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Dear

Heathrow airport: summary the holding price cap for 2022

In the light of the urgent need to finalise charging arrangements at Heathrow airport for 2022, I set out below a summary of the CAA Board's decisions on the holding price cap for 2022. We will publish the formal decision document including the legal notice under section 22(6) of the Civil Aviation Act 2012 implementing the Board's decisions before Christmas. This will contain the full details of our decision together with a more detailed explanation of the reasons for our decisions and trigger the timeline for bringing the required modifications to HAL's licence into effect.

As you will know, we consulted on a holding price cap of £29.50 (in 2020 prices) in October 2021 and received responses from a range of stakeholders including HAL, airlines, airline representative and others. We received a wide range of comments from HAL and airlines, including comments on the overall level of the holding price cap:

- HAL said that we had made errors in our approach (including that the allowances we had made for its operating costs were too low) and that the holding price cap should be significantly higher; and
- airlines and their representatives said that airport charges at Heathrow were already the highest in the world and that we had also made errors in our approach (including that we had under-estimated the number of passengers likely to use Heathrow airport over the period of the H7 price control and that the allowances we made for operating costs were too high) and that these meant the holding price cap should be significantly lower.

In the October 2021 consultation, we said that, given the impact of covid-19 on Heathrow and the wider aviation sector, it is not straightforward to calibrate a price control that protects consumers with respect to prices while also allows for the funding of necessary investment (including in relation to safety, security and resilience) at Heathrow airport.

Since the close of our consultation period on 17 November 2021, new information about the Omicron variant of covid-19 has emerged, and continues to emerge. As a result, there now appears to be a greater level of uncertainty about the likely level of passenger volumes over 2022 than there was at the time when we published the October 2021

consultation and when that consultation closed. This is not just due to the immediate responses by Governments to the emergence of the Omicron variant, but also the indication it provides about how Governments may respond to future variants of concern.

Nonetheless, it remains important for us to protect the interests of consumers by setting a holding price cap for 2022. This is needed even though we intend to true-up the charges in the early part of 2022 to the level of the price control for the full H7 period that we intend to put in place during 2022. If we were not to do this, prices might be too high in 2022 and this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period.

In setting the holding price cap for 2022, it is appropriate that we take account of a broad range of information, have appropriate regard for the wider process for setting the main H7 price control and act in a proportionate and focused way. In particular:

- we have reviewed the additional information provided by HAL and airlines on projections of passenger numbers and consider that in the light of the developments associated with the Omicron variant it would be premature at this time to adopt the significantly higher forecasts of passenger numbers put forward by airlines;
- in relation to the forecasts of operating costs and commercial revenues, we remain of the view that, at this stage of our process, (when HAL has not had the opportunity to respond to the detail of our consultants work) it is appropriate to take account of the evidence provided by both the information in HAL's business plan and the work of our consultants in determining a range with respect to these costs and revenues. Bearing this in mind, we do not accept the views of airlines that we should focus solely on the projections made by our consultants. We are also not persuaded by HAL's arguments that because our projections of costs are lower than those in its business plan they must be flawed, particularly given the weaknesses in HAL's business plan information highlighted in our October 2021 Initial Proposals. As such, it is not appropriate for us to discount either source of evidence at this stage; and
- we note HAL's concerns about its financeability, but note that credit markets and credit rating agencies did not react adversely to our consultations in October 2021 on the Initial Proposals and holding price cap. Bearing this in mind, and the increasingly strong outlook in our forecasts of its key credit metrics over the H7 period, we consider the suggestion by HAL that the holding price cap could jeopardise its financeability to be unduly pessimistic and not properly supported by evidence.

We note it is looking increasingly likely that the affordability of air travel for consumers in 2022 will be put under greater pressure by the costs of new travel requirements, such as additional testing. We have also reflected on airline suggestions that we should give more weight to the detriment to consumers caused by the relatively high level of airport charges at Heathrow.

There would undoubtedly be benefits to passengers in seeing lower airport charges as we expect that this would be reflected in lower fares and through airlines having an extra incentive to bring back additional services in 2022. Nonetheless:

- these benefits would be limited as we have committed to a true-up of 2022 revenues against the main H7 price control, so a lower cap in the first part of 2022 would mean higher charges in the future;
- while, as discussed above, we are confident that a £29.50 holding price cap for HAL would be consistent with efficient financing for HAL, we would have less confidence with respect to financeability if we were to set the holding price cap at a significantly lower level and, in particular, the £19.39 suggested by airlines. In particular, we observe that the news around the Omicron variant caused a widening of the spreads on HAL's investment grade bonds and that an unexpected and significant tightening of the holding price cap could exacerbate these issues;
- we also note that, in adopting our proposed holding price cap of £29.50, we have already ensured that consumers already benefit from the profiling of charges in 2022. In developing the range we set out in our October 2021 consultation (£24.50 to £34.50) we smoothed the level of charges over the five years of the H7 price control. Had we not done this, taking 2022 in isolation, the unprofiled range for charges was £38.44 to £51.02 (CPI-real 2020 prices) with a mid-point of £44.73, compared to the holding price cap we proposed for 2022 that benefitted from smoothing of £29.50; and
- a substantial change to our proposals for the holding price cap would trigger the need for additional consultation to support the associated licence modification and lead to a greater period of time at the start of 2022 when HAL would not have a price control condition in place restricting the amount it could charge airlines.

Bearing the above in mind and the advantages of retaining the assumptions in the Initial Proposals on passenger forecasts, operating expenditure, commercial revenues and the cost of capital, at least during the current period of heightened uncertainty about the impact of the Omicron variant, the balance of evidence suggests that retaining £29.50 (in 2020 prices) as the basis of the holding price cap.

In formulating our Final Proposals for the main five year price control for H7, we will consider the points made by HAL and airlines on issues such as passenger forecasts, operating costs, commercial revenues, cost of capital and financeability. Our Final Proposals for H7 may be different from our decision on the holding price cap as it will benefit from the further evidence and analysis that we are conducting prior to making our final decision for the full the H7 price control. Nonetheless, the approach set out in the October 2021 consultation to calibrating the holding price cap remains valid for this stage of our process as an accurate a reflection of the evidence we have overall, especially in the context of the present levels of uncertainty.

We are conscious of the challenges that the level of the holding price cap will create in the short term for consumers and, in the context above, the airlines that serve them, but we are also of the firm view that the holding price cap needs to be established in a way that is consistent with HAL continuing to be able to finance necessary investment in security, safety and resilience. These issues are vital to the interests of consumers and, given the greater uncertainty that has been created by the Omicron variant, now would not be an appropriate time to bring forward a significant tightening of the holding price cap.

In formulating Final Proposals for the five year price control for H7, we will look to set suitably stretching targets for HAL, such that the path of its charges delivers value for money for consumers in the medium and longer-term. By retaining our approach to the holding price cap, but also looking again at the underlying assumptions and efficiency targets for the five year price control, we should ensure that consumers interests are appropriately protected while also having regard to HAL's financeability and the financing of new investment.

We need to translate the £29.50 from 2020 prices to 2022 prices so that we can include in HAL's licence and remove any ambiguity about adjustments for price indexation. Consistent with the method set out in HAL's licence, we adopted price indices in April to calculate the applicable inflation uplift. The increase in the consumer price index was 0.8% in April 2020 and 1.5% in April 2021 giving a compound increase of 2.32%. Applying this to £29.50 gives a cap of £30.19. This will be the cap used in the final licence modification. We have used the CPI as it is now a properly recognised measure of inflation and is preferred to the RPI.

As noted above, we will publish the statutory notice for the modifications to implement this before Christmas. We will also put a copy of this letter on our website.

Yours sincerely

Paul Smith
Director, Consumers & Markets Group