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Sent Via E-Mail
Paul.Smith@caa.co.uk
Economicregulation@caa.co.uk

Paul Smith
Group Director of Consumers and Markets
Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

RE: American Airlines Response to CAP2265 – Final Proposals for H7

Dear Paul:

Thank you for the opportunity to respond to the CAA's Final Proposals covering the H7 regulatory price control period from 2022 – 2026.

As the 3rd largest airline operating at Heathrow, paying Heathrow Airport Limited (HAL) around £80m a year pre-COVID, American is greatly impacted by the max yield that HAL can collect. Through the challenges presented by COVID, American provided consumers with multiple flights every single day during the pandemic. As traffic has rebounded, we have delivered excellent operational performance with a team that is currently fully staffed to support our customers and the airport, even in the face of numerous HAL-driven challenges to running an efficient operation at Heathrow.

Executive Summary

Heathrow Airport should be an economic engine for the United Kingdom via the power of connectivity with the world, connecting people and goods with key markets as an important part of the government's vision for an open, outward-looking, and confident Global Britain[1]. However, as Heathrow's airport operator is a monopoly, seeking primarily to maximize financial returns for its shareholders, there is great danger that it could elevate prices, stifle competition, and chip away at productivity through inefficiency. A monopoly whose interests are with its shareholders will leave consumers poorer as a result.

Therefore, regulation of this monopolistic entity is in place, and its highest and best use is effective protection for consumers alone. The regulated company will inherently be looking out for the interests of

[1] https://www.gov.uk/government/collections/global-britain-delivering-on-our-international-ambition

its shareholders, and regulation should avoid leaning towards the regulated company's positions, else consumers will be left unprotected.

As a result, though we appreciate the CAA's Final Proposals view that charges should average no more than £24.50[2] in 2020 prices, we believe this number remains too high. In the Final Proposals, the CAA has guided to the floor of the £24.50 to £34.40 range presented in Initial Proposals[3], which is a correct recognition that the Initial Proposals range was inflated, as noted in our response to those Initial Proposals[4]. With appropriate adjustments to the inputs as detailed later in this response, we support the airline community view that a more accurate and realistic price cap target should average no more than £18.53[5].

There are several elements of the Final Proposals that we are happy to support:

- **Rejection of Heathrow's inflated proposal**, which advocated charges in some instances up to three times greater than those in Q6
- Symmetrical **Traffic risk sharing** based upon volume swings
- The approach to **operating expenditure and commercial revenues** that takes a bottom-up, analytical view of each element
- **Capital efficiency incentives** that ensure Heathrow's capital expenditures are matched with solid **delivery obligations**
- **Rejection of Heathrow's appeal for adjustments to the Regulated Asset Base**, maintaining certainty in the framework by not allowing for back-end changes

However, we do not believe the Final Proposals go far enough. Our primary areas of concern in the building blocks are as follows:

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[2] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals - Summary", Table 3: Summary of our initial proposals for airport charges

[3] CAA CAP2265A, "Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary", Table 3: Summary of our initial proposals for airport charges

[4] American Airlines response to CAP2265

[5] The community is 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

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- Passenger **forecasts remain too low** for the H7 period. Recent independent forecasts for UK aviation show traffic rebounding more quickly, while the CAA remains too reliant on Heathrow's overly pessimistic model

- **Traffic risk sharing implicitly transfers risk** from Heathrow to the airlines. The outer band undermines key incentives, while the inner band is too narrow

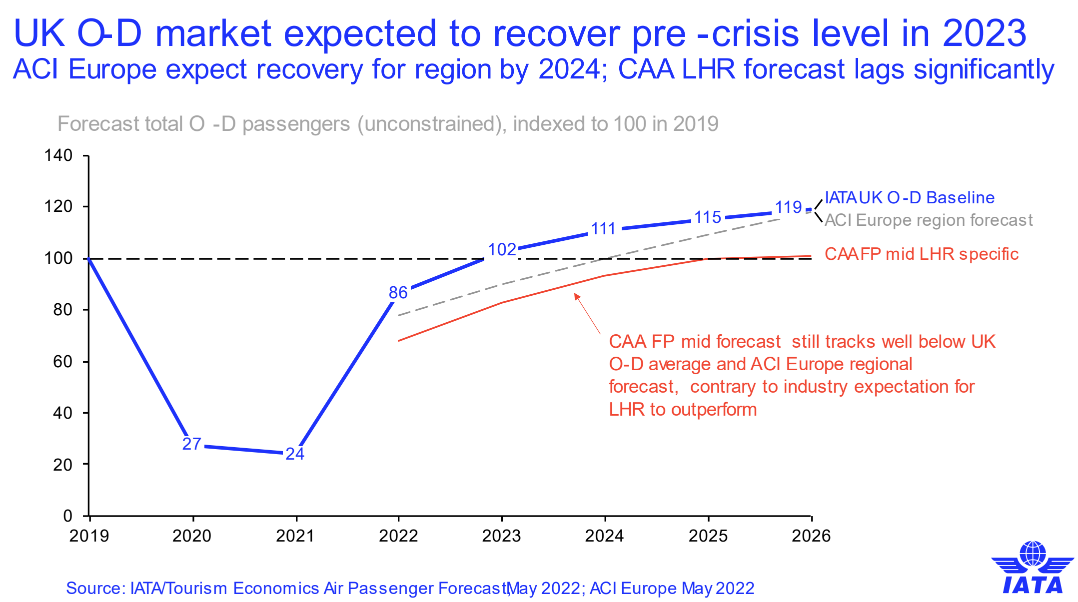
- The **cost of capital is inflated** by an asset beta that fails to recognise the significant transfer of risk identified above and over-estimates its starting point in the market

- The **Regulated Asset Base is inflated** by a RAB adjustment that was given in error and on the basis of service commitments that have not been kept

- **Outcome based regulation** results in lower targets than those in place in Q6, an easier ability to earn bonuses, and omits key aspects of critical infrastructure

Primary Building Block concerns

Passenger Forecast
It is a fundamental concern to us that despite the improvement from the CAA's Initial Proposals, the CAA's passenger forecast is based on outdated information which continues to lag significantly behind wider industry views. The CAA appears to have taken an overly cautious approach due to influence from Heathrow's own internal modeling, which sits in the face of stronger recent forecasts such as the IATA / Tourism Economics forecast for the UK O-D market, updated in May 2022, which indicates a recovery of passenger volumes to pre-Covid levels in 2023:



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Other independent analyses paint a similar story:

1. The ICAO Economic Impact Analysis was updated on 22 June 2022. The forecast for all 4 scenarios showed European passenger numbers exceeding 2019 levels by July 2022.

ICAO UNITING AVIATION

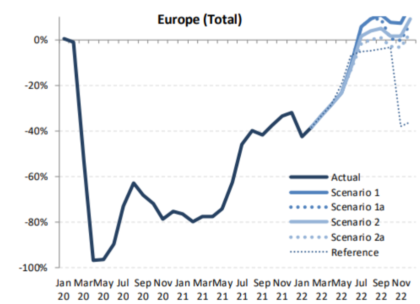
Passenger number

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

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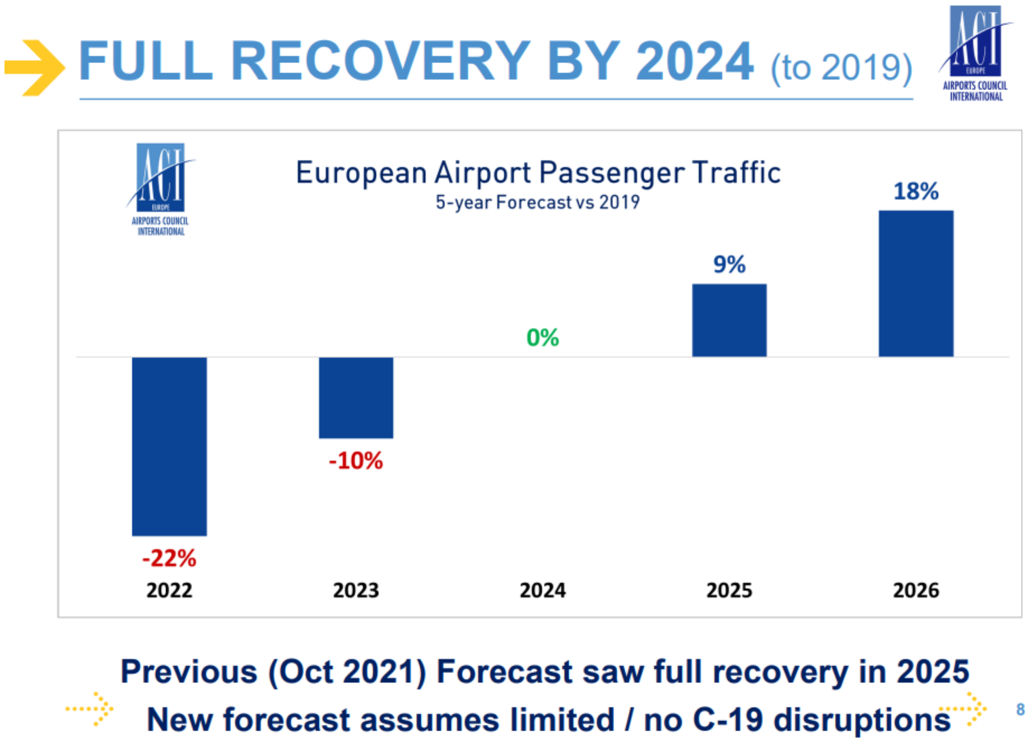
2. The recovery profile of ACI Europe's forecast for the region was brought forward by one year to 2024 in their May 2022 update[6].



Macro economic forecasts also support a rapid return of passenger volumes. Despite the impacts of Covid-19, according to the IMF[7]:

- 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;
- unemployment is expected to remain relatively low at 4.6%, compared with 3.8% in 2019; and
- population is likely to be 1.3 million people higher, moving above 68 million

[6] ACI Europe Airport Traffic Forecast: 2022 Scenarios and 2022-2026 Outlook, May 2022 update
[7] World Economic Outlook database, April 2022

Heathrow Airport is also known to be the most resilient large airport in the UK in its ability to rebound from traffic downturns. According to the CAA's own data[8], for the period from June 2021 to May 2022, Heathrow handled 45% of its 2019 volume, well ahead of 33% for London Gatwick and above also Manchester, Edinburgh, and Birmingham.

The CAA Final Proposals mid forecast indicates a recovery to pre-crisis levels for Heathrow by 2025, which is 1-2 years slower than the IATA and ACI comparators. When taken together with the macro level data and the evidence presented for Heathrow's relative ability to recover, it is clear the CAA needs to update their passenger forecast inputs before making a final determination. We believe a more accurate passenger forecast is around 396.1m passengers across the license period, roughly 36m more than the CAA's current mid-range scenario.

Misalignment of Risk

The CAA is proposing a fundamental shift in risk as part of the H7 framework, introducing a symmetric Traffic Risk Sharing ("TRS") mechanism, a new allowance for asymmetric risk, and continuing to use a "shock factor" to traffic forecasts. Each of these elements taken alone and as a group shift the balance of risk in favor of HAL's shareholders and to the detriment of consumers.

On its face, TRS could be reasonable if proper counterbalancing measures are put in place, notably a substantial reduction in the cost of capital to compensate shareholders more appropriately for the greater certainty (reduced risk) they are receiving. We have consistently noted this as a precondition for support for TRS[4]. As detailed in the next section, we do not believe the CAA has gone far enough in reducing the cost of capital compensation for HAL shareholders. Further, the over/under scenarios of TRS are inappropriately weighted in Heathrow's favor – as currently written in the license and seen very recently, Heathrow has the ability to unilaterally limit capacity and passenger throughput. Meanwhile, the airport is capacity-constrained in its upside, and the outer band of 105% gives Heathrow no incentive to seek cost efficiencies or facilitate traffic growth.

We also note that the introduction of a new allowance for asymmetric risk is excessive given that there is already a shock factor added to traffic forecasts for unforeseen events. This asymmetric risk allowance is an additional benefit for Heathrow shareholders and assumes the CAA would not step in in the event of a major disruptive event such as a pandemic. This assumption is faulty, as the CAA has already very recently proved willing to step in outside of the license to provide Heathrow with a sizeable RAB adjustment.

In our view, the CAA should adjust the TRS mechanism to account for inappropriately weighting the rewards in Heathrow's favor, and it should remove the asymmetric risk factor as being duplicative of other actual and likely measures to account for unforeseen events.

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

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Cost of Capital
The significant transfer of risk from Heathrow to the airlines as noted above will have a material impact on shareholder willingness to invest in Heathrow – making it less likely that shareholders will lose their investment by virtue of an unexpected drop in traffic. The CAA recognizes this fact by reducing the WACC by about 140bp from the Initial Proposals to 3.26% (real, vanilla) in the Final Proposals.

However, we believe this amount remains inflated and is undue excess compensation to HAL shareholders – at the expense of consumers – for the true risk they bear. CEPA has provided expert advice and support to the airline community through this process (attached, Annex 1). They note that the CAA has incorrectly applied an uplift in the asset beta, weighting the cost of capital more favorably for Heathrow. In addition, AlixPartners has undertaken expert analysis on behalf of a number of airlines. These independent analyses are remarkably similar, yielding (real, vanilla) results of 2.48% from CEPA and 2.37% from Alix, which show that the CAA should reconsider the significantly higher number included in the Final Proposals.

Regulated Asset Base (RAB)
The CAA awarded £300m to Heathrow in 2021 to protect financeability and service standards and indicated it will be introduced via the license modifications being proposed for H7. While the CAA may believe this decision is final, it is still appropriate for the airline community to reiterate our opposition to any adjustment whatsoever. Though the CAA made references to expectations on ensuring Heathrow capacity met demand in 2021, it seems reasonable that the CAA's ultimate intent was to make certain that Heathrow was appropriately prepared for when demand did return, whether that be in 2021 or 2022[9].

We would call attention to the fact that the airline community was vocal in advocating for the need for early investment, particularly the re-opening of Terminal 4 to meet demand. Notably, the AOC sent a letter in November 2021[10] that was rejected by HAL as being unreasonably optimistic. Unfortunately Heathrow was dismissive of our concerns, which led to inaction that directly resulted in capacity challenges and an unnecessary failure to sufficiently meet returning demand. This has had negative consequences for airlines and consumers alike. Well-publicized incidents of baggage failures from April – July 2022 in nearly all terminals, plus lengthy security checkpoint queues, has led Heathrow to demand that airlines cap outbound seats sold (and thus, revenue) during the peak summer travel period in the first summer since 2019 when many people were able to travel.

It is clear that Heathrow did not make the necessary investment in service standards as originally envisioned in the RAB adjustment, and we urge the CAA to conclude a review which we believe will warrant a removal of the proposed adjustment.

[9] CAA CAP2140, "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", para 4.13
[10] Letter from Nigel Wicking (Heathrow AOC Ltd) to John Holland-Kaye (Heathrow), "*LHR 2022 Capacity Plans*", dated 30 November 2021

Outcome Based Regulation (OBR)

Through the introduction of OBR, the CAA is seeking to incentivize the proper behaviors from Heathrow to focus on service standards and their impact on consumer outcomes. While the airlines have shared our views and positions throughout the development of the OBR framework, unfortunately the Final Proposals lack some key elements that would forcefully protect consumers. We believe OBR falls short and require revision from the Final Proposals in the following areas:

- **Baggage –** it is surprising and disappointing that Heathrow is not financially incentivized to deliver passenger bags to the airlines' baggage handlers in time for passengers to travel with their bags. A Vanderlande analysis shows that in a normal pre-Covid year, around 25,200 bags would be left behind due to problems with Heathrow's own baggage system. Besides the very high cost of operating and maintaining this system, airlines have to pay to repatriate these missing bags to our customers. We have seen in recent months several notable baggage failures that have resulted in significant numbers of bags not traveling with customers. Many of the in-system issues are within Heathrow's control and thus should be part of the OBR scheme
- **Check-in Measures** – availability of check-in infrastructure is a welcome addition to the OBR framework, but excluding baggage input belt performance is a surprising omission. This is a critical element of the check-in process that Heathrow controls and should be part of the regulatory framework for the benefit of consumers
- **Security targets** – the Final Proposals omit some necessary elements in our view and fall short in other places. It is surprising there is no reference to automated measurement of queues given that in 2013 the CAA included as a license condition the establishment of automated queue measurement system – so 14 years later, by the end of the H7 license period, it is possible that this consumer-benefitting system still may not exist. Also, the SQRB and OBR targets for Security are each too low. As shown in the data from the attached Community response, Heathrow is already consistently meeting the SQRB targets set by the CAA, and – while we disagree with the principle of allowing bonuses – if they are to be established, they should be for exceptional performance. The OBR bonus thresholds established in the Final Proposals are too low given that Heathrow meet these standards already. The CAA is thus rewarding Heathrow shareholders – at the expense of consumers – for performance consumers routinely received in Q6.

Other Building Block concerns

- **Operating expenditure** remains greater than necessary
- **Commercial revenues** are lower than desirable with a weak management stretch target
- **Capital expenditure** was inflated by a poorly-defined ~£1.2bn from the Initial to Final Proposals to a level that exceeds delivery capability and any likely capital requirements
- There are **weaker capital incentives** compared to other regulated sectors
- The **asymmetric risk allowance** double-counts the risk measurement in the cost of capital
- **Capping passenger numbers in 2022** will result in consumers paying for Heathrow's inability to provide capacity, which is unaccounted for in the CAA's model

Procedural concerns

- London Heathrow is already **more expensive than comparable European hub airports**, and the Final Proposals do not address this fact, to the detriment of consumers

- **Information asymmetries** favor Heathrow as airlines are unable to challenge Heathrow's modelling. Heathrow has been allowed to submit an RBP Update 2 in its response to Initial Proposals plus add further submissions during the CAA's development of Final Proposals. Airlines have not been able to give this work proper scrutiny, and in some cases we have not even been allowed to see Heathrow's work

- **Heathrow's financeability** is taken into account at the expense of the consumer, particularly as shareholders have been happy to receive dividends but not inject capital

- **The process of this periodic review** has not worked well, with lengthy process delays and a failure of constructive engagement due to Heathrow's unwillingness to share detailed information

Conclusion

In summary, we believe the CAA has been overly deferential to Heathrow's position by accepting many of their arguments in the Final Proposals, particularly where the airlines' challenge to Heathrow's position has been hampered by a vast information asymmetry. The CAA can properly address the deficiencies in the Final Proposals model inputs and the flaws in how the price control mechanisms work together. This would achieve a max yield closer to £18.53, a result that is more appropriate and more beneficial for consumers.

Finally, we include and support the response of LACC/AOC, which represents the entire airline community at Heathrow.

We appreciate your attention to the points we and the rest of the Airline Community raise and look forward to your response.

Respectfully,

Walter Weems
Senior Manager, Airport Affairs & Properties

cc: Robert Wirick – Managing Director, International Government Affairs
Rhett Workman – Managing Director, Europe & Asia Operations
Amanda Zhang – Managing Director, Airport Affairs & Properties
Philippe Serafino – Director of Operations, Heathrow Airport