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VIA EMAIL:

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Paul Smith
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Re: Comments from Delta Air Lines regarding H7 Final Proposals

Dear Mr. Smith

Delta Air Lines, Inc. ("**Delta**") welcomes the opportunity to provide comments to the Civil Aviation Authority (the "**CAA**") regarding the Economic regulation of Heathrow Airport Limited ("**HAL**"): H7 Final Proposals (CAP2365) (the "**Final Proposals**"). Appended to this letter is the joint consultation response to the Final Proposals submitted by Virgin Atlantic Airlines ("**VAA**") and Delta (the "**Consultation Response**").

VAA and Delta have collaborated on a single response in the interests of efficiency and to assist the CAA in its review. While reference is made to VAA throughout, Delta fully endorses the views expressed in the Consultation Response. Any information included with the Consultation Response which is confidential to VAA has been submitted in a separated annex which has not been shared with Delta. Similarly, information which is confidential to Delta is included in the supplement on passenger forecasting enclosed with this letter and has not been shared with VAA. Delta fully endorses the attached report prepared by AlixPartners ("**AP Report**"), at the request of VAA, Delta and British Airways, and requests the CAA to reconsider the Final Proposals in the light of the AP Report. Delta also supports and endorses the submission made by the LACC, AOC and IATA on behalf of the airline community.

Delta has engaged with the CAA throughout the H7 process in order to ensure that the final settlement furthers the interests of consumers. Delta has identified material concerns with the CAA's methodology and the proposed substantial and unfounded increase to Heathrow's charges as part of this process. In particular, Delta described its concerns with the CAA's H7 Initial Proposals (CAP2265) ("**Initial Proposals**") in a joint response with VAA, which was submitted by VAA on behalf of both airlines on 17 November 2021. On 17 December 2021, Delta provided further comments on the Initial Proposals in its individual submission and also endorsed the submission made by VAA. Subsequently, Delta commented on the Notice of Licence Modification (CAP2305) on 31 January 2022 and shared additional evidence (a report by WPI Economics) with the CAA on 25 May 2022. Additionally, as a member of Airlines for America ("**A4A**") and the International Air Transport Association ("**IATA**"), Delta fully supports the prior submissions by A4A and by IATA and AOC/LACC.

In order to satisfy its primary duty to further the interests of consumers, the CAA must demonstrate that in setting the overall H7 price cap it has given proper regard both to the asymmetry of information that exists between it and HAL and to HAL's natural incentives as a monopolist to adopt pessimistic passenger forecasts and to overplay the extent of the financial jeopardy it faces. Simply put, the CAA

should not be relying on poorly justified business plans from HAL to set a price cap that harms consumers. Nor should the CAA seek to afford HAL layer upon layer of protection against any future downside risk in the underlying building blocks to the price control. The Final Proposals, while correcting some of the shortcomings in this regard from the Initial Proposals, continue to suffer from these defects with the result that the overall level of passenger charge proposed remains unjustifiably high. Heathrow is already one of the most expensive airports in the world and the proposed increase in passenger charges is wholly unreasonable. Accordingly, Delta has significant concerns over the CAA's overall approach to the H7 price cap review and how the CAA purports to satisfy its statutory duties, as well as in relation to the specific building blocks underpinning the Final Proposals.

In particular, Delta has considerable concerns over the CAA's failure to assess the overall impact of the Final Proposals on both HAL and consumers. Contrary to its duties, the CAA has failed to produce a robust impact assessment and to consider the cumulative impact of the various building blocks. This is evident in the multiple elements of the Final Proposals designed to protect HAL in the event of both non-pandemic shocks as well as pandemic-like events, including through the Traffic Risk Sharing ("TRS") mechanism, asymmetric risk adjustments and choice of the WACC point-estimate. These multiple layers of protection are duplicative and give HAL disproportionate protection. As a result, they fail to properly apportion risk between HAL, on the one hand, and airlines and customers on the other. The overall effect is that the Final Proposals over-compensate HAL and disincentivise it to promote growth and/or to achieve further cost efficiency. Indeed, there is no evidence that the CAA has adequately assessed the impact of this re-allocation of risk, and of the resulting unjustifiably high charges, on airlines and passengers. This also suggests that the CAA has not undertaken an evidence-based assessment of trade-offs relating to its Final Proposals, most notably between the protection of HAL and the interest of consumers. This leads Delta to question whether the CAA has appropriately discharged its statutory duty of acting in the best interest of consumers. Indeed, the Final Proposals do not provide evidence of the CAA deploying proper frameworks for defining and assessing consumer interests.

Below, we summarise the key views and concerns expressed in the attached Consultation Response and highlight the key issues that are most likely to affect Delta and Delta's customers.

Passenger forecasts

Delta considers that certain improvements have been made in forecasting the passenger volumes compared to the Initial Proposals. These are summarised in the AP Report. In particular, Delta welcomes the CAA's recognition of the need to reduce reliance on the HAL model, make adjustments to the model and, importantly, to include evidence from independent forecasts to reduce the impact of the selectivity and bias which must inevitably impair HAL's modelling.

Nevertheless, there remain material flaws in the CAA's approach to forecasts in the Final Proposals which significantly understate expected passenger numbers, as detailed in the Consultation Response. This is highly concerning given the critical impact traffic forecasts have on the overall price cap through their use in various building blocks underpinning the H7 control. Further supplemental data on passenger forecasts, which contains information that is confidential to Delta, is enclosed with this letter. In this supplement, Delta emphasises the need for the CAA to address the recent actions taken by HAL, which have had the effect of unilaterally reducing capacity to an artificially low level. It is clear that HAL currently has every incentive to extend such capacity restrictions through to the end of the current season (and beyond). It is vital that the CAA should not reward HAL for this behaviour when finalising the passenger forecast for H7.

In addition, Delta would draw the CAA's attention to the analysis in the AP Report which identifies three material concerns with the CAA's approach. First, the CAA continues to excessively rely on HAL's model, despite the fact that HAL has an undeniable incentive to suppress forecasts. Such continued over-reliance on HAL's model is wrong particularly given that the airlines and wider stakeholders are unable to scrutinise the model and provide robust challenge. Second, the CAA has made arbitrary adjustments to account for industry risks, which cannot be supported. Third, the CAA has placed insufficient weight on external forecasts, which forecast materially higher passenger numbers.

Delta agrees with the proposal in the AP Report that the CAA should promote transparency by publishing HAL's model and use independent forecasts as the starting point for its analysis. Delta notes that, on behalf of the airlines including Delta, British Airways wrote to the CAA to request sight of this model on 20 July 2022 (and in that letter also sought a number of related clarifications). Regrettably Delta understands that no response has been provided by the CAA.

The Consultation Response and the AP Report set out further recommendations to correct the flaws in the CAA's approach.

TRS

Delta strongly opposes the use of TRS mechanism as set out in the Final Proposals, and is particularly concerned about the calibration and implementation of the mechanism.

The proposed TRS does not appropriately share risks, and could have a material disproportionate and asymmetric impact on airlines as compared to HAL, to the adverse effect of consumers. Positive deviations in traffic will generally be limited due to HAL's capacity constraints, which HAL has now demonstrated can be exacerbated unilaterally with Local Rule A. Accordingly, the upside scenario of the TRS mechanism does not accurately reflect the impact of positive traffic deviations. This means that HAL would be protected from negative traffic deviations with little incentive to promote traffic growth. For these reasons, supported by the recommendations in the AP Report, Delta considers that the CAA should implement asymmetric risk sharing in the middle band to counteract the proposed unjustified asymmetry between HAL's and airlines' traffic risk exposure.

In addition, the CAA should drop its use of an outer band with the proposed 105% sharing. This level of risk sharing fails to provide incentives for HAL to achieve cost efficiency and will likely disincentivise HAL to take actions to facilitate traffic growth if it is able to achieve more than full recovery in the event of a 'downside' scenario. This is not an appropriate balance of risk and reward for a monopoly. In this context, Delta also draws attention to section 3 of the Consultation Response, which highlights that, if applied during the pandemic period, the TRS mechanism would have resulted in a higher adjustment to the RAB than the additional £2.5 billion sought by HAL for H7 and which the CAA has considered to be not justified. Any such analysis of the likely impact of the TRS is absent from the CAA's Final Proposals. The failure to assess the impact of what is a new regulatory mechanism across a range of plausible scenarios is a clear breach of the CAA's statutory duties.

WACC

Delta notes that the CAA has made certain improvements to the WACC methodology in the Final Proposals, particularly the reduction to the asset beta and the cost of embedded debt.

Nevertheless, there remain flaws in the proposed methodology and further downwards adjustments are required to correct these. Most notably, given the multiple layers of protection afforded to HAL, in particular through the TRS, the asset beta should be reduced. Failure to do so would further demonstrate that the CAA has not appropriately considered the various composite elements of the Final Proposals and has not assessed their holistic impact on HAL and consumers. Details as to the further adjustments required are provided in the Consultation Response and the AP Report.

Allowance for asymmetric risk

Delta continues to consider that the allowance is unnecessary and duplicative of the various other protections HAL would gain in the Final Proposals.

With respect to non-pandemic shock factors, Delta continues to oppose incorporation in the Final Proposals of an annual shock factor to the traffic forecasts, given that such shocks should have been accounted for already in the asset beta for the WACC (as well as the CAA's proposed TRS mechanism). In particular, Delta highlights the conclusion in the AP Report that the asymmetric shock factor is invalid without clear evidence that the effect is not already embedded in the underlying

passenger forecasts. This, again, underlines the fundamental issue of the lack of transparency in the process due to the HAL model not being available for scrutiny.

Regarding the pandemic-magnitude events, pandemic-like events are accounted for in the Final Proposals through: (i) the TRS mechanism, (ii) an allowance for asymmetric risk, and (iii) the asset beta within the WACC. In addition, further protection for HAL is being offered in the form of overly pessimistic passenger forecasts, with an annual shock factor applied, being built into the final H7 price control. In light of insufficient downward adjustment to the asset beta within the WACC, a TRS mechanism which could excessively benefit HAL in practice, additional allowance for shocks and asymmetric risk and an overly pessimistic passenger forecast, this results in a disproportionate imbalance in the risk sharing between airlines and HAL.

Regulated Asset Base (“RAB”) Adjustment

Delta remains strongly opposed to the £300 million RAB adjustment given to HAL in April 2021. This was an artificial change which has a distorting effect on the price control and dulls HAL’s incentives. There is no evidence to demonstrate how HAL used the £300 million RAB adjustment, and, in the light of the recent operational problems at Heathrow, the suggestion that HAL met the objectives set by the CAA of preparing for a higher-than-expected increase in passenger demand is wholly unconvincing. Therefore, as explained in the Consultation Response, and in Delta’s/VAA’s previous engagement with the CAA, Delta considers that there should be a structured reversal of the £300 million adjustment, unless HAL provides clear evidence that it has met the deliverables linked to the adjustment. Similarly, any upward adjustment of the RAB (contrary to the CAA’s decision in the Final Proposals not to make a further adjustment) would be wholly inappropriate.

Capital expenditure (“Capex”) and incentives

Delta considers that the proposed Capex sharing factors are too low to promote efficiency. As described in more detail in the AP Report at paragraph 7.4.4, the sharing rate in the Final Proposals could lead to a scenario where there is significant overspend in Capex but only a relatively small reduction in HAL’s Return on Regulatory Equity. Moreover, since HAL has never faced ex ante Capex incentives, there is material scope for HAL to improve its delivery.

Delta also supports the view expressed in the AP Report that the Capex sharing factor should encourage detailed information sharing, and failure to do so should result in HAL retaining a smaller share of cost savings.

Operational Expenditure (“Opex”)

Delta considers that it is appropriate for the CAA to use the CTA forecast, instead of calculating a weighted average that relies on HAL’s own business model, particularly given the significant information asymmetry.

However, there are still fundamental issues with the CAA’s assessment of HAL’s Opex forecasts. First, HAL appears to have provided limited detail or justification for its costs, and thus CTA’s Opex assessment is likely to both lack precision and overstate efficient costs. Second, the CAA has relied on selective information provided by HAL to justify certain cost increases, which it has then directed the CTA to apply to produce a revised estimate. There has been no real opportunity for the airlines to provide customer led challenge, which would require disclosure of the underlying data and methodology. The failure of the CAA to facilitate meaningful consultation on this issue is contrary to the CAA’s statutory duties.

Commercial Revenues

As with Opex, Delta considers it appropriate to adopt CTA’s revised forecast, and supports the CAA’s decision to apply the terminal drop-off charge only to passenger drop-offs.

However, there are two aspects of the approach to commercial revenues that raise concerns. First, the CAA accepted HAL's view on retail revenues, including the impact of tax and duty changes. Second, Delta is disappointed about the management stretch target being set at the low level of 1%, contrary to the CTA advice. Increasing the management stretch target, and accordingly increasing HAL's incentives to grow its revenue, would be clearly in the interests of consumers.

Other Regulated Charges ("ORCs")

Delta is generally supportive of the proposed marginal cost-based approach to ORCs.

Outcome Based Regulation ("OBR")

The CAA has failed to devote adequate time and resources to this important area of the regulatory framework, and has effectively accepted HAL's proposals. The proposed outcomes, measures and targets are not appropriately selected, and in any event they are not sufficiently stretching for HAL. This has a direct detrimental effect on customers' experience. In order to incentivise HAL to perform better, the CAA should adopt the mid-point of Arcadis' recommended range.

Financeability

Delta considers that the proposed price cap for HAL would be financeable from both a debt and equity financeability perspective. However, Delta considers that the CAA made a number of errors in its financeability assessment in the Final Proposals.

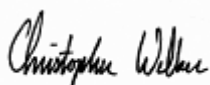
In particular, Delta does not agree with the Final Proposals that an assessment of financeability should be based on a target of a credit rating of BBB+. There is no requirement that the CAA should ensure that HAL is financeable at a particular credit rating at the expense of consumers. The CAA should be highly skeptical of assertions by HAL that it continues to suffer financial jeopardy given the absence of any equity support from its shareholders.

Alternative proposal

Overall, Delta considers that the average price per passenger identified in the Final Proposals is set at a level that is unjustifiably high and does not further consumers' interests. For the reasons explained in the Consultation Response, a more appropriate price per passenger for the duration of H7 is in the range of £18-£19.

Delta requests the CAA to take into account its submissions, and reconsider elements of the Final Proposals.

Respectfully submitted,



Christopher Walker

cc: Abigail Grenfell, Policy Adviser, Regulatory Implementation, CAA
David Kendrick, Head of Airline Licensing, CAA