Supplementary written evidence submitted by Heathrow Airport (AAS0048)

INTRODUCTION:

Heathrow welcomes the opportunity to provide further information and supplementary evidence to the Transport Select Committee (TSC)'s inquiry into the Aviation sector recovery. As set out in our original evidence to the committee in November, the regulatory framework and conditions that Heathrow operates within are integral to the way the airport is able to operate, invest and compete.

The upcoming H7 price control period (running between 2022 and 2026) is therefore a critical decision point in supporting the airport's recovery, and our ability to support the Government in its ambitions for Global Britain. The Civil Aviation Authority (CAA) in its determination for H7, must reflect both the devastating impacts of Covid-19 and the uncertainty we still face as an industry going forward, but also ensure that the environment is right to encourage and allow for Heathrow to continue to invest to support the needs of our passengers, airlines, cargo handlers, and wider 'Team Heathrow' stakeholders.

During the Covid-19 pandemic, Heathrow went from being Europe's busiest airport to the tenth. Our competitors in Amsterdam, Frankfurt and Charles de Gaulle have all recovered – and continue to recover – at a far greater pace due to the different approaches to travel restrictions adopted by their governments in response to Covid-19. Without the ability to continue to invest in those areas which can drive a greater passenger experience and restore passenger numbers to previous levels, Heathrow's ability to support the delivery of Global Britain will be significantly reduced.

In October 2021, the CAA published its Initial Proposals (IP) for the H7 period. In this, the CAA recognised the economic reality that lower passenger numbers, until full recovery, must mean a higher charge per passenger. Alongside this, it also reflected that airport charges typically represent a relatively modest proportion of the overall average air fare at Heathrow.

The CAA – in its review of consultation responses, and analysis to develop its Final Proposals over the next few months – must reflect these realities and create an environment that will encourage private investment to enable sustainable levels of passenger service and resilience. Key to this will be providing confidence that investors will have a fair opportunity of recovering efficiently-incurred investment if the airport meets the targets set out by the price control.

In addition, the CAA must recognise and rectify the errors and inaccuracies in its Initial Proposals, to ensure the Final Proposals are a more accurate reflection of the financial and regulatory environment Heathrow faces. These include: updates to its traffic forecast; correction of the errors driving undeliverable assumptions on operating costs and commercial revenue growth; and recognising that safe, secure and resilient services cannot be maintained or improved without sufficient capital investment.

The airlines' very public and continued position of pushing the CAA to reach a determination focused solely on lowest cost does not reflect the reality of the situation at hand. In its Initial Proposals, the CAA notes the importance of ensuring that the airport charge allows Heathrow to invest where it is needed, however doesn't allow for sufficient investment. We have proposed £4.1bn of private and direct investment to ensure the UK remains competitive via its hub – however this cannot be delivered without a fair regulatory settlement in H7.
A fair H7 settlement based on updated and evidence-based CAA analysis, that encourages investment to enable Heathrow to deliver the services and outcomes that consumers and airlines expect while reflecting the balance of risk and return for Heathrow's investors, must be the desired outcome.

FINANCIAL IMPACT OF COVID-19:

The unprecedented fall in both aeronautical and commercial revenues as a result of the Covid-19 pandemic has had significant implications for the entire UK Aviation sector. And as the UK's only hub airport, Heathrow has been at the very forefront of this impact, losing £3.4 billion over the past 18 months, and is continuing to lose an average of £3m every day.

In the first nine months of 2021, revenue declined a further 26.9% vs 2020 levels (£695 million) but around 70% vs 2019 levels (£2,032 million). Aeronautical income fell predominantly due to reduced passenger numbers and fewer aircraft movements. Commercial revenues, which are a core building block of the single till and accounted for approximately a third of Heathrow's total revenues in 2019, declined as a result of reduced passenger numbers and the mix of retail service available due to Government-imposed restrictions on non-essential shops in the first five months of the year.

The nature of the shock to passenger demand is multi-faceted and more complex than during previous demand shock events, with three distinct but inter-related elements:

1. Travel restrictions – enforced by governments globally as an immediate response to controlling the Covid-19 pandemic, these have served to artificially suppress demand for the periods that they have been imposed and their ongoing use has a negative impact on consumer confidence.
2. Consumer behaviour – in the absence of any prevailing government restrictions on travel, consumer behaviour, and crucially consumer confidence to travel, in the wake of the pandemic will be the dominating driver of passenger demand.
3. Economic impact – economic damage, driven by national and international responses to contain the spread of Covid-19, is likely to be the dominant driver of passenger demand once the impact of travel restrictions and consumer behaviour have subsided, as the slower process of economic recovery plays out.

This is an event that for Heathrow - and the wider UK Aviation industry – has far exceeded all others. As such, the foundations for the next regulatory period are fundamentally different to any previous price control at Heathrow.

FORECASTS FOR 2022 AND OVER THE H7 PERIOD:

Heathrow approach and conclusions:

Heathrow's approach is to develop a 'bottom-up' forecast to reflect a staged recovery in passengers over the remainder of this year and into 2022, and beyond. Our modelling is based on a timeline for the progress of recovery for the various markets and destinations Heathrow serves around the world. Differing testing and quarantine restrictions are modelled in each stage and potential infection and vaccination rates are taken into account. Travel restrictions at both ends of the route are considered and we forecast the level of demand at each stage of recovery using the latest data on actual passenger numbers to date. The modelling is performed at a granular level, splitting into geographical markets and purpose of travel. The approach reflects the potential impact of varying government rules and categorisations for restrictions, as well as gradual roll-out of vaccines across all markets.

As part of this process, we engaged extensively with the airline community and others to develop our approach and gather evidence for our assumptions – alongside key differentiators such as industry resource constraints and planned schedules.

Our forecasts so far in the pandemic have proved to be amongst the most accurate in the industry, but there is still room for significant downside with so many moving variables – our total 2021 passenger numbers will be 10% below what we forecast as recently as June 2021.

Source: Heathrow Investor Report, December 2021

Our base case assumptions are derived from the Government's roadmap on reopening at the time of forecasting: recovery back towards 'normality' continues although certain challenges with Covid-19 over the winter cause some consumer hesitancy it does not lead to any explicit increase to UK restrictions; the Government removing the need for any testing with international travel in time for the summer months of 2022; European countries currently allowing travel without testing continuing to do so, and the remaining European countries following suit in time for the summer months; cheaper and easier testing being permitted for travel to North America by the summer months of 2022 and then no testing being required from Q4 2022 onwards; and East Asia gradually easing restrictions throughout 2022 to the point that travel with cheap and easy testing is permitted by Q4 2022; and some rebound of pent-up consumer demand in 'Visiting Friends & Relatives' and leisure. However, this is being somewhat dampened because of an ongoing sense of caution and uncertainty on government border rules. The outcome represents a forecast recovery in 2022 to a total of 45.5m passengers, 56% of 2019 volumes.

This forecast aligns closely with that of the airlines' international trade body, IATA, which predicts global passenger numbers in 2022 will be about 60% of 2019 levels.

Our current forecast – based on the key drivers, uncertainty and assumptions outlined above – that passenger traffic will likely return to 2019 pre-pandemic levels in 2026. This is also similar to assumptions made by EUROCONTROL and IATA.

<u>Heathrow forecasts vs airline and CAA assumptions:</u>

Typical airport regulatory frameworks consider traffic forecasts as a critical determination of airport charges, both as a consideration for future costs as well as the denominator for allowable regulated revenues.

However, because there is such a high degree of uncertainty in forecasting future traffic volumes, there is an increased risk of price volatility if an airport's regulatory framework does not allow for the consideration of such high levels of volatility. The CAA has recognised this volatility through the proposed introduction of a traffic risk sharing mechanism, similar to the mechanisms in place at many other airports including Madrid and Aeroports de Paris. However, this will not mitigate the impact of an unrealistic traffic forecast.

As outlined above, the output of our forecasting approach closely aligns with the global airline view of the market as advocated by IATA. However, these sit in stark contrast with both the Heathrow airline community's collective input into the CAA consultation process and the CAA's own forecasting and analysis in later years of the H7 period.

For example, the AOC, British Airways and Virgin Atlantic Airways responses to the CAA's 2022 interim airport charges proposals presented a scenario of 72m passengers at Heathrow in 2022. These claims are built on incorrect assumptions and very little supporting evidence.

Passenger volumes of 72m in 2022 would require an average of 6m passengers a month. As both the airlines and we knew at the time, January and February were unlikely to be very much above the 3m to 4m range each. To achieve 72m for the full year would require a scarcely credible c.95% recovery in Heathrow's passenger numbers for every other month of the year. This was before the discovery of Covid-19 variant B.1.1.529 (Omicron), which has resulted in a reduction of c. 20% of the forecast demand in December 2021, and seen airlines cancelling significant parts of their planned schedule for the first quarter of 2022.

There are also a number of operational constraints that would prevent Heathrow and the airlines from being able to service over 90% of 2019 passenger volumes. Data regarding the number of airside ID passes issued at Heathrow shows that Team Heathrow (Heathrow, airlines, ground handlers and other businesses operating at the airport) is c.25,000 (1/3rd) of the workforce short of the number of colleagues required to run the airport at 2019 levels. These would all have to be recruited, trained and complete airside ID screening by the end of January to be able to deliver a 'full 2019' operation.

In addition, the challenge of dealing with ever changing global governmental requirements has materially increased check-in transaction times. The limited data made available to us suggests that our airlines and handlers are currently able to operate at only c.50% of pre-Covid-19 capacity. We would require approximately 7 terminals to be able to deliver 2019 passenger volumes.

With regards to the CAA's H7 forecasting and analysis, it concludes that a high case forecasts 88.3m passengers travelling through Heathrow in 2026. Physical and legal restraints on the airport are not considered in the CAA's output – leading to the IP producing physically impossible passenger numbers for the later years of the regulatory period.

These constraints include:

- **ATM Cap:** Heathrow is subject to a legal limit of 480,000 ATMs a year. The CAA's analysis does not take account of this legal constraint. If Heathrow flew every slot within the ATM cap with no cargo or freight and zero resilience, we could still not achieve 88.3m passengers with 2019 air frames and load factors (and many airlines have retired their larger aircraft e.g. 747's through the pandemic). In fact, to do so would require the ATM cap to be lifted by 37k movements, an extra 100 flights a day.

- **Terminal Capacity:** While preparing the Development Consent Order application for the third runway, we carried out extensive analysis to understand our current runway and terminal capacity, in order to determine the additional capacity that was being sought as part of the planning application. That work had concluded that our runway capacity is a maximum of 82 million passengers per annum and our terminal capacity is a maximum of 85 million passengers per annum. To increase above those figures would need significant capital investment to either extend terminal buildings or build new terminal satellites, neither of which is reflected in our H7 capital plan – or has been requested by the airline community.

Alongside its passenger forecast, the CAA has made further errors in developing proposed operating costs, resulting in a forecast for 2022 that is £173m lower than our actual budget. This would be undeliverable without drastic reductions in service and resilience and a consequential risk to safety and security. The CAA's forecast is even lower than we were able to achieve in 2020, when we served half as many passengers with only one runway, and two terminals operational and the benefit of a government-funded furlough scheme. The CAA conclusion on commercial revenues is also unrealistically high. Heathrow sets the international benchmark for commercial revenue generation. However, the CAA is forecasting materially higher commercial revenue growth than has been possible historically with no provision for the capital investment needed to support it even historical levels of growth.

It is vital that the CAA corrects these basic but fundamental errors to ensure that the basis on which the regulatory settlement is decided is a fair and accurate reflection of the financial and operating capacity of the airport.

ROLE OF AIRPORT CHARGES FOR CONSUMERS:

In its IP, the CAA acknowledges and makes clear the role that airport charges play in the overall cost borne by the consumer.

"Nonetheless, it is important to note that airport charges typically represent a relatively modest proportion of the air fares at Heathrow and so they would create a very significantly smaller percentage increase in the overall cost of travel. It is also vital for consumers that airport charges raise sufficient revenue to allow HAL to provide an appropriate level of service and finance new investment, including the capital spending necessary to keep the airport safe and secure".

While a focus on airport charges in the short-term may, if passed on by airlines, save consumers a small amount of money on their overall ticket price today, the consumers of tomorrow will suffer through lower levels of investment and resilience.

The average fare from Heathrow is around £650. Heathrow's passenger charge is currently £19.60 - 3% (£19.60) of this amount. Our proposals would only increase that proportion to between 4-6%.

Set against this context, airlines have continued to benefit from the service and operation that Heathrow provides – as well as the private investment that has transformed the airport from 'Heathrow hassle' to one of the best airport services in the world. Pre-Covid-19 six out of the top ten most profitable routes in the world were to/from Heathrow. Pre-Covid-19 the congestion premium at Heathrow was on average £34 for Short Haul flights and £200 for long haul flights, demonstrating the value that Heathrow provides to airlines and how they are able to charge premium fares, regardless of the airport charge[1].

INVESTOR RETURNS:

In his evidence to the TSC on 17th November 2021, the Director General of IATA commented on the returns that Heathrow's shareholders had taken over the past years. However, Heathrow's economic regulatory framework is loss making for equity in real terms.

Heathrow is a private organisation, a critical piece of national infrastructure, and an asset with a value pre-pandemic in excess of £20bn. Over the last 15 years, Heathrow has distributed £4.1bn in dividends to shareholders. In exchange, shareholders injected equity (£0.6bn) during the Global Financial Crisis and are now facing cumulative losses from pandemic of (£3.4bn) by 30 September 2021, and still growing at an average daily rate of £3m. Cumulative net dividends and Covid-19 losses are now fully offset, which means no net equity value has been generated over 15 years – not enough to even meet annual average inflation.

As such, the H7 settlement and decision is taking place amongst a backdrop where the investors and shareholders returns for their investments made at Heathrow have been negative to neutral at best. At a time when the Government is seeking to use the RAB-based model to encourage private investment across existing and new UK infrastructure, it is important that the H7 decision returns investor confidence in the RAB-based regulatory model. If the model does not give investors a fair opportunity to recover their costs and earn a reasonable return this will have lasting and damaging effects on these ambitions.

H7 PLAN AND SUMMARY:

Consumer expectations for service levels remain high over the next five years, and we will remain focused on working with all our partners across Team Heathrow to meet their needs and deliver the outcomes our insight tells us they value most: feeling comfortable and secure; having a predictable and reliable journey; feeling cared for and supported; having an enjoyable experience at an airport they want to travel from that offers a good value choice of flights; and feeling confident they can get to and from the airport. We also need to start the transition to net zero aviation, which is an existential challenge for our industry.

As such, our plan commits £4.1bn of investment and includes:

- Security – By June 2024, the DfT have mandated that we must replace all of our current 2D cabin baggage screening machines with 3D CT scanners. As well as improving security, the new machines and associated new technologies will increase passenger satisfaction, as passengers will be able to leave laptops and liquids in their bags. In the long term, security costs per passenger will be reduced by allowing an increased flow rate (although in the short-term efficiency will be reduced as the project is delivered). This is a major infrastructure investment, which will need to be carried out in a live operation

- Baggage - We plan to build a new baggage system for Terminal 2 to replace the current system that is 50 years old and located in the old Terminal 1. This is a single point of service failure for passengers, which relies on spare parts which are no longer available, and replacement has already been deferred for nearly a decade. If the baggage system were to fail, at best it would lead to passengers travelling without their bags for a few days, but at worst it could lead to the closure of Terminal 2, which currently serves 50 airlines and represents 25% of our capacity, for several months.

- Cargo – Heathrow is the UK's biggest port, but our cargo facilities have seen limited investment for decades as we and the airlines instead prioritised investment in new, world-class terminal facilities and transformed passenger service. The importance of cargo has been highlighted during the pandemic, and Brexit has made it even more important for the British economy that Heathrow is able to compete effectively with Amsterdam, Paris and Frankfurt for a growing share of global trade. Cargo is also critical to maintain the high value of slots for airlines at Heathrow, sustaining route economics and enabling a high frequency schedule that is valued by passengers.

- Retail – We are continually improving our retail offer to remain relevant but have only seen material growth in revenue per passenger when we have opened new terminals, T5 and T2, which enabled us to increase the amount of retail space. Our plan for H7 is to keep refreshing our retail offer and to increase investment in digital sales and fulfilment, reflecting the consumer trend away from physical towards online. We face some significant headwinds, with the Government's decision to remove VAT free shopping reducing the attractiveness of luxury shops at Heathrow.

- PRS – Consumer outcomes and needs have not changed as a result of Covid-19 but just under a quarter of all passengers remain anxious about returning to flying. This anxiety to return to travel is most pronounced in Passengers Requiring Support (PRS) - who are also the group least satisfied with their Heathrow experience. Our plan is designed to make significant improvements to the experience for these passengers. It includes:

    - An Enhanced Service Overlay to provide additional assistance to PRS who require it.
    - Higher availability of lifts, travelators and escalators – which PRS value relatively more than non-PRS passengers – due to increased maintenance and inspection regimes
    - Shorter queues at security to enable greater social distancing, which our consumer insights indicate PRS passengers' value relatively more than non-PRS passengers.

  Overall, we forecast that an additional 5 million PRS passengers will have an improved experience of Heathrow in H7 as a result of delivering our Optimal Plan.

- Airspace Change - We plan to invest in airspace change, which will reduce delays to passengers from aircraft stacking on approach, as well as reducing airline fuel burn and carbon emissions in flight by up to 8%. We also plan to invest in pre-conditioned air and fixed electrical ground power and the charging infrastructure across the airport to allow us, airlines and handlers to convert their current fleet of 6,000 vehicles to electric in order to meet our common decarbonisation plans and support the growing numbers of passengers and colleagues who will switch to electric vehicles, and we plan to start feasibility studies to define potential future needs for electric charging and hydrogen for aircraft, which could be required during H8.

Our plan for H7 is based around meeting these needs and based on extensive engagement with our key stakeholders – and without a fair regulatory settlement from the CAA's H7 process, their delivery is under threat. In order to avoid this, the CAA need to correct the mistakes in its Initial Proposals. By assuming that Heathrow can generate unrealistically high revenues at unrealistically low costs, with unrealistically high passenger numbers, the price control they have proposed is not deliverable or financeable.

January 2022

Endnotes

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[1] Frontier Economics: https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/Estimating%20the%20congestion%20premium%20at%20Heathrow.pdf