

ACI EUROPE response

to the

UK Civil Aviation Authority's Initial Proposals for the Heathrow Airport Limited's (HAL) H7

17 December 2021

ACI EUROPE (Airports Council International) represents the interests of over 500 airports in Europe across 55 countries and has extensive experience in playing a constructive role in the formation of aviation policy. ACI EUROPE's mission is *"to advance the development of safe, secure, sustainable and efficient airports for the benefit of the travelling public and businesses, as well as local and regional communities throughout Europe"*.

ACI EUROPE has been closely involved in discussions with airports, users and regulators, as we jointly grapple with the challenge: how should economic regulation respond to support an inclusive and sustainable long-term recovery post-COVID?

The way forward requires the right balance between ensuring airport pricing that supports recovery, recovering the costs of providing airport services and costs in the long-run, and ensuring investment to deliver needed capacity and decarbonisation. One-sided simplistic demands for "lower charges" must be rejected, and a real comprehensive solution found.

We recognise that the UK's Civil Aviation Authority long-standing leadership in putting the interests of consumers first. Now more than ever, economic regulators face decisions which will have material impacts on a number of actors. We believe that the consumer-interest is the correct approach, and it requires a more intensive consideration of the many factors that determine airport price controls. However, questions of consumer-interest suffer from different views and definitions of what is the consumers' interest, which segments, and over which time-frame.

This note focuses on two over-arching themes which are important for the UK CAA to consider for the way forward in this crisis:

- 1) Re-anchoring expectations**
- 2) Managing the optimism bias**

1. Re-anchoring expectations

Historically, the airport sector has experienced largely stable demand characteristics, where large shocks were in the low single-digit percentage points (2001, 2008/9, 2010). This has created an expectation for “*stable*” and “*smooth*” prices and conditions; something which is not observed or expected in other sectors – take air freight or semiconductors as timely examples. Airlines maintain an ideological belief that airport charges should be constant, and even more, constantly decreasing over the supply curve. Finally, regulation itself, whether in the ICAO principles for airport economics (ICAO docs 9082 and 9562) have stated that stable pricing should be an aim, though without explaining how this benefits consumers.

It should be recognised that a consequence of the above is to strongly anchor expectations about what the appropriate level of airport pricing should be on prior year prices.

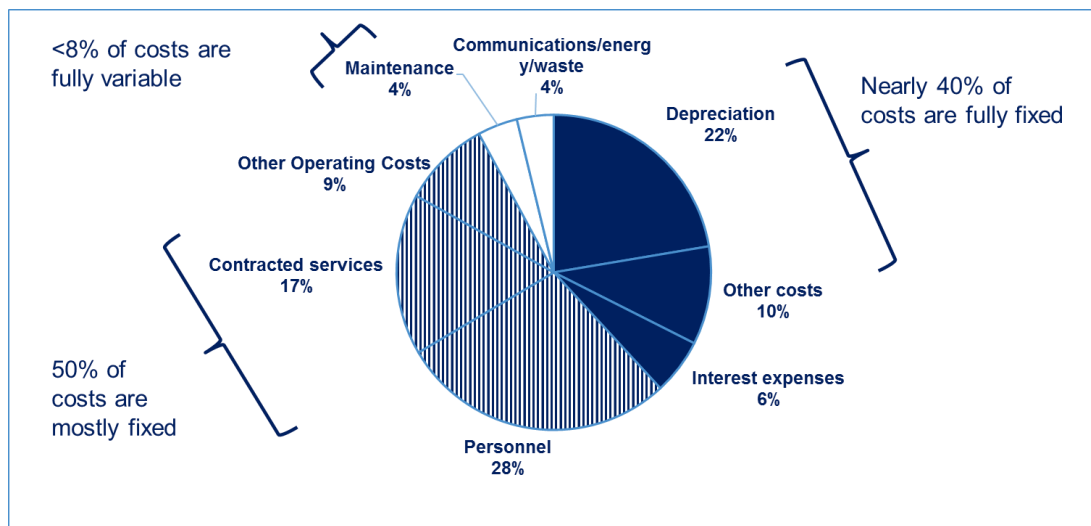
It is important to consciously de-anchor from the past. The actual levels of airport pricing must be anchored on the real information available today.

a. Airports have borne the brunt of the pandemic

[Consultation questions: Initial proposals for H7 & approach to airport charges in 2022]

Airport costs are largely fixed, so airport running costs remained high, while revenues fell to very low levels. Consequently, airports have debt financed operations, which will increase long-term financial costs.

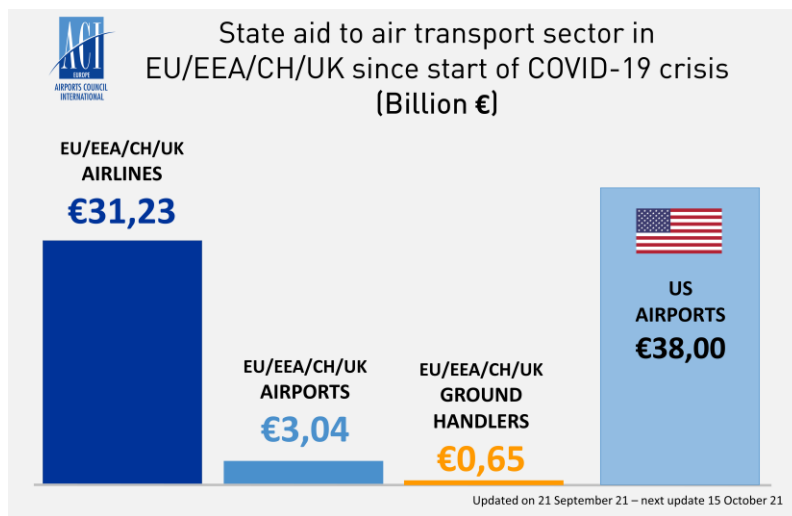
Airports have highly-powered incentives to take every action that they can to reduce costs. However, airports are indivisible infrastructure assets, which normally recover their costs via depreciation and a return on the asset base with relatively steady traffic volumes. At an aggregated level for all European airports, only 8% of costs are fully variable, and most other costs are fully or partially fixed costs. Airports do not have the same ability as other operators to reduce costs; and conversely are required to stay operational to support emergency, medical and cargo flights.



Source : ACI World Key Performance Indicators for European airports 2019

Furthermore, we note that the balance of state support for the aviation sector has been targeted at the airlines. It follows that elements of this support should

be used to ensure that airlines pay airports for the cost of using the airport services and facilities.



With limited state support, and a substantially different cost-base given current traffic levels, the expectation for airport charges should be appropriately set .

b. Airlines will not fully pass on changes in airport charges to passengers

[Consultation questions: Initial proposals for H7 & approach to airport charges in 2022]

The UK CAA has been a leader in researching and assessing the impact of scarcity rents, and the extent to which such rents accrue to airlines, whether at fully congested airports or at airports congested during peak hours, notably in CAA paper CAP1871a; *Independent Peer Review of Recent Research on the Existence of Scarcity Rents at Heathrow, Institute for Transport Studies, August 2019.*

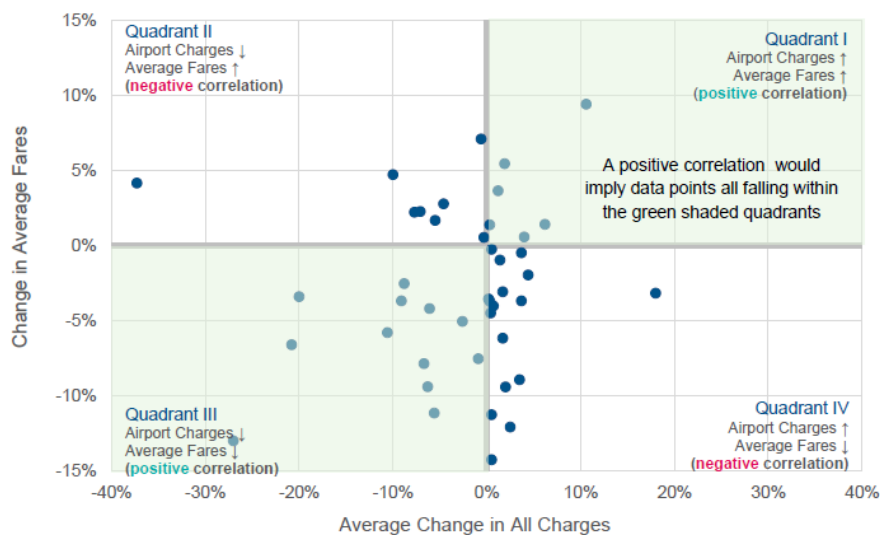
Airport charges are a relatively small and stable part of total airline costs, incurred for the use of airport facilities and services. As such, airport charges can and do influence airlines' capacity planning and network development, as airlines seek to maximise their own returns by focusing on the most profitable routes.

However, there is no one-for-one correspondence between airport charges- and any change in their level - and air fares. Indeed, airport charges usually have a non-significant influence on air fares, which are constantly changing, based on dynamic pricing techniques driven by demand patterns, price elasticity and the level of competition on any given route.

In addition to CAP1871a cited above, evidence for this comes from a 2018 [analysis](#) by the [consultancy ICF](#) of specific case studies in which airports have adjusted their charges, and the impact that has had on airline fares, presented in the figure below.

The lack of clear pattern makes the point: there is very little correlation between changes in air fares and changes in airport charges. Hence, there is weak evidence that airlines will change air fares.

Figure: Changes in Airport Charges vs. Changes in Average Fares¹



Note: Scatter Plot shows observations where a change in charges occurred. The airports observed include Amsterdam, Brussels, Gothenburg, Helsinki, Ljubljana, Sofia, Stockholm, Vilnius, Warsaw, Zagreb and Zurich from 2010 to 2017. A given airport can account for multiple data points corresponding to different years.
Source: ACI EUROPE airport charges survey, IATA PaxIS

In part, this is because the maximum airport recoverable revenue derived by the cost driven calculations of economic regulation is not the same as the price that would result from a competitive market.

In most cases the 'cost-based' price is far lower than the what the actual market-based price would be – especially at congested airports. This is a result of the nature of the airport market with its scarcity and locational characteristics. The clear indicator of this is the large financial value that airlines pay for airport slots. That means that there is scope to raise prices without exceeding the market-clearing price for demand for airport services.

Fixed-ideas about cost-pass through and the responsiveness of consumers to changes in down-stream costs need to be re-assessed in light of changing travel preferences.

c. Recovery of losses by a price-regulated entity in response to an extreme shock will reduce future risk perceptions

[Consultation question: Targeted RAB adjustment...]

The CAA's targeted RAB adjustment similarly seems to suffer from being anchored on outdated views of the ability of the airport to book revenue against depreciation costs.

There is a reasonable arguable that a large retrospective adjustment is called for, given the scale of the losses. In effect, the degree of risk around airports has been significantly miscalculated in the past. The regulatory determined cost of capital customarily included a low risk allowance. Airports have generally been regarded as regulated assets carrying less risk than the stock market norm. Moreover, regulatory assessments in recent years have also been against a relatively benign environment, both in relation to underlying economic circumstances and lack of one-off events which may have accentuated perceptions of low airport risk.

There is a variety of approaches to risk sharing across airports with some having more protection than others. The market's and regulators' assessment

¹ Identifying the Drivers of Air Fares, An ICF report prepared for ACI EUROPE, May 3, 2018

of traffic risk will not have encompassed the scale and longevity of the Covid downturn. That is demonstrated by the marked movement in airport betas.² Had Covid turbulence been within anticipated risk parameters such movement would have been more constrained.

While it might be tempting for regulators and customers to argue that such losses be met by shareholders, two countervailing considerations need to borne in mind.

Firstly, regulatory systems are generally expected to adjust to exceptional events, even if these have not been spelled out explicitly. Covid would meet any conceivable definition of ‘exceptional’.

Secondly, even if regulators would prefer to avoid this above responsibility, there is still good reason for action. Investors’ perceptions of sector risk are formed by their experience of how regulation has operated in practice, particularly when confronted by an exceptional crisis and truly transformative losses, and are not formed just by the theoretical design of regulatory frameworks. Where losses are not recovered, risk perceptions will increase, and the future Weighted Average Cost of Capital (WACC) will increase. Putting more demand risk on the airport will require also accepting a higher regulatory WACC based on this risk.

While the UK CAA’s consultation paper accepts this point, it may be anchored on pre-Covid risk perceptions and not current perceptions, and consequently require further aiming up.

There is a further consideration, which is the limited opportunities that airports have, given the existence of the airport slot allocation system, to lay off volume risk in a way that is available to operators in other capacity markets. To be clear, airlines are willing to go to great lengths to protect their airport slots and prevent other airlines from gaining access to those slots and providing traffic volume. As one airline CEO stated in January, *“If we have to fly empty, we’ll*

² Post-COVID airport regulation: a clear path, Oxera Agenda series, March 2021, p.2

*probably offer nine euro tickets ourselves to keep those flights in the system”.*³ During the pandemic the slot usage rules were suspended by the UK’s Department for Transport. The rules are a fundamental pillar underpinning the allocation of risk in the aviation industry and transferred a substantial proportion of demand side risk from airlines and airports. This action exposed owners of airport (particularly those who take volume risk) to substantial additional risk without any compensation.

The degree of risk around airports was significantly miscalculated in the past; adequate responses allowing for substantial recovery of losses for price-regulated entities is necessary to ensure continued investment that will benefit future consumers.

2. Recognising the optimism bias

Given the stakes, it is important to recognise and account for overly optimistic estimates and projections. This is especially important for the economic regulation of LHR, as the framework is based on many assumptions about the future, any one of which, if the actual turn-out varies greatly from the projection, could have significant consequences.

a. Traffic forecast

[Consultation question: projections of passenger forecasts...]

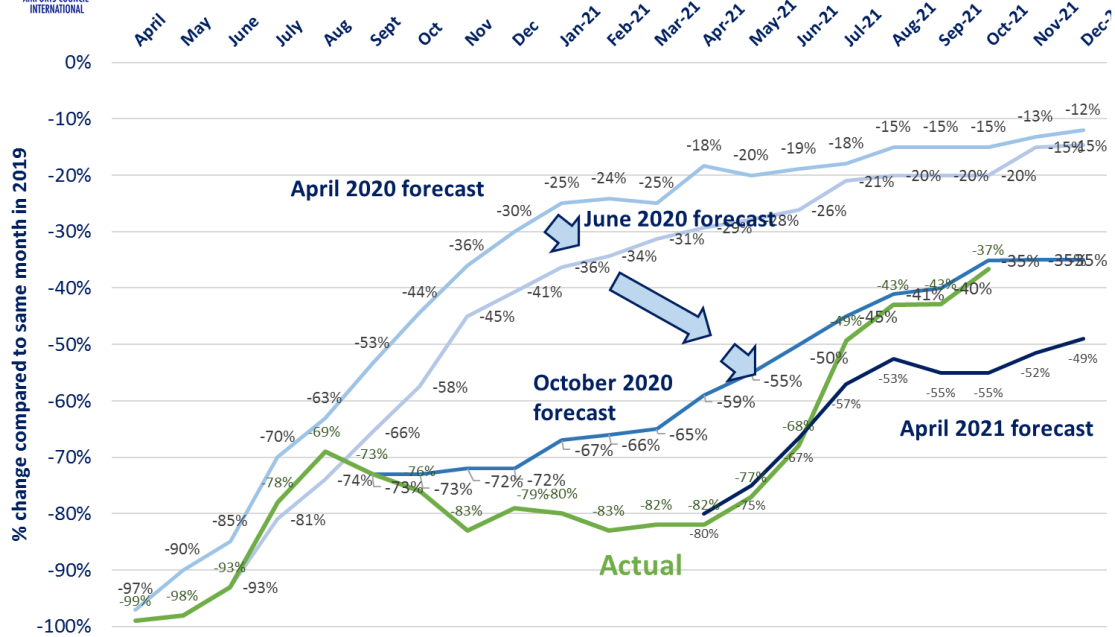
The past 18 months should have offered lessons about the optimism bias. ACI EUROPE is not alone in suffering from this, but the chart below shows the experience of ACI EUROPE’s forecast, which is derived from a Delphi approach working with approximately 30 airport Chief Traffic Forecasters.

Forecasts consistently proved too optimistic and did not anticipate the emergence of new variants and reimposition of travel restrictions.

³ Lufthansa Would Operate €9 Flights To Keep Its Airport Slots, Simple Flying (January 21, 2021). <https://simpleflying.com/lufthansa-9-euro-fares/>



**ACI EUROPE - Airport Passenger Traffic Forecasts
(% change compared to same month in 2019)**



Furthermore, it is overly restrictive to focus on the public health control of COVID-19 as the primary factor determining future travel demand. Macroeconomic conditions, weakness of the Chinese economy, inflation in the United Kingdom and globally, and geopolitical tensions on Europe’s borders all may shock traffic levels in the years to come.

In this case, we note that the CAA High case in Figure 1 forecasts LHR’s passenger volumes to reach nearly 90 million passenger in 2026. This is nearly 10 million passenger more than LHR welcomed in 2019, a year when it was already congested, and for a future period during which airlines are retiring their largest capacity aircraft and will have less ability to increase seats per air traffic movement. This CAA High case should be re-estimated with the application of real-world constraints.

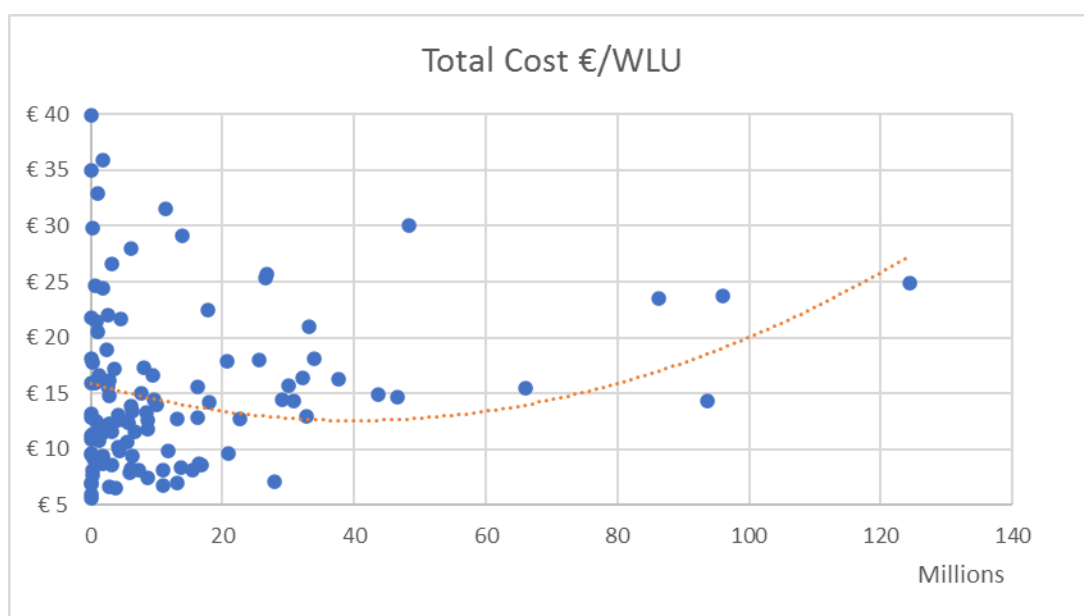
Forecasting in today’s environment must be clear-eyed and avoid being too narrowly focused on Covid and overly optimistic.

b. Operational costs

[Consultation question: projections of HAL's costs and commercial revenues]

ACI EUROPE, noting its wide range of experience with airports in Europe, believes that the CAA's consultant has underestimated the complexities associated with managing the volumes of passengers for a major hub. The 'idée fixe' of constantly decreasing cost curve for a firm over the long run, does not hold for airports. Empirical evidence is clear that airport costs per work load unit (WLU = 1 pax or 100 kg of freight) decrease to the volume of around 20 – 30 million work load units, but that after that volume operating cost per unit increase.

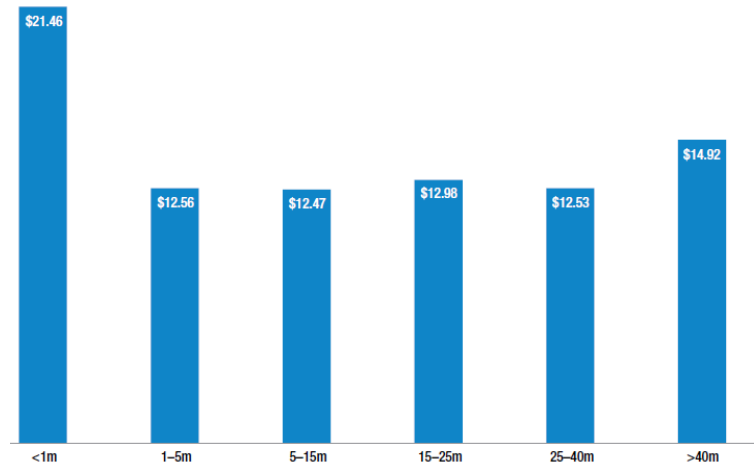
Figure: Airport level data for European airports



Global and long-trend evidence shows that per unit operational expenditure can start to increase at a certain passenger volume, in the range of 15 – 30 million passengers a year. The above chart shows that the convex shape of the cost curve is empirically consistent.

Figure: Total Cost per passenger (Source: ACI WORLD Airport Economics 2019 Report, p 37)

Total cost per passenger (US\$) by airport size category (2017)



Source: ACI Airport Economics Survey (2018)

The repercussions of Covid-19 on airport operations, terminal cleaning and ventilation requirements as well as requirements for contact less processes , and labour costs, will all put upward pressures on operational costs.

3. Conclusion: Recognising the challenge, preparing for future

London-Heathrow Airport, as Europe's perennially largest and one of the world's most storied airports, attracts its share of attention.

Heathrow has suffered from the three aspects that most determine how an airport's traffic has held up to COVID-19 pandemic: transatlantic, business, UK.

- Heathrow is heavily exposed to North Atlantic transatlantic traffic, which has largely closed down as a result of US and UK travel restrictions that persisted until November 2021.
- Heathrow is one the airports with the highest share of business-travellers in the world; and business travel especially collapsed during the crisis, as business meetings could more easily be replaced by virtual meetings.
- The UK applied some of the most stringent and long-lasting restrictions on travel or testing and documentation requirements which caused friction.

No other airport in the world was as exposed as Heathrow to these three aspects. This is reflected in the traffic underperformance of Heathrow compared to other major European hubs.

In addition, Heathrow has less margin to sustain losses on the aviation business. The regulatory framework for London-Heathrow sets prices under a single till regime, so it has no scope for additional voluntary contributions from the commercial business to the aviation business, which were available to other airports already on a hybrid or dual till. In short, the consequence of a single till is that it amplifies shocks to users.

Heathrow is not alone in having to raise charges to ensure that it sets itself on healthy financial footing for the future. Airports will set charges at the level that is strictly necessary to remain competitive and remain financial healthy in order to keep investing and provide high quality serviced as requested by their users and stakeholders.

These charge levels should be anchored against current costs and traffic, and projections for the future must avoid hoping for the best.

If current regulatory frameworks prove insufficiently flexible to enable a resilient recovery, then that will itself add to the arguments for a more fundamental look at how far they are really adding value for end consumers.

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