwhile to review the performance of LHR against other airports in the UK. VAA agrees with the CAA's view that "*demand at Heathrow has historically been more robust in the face of economic headwinds than that at the rest of the UK airports, helped by the pressure on airlines to protect valuable Heathrow slots.*"[22] According to CAA data for the 12-month period from June 2021 to May 2022, LHR handled 45% of 2019 passenger volumes, well ahead of the 33% for LGW and above a number of other large UK airports.

1.31   This supports the industry expectation of a recovery for LHR that is in advance of, not lagging behind, the UK market on average.

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[22] CAA Final Proposals, Section 1, Chapter 1, page 26, paragraph 1.74.