WPI ECONOMICS

Clipping Britain's Wings

Why the CAA's proposals for charges at Heathrow are bad for Global Britain

May 2022

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About this report

This report was commissioned by Virgin Atlantic, British Airways and IATA. Analysis, conclusions and views expressed in this report reflect the views of the authors, not those commissioning the work.

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Key Findings

- Connectivity provided by airlines based at Heathrow, including two UK flag carriers, is essential to growth and living standards right across the UK. And it is essential to the Government's Global Britain Agenda.
- **But this is all at risk. Even before increases in charges this year, Heathrow was Europe's most expensive airport, and one of the most expensive in the world. Between 2014 and 2020 it was the most expensive airport in the world. Now the Civil Aviation Authority (CAA) has allowed the monopoly operator of Heathrow (Heathrow Airport Limited, HAL) to increase regulated per-passenger charges by 56% in 2022.** The CAA may also allow it to increase them further between 2022 and 2026.
- **The starting point for this was an unreasonable request for an increase of 117% by HAL**, despite having chosen not to inject any permanent capital over the course of the pandemic; instead continuing to rely on debt-financing.
- **Compared to independent advice the CAA commissioned on the reasonable level of charges, the CAA's proposals could lead to an overcharging of some £5bn between 2022 and 2026.**
- These costs will be felt by airlines, and particularly UK flag carriers, who will be unable to pass these costs onto passengers because of strong competitive pressures or spread them across their operations in other countries because of their commitment to the UK.
- **The result will be to make the UK's global aviation industry less competitive, undermine the hub operation at Heathrow and reduce the domestic and international connectivity** that is vitally needed to achieve Global Britain and Levelling Up.
- To ensure that Heathrow continues to benefit UK passengers, businesses and the whole of the UK economy, rather than overcompensating HAL shareholders, the CAA and Government must act now. **The CAA must urgently review its approach to ensure that it brings charges down to the level suggested by independent analysis**.
- The Government should also consider other choices for the operation and regulation of the UK's only airport capable of hosting airlines' hub operations. This should include changes to the remit of the CAA and, in the longer term, consideration of whether Heathrow should be opened up to more competition - for example, by requiring the licensing of more than one operator at the airport.

Executive Summary

The UK's most important airport…

Heathrow is the UK's only hub airport, with airlines there providing connectivity to more than 80 different countries. This provides benefits to passengers, businesses, and the whole of the UK economy. The global connectivity achieved by airlines at Heathrow is simply not possible at any other UK airport.

Prior to the pandemic:

- Airlines operating at Heathrow, including two British flag carriers, carried 81 million passengers a year. That's 73% more passengers than airlines at the second busiest airport in the capital (Gatwick) and 110% more passengers than at the busiest airport outside the capital (Manchester).[1]
- Flights from Heathrow account for 75% of the UK's long-haul flights, with airlines providing connections to 84 countries.[2]
- By value, around 40% of UK exports were handled through Heathrow.[3]
- Connectivity provided from Heathrow and the economic footprint of Britain's global aviation sector provide large benefits for consumers, businesses and places right across the UK.[4]

Looking to the future, connectivity from Heathrow must be central to the Global Britain vision, supporting the continued success of both Britain's only Global City[5] and the levelling up agenda outside the capital, using connectivity and its unique position as the UK's only airport to host a viable hub that can connect all of the UK with all of the world.

…but all this is at risk

Based on the per-passenger charges which operators charge airlines flying from the airport, Heathrow is already Europe's most expensive airport and one of the most expensive in the world. Compared to Heathrow, per-passenger charges in 2021 were:

- 54% less expensive at Paris CDG.
- 57% less expensive at Amsterdam Schiphol.
- 39% less expensive at Frankfurt.
- 58% less expensive at Madrid.[6]

And this was before a 56% rise in per passenger charges in 2022. The CAA will report soon on whether they will allow this increase to continue, or even rise further, over the period between 2022 and 2026.

Heathrow is already Europe's most expensive airport. Regulated per-passenger charges have risen by more than 50% this year and will rise further between 2022 and 2026.

Why this matters

The UK is in a global race for connectivity, where countries that attract more passengers and more businesses through their hub will be able to support more routes, with higher frequencies, to open up new markets and attract investors, tourists and businesses to their country.

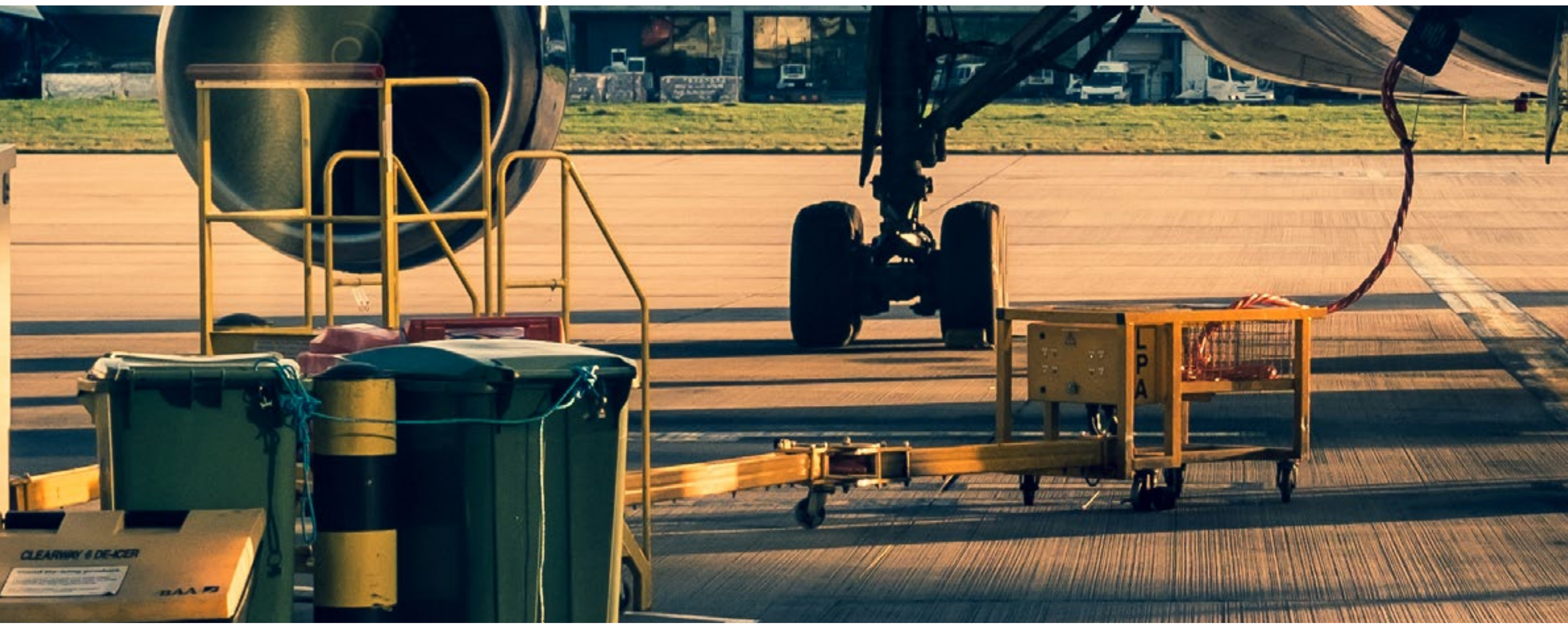
Such a large increase in prices in what already is Europe's most most expensive airport, particularly when many other competitor airports are not doing the same, risks undermining the UK's position. Ultimately, this rise in charges will be borne by airlines, with the impacts felt by passengers. Each will be pushed to make decisions that will undermine the UK's hub operation.

Even if increases for individual passengers represent a small proportion of their overall ticket prices, connecting passengers are particularly price sensitive, meaning they do not need to see large increases to begin to connect through another hub.

For airlines, unlike increases in fuel prices (which are typically largely hedged by airlines) and staff and other operating costs (which can be managed by improved efficiency and productivity), there is no way of mitigating the increase in charges. Given the level of competition between 80 airlines at Heathrow, there will be a limit to the extent to which airlines are able to pass increases through to passengers.

This is particularly true of the UK's flag carriers based at Heathrow. These airlines have the large majority of their fleet at the airport, meaning that the rise in charges cannot be spread across non-Heathrow operations. As such, this degree of charge increases risks fundamentally undermining these UK airlines in a way which will damage their, and the nation's, global competitiveness. As a result, the attractiveness of Heathrow as a base is eroded and airlines will have to make commercial decisions both over the routes they fly from Heathrow (by prioritising and consolidating around existing profitable routes, rather than taking a risk on new and / or marginal routes) and the balance of their fleet based at Heathrow as compared to other European hubs.

This shows that why we cannot let this happen. **Increases in charges of the scale proposed by the CAA, leading to overcharging amounting to some £5bn between now and 2026, could be severely detrimental to passengers, businesses and living standards and fundamentally undermine the Government's objectives for Global Britain and Levelling Up.**



Increases in charges were allowed to happen at the worst possible time for airlines and the UK economy

This significant increase in charges came despite the fact that Heathrow's uniquely important role means that it is regulated by the Civil Aviation Authority (CAA). This is supposed to ensure the operator of Heathrow cannot abuse its monopoly position by charging excessive rates or neglecting to invest to maintain its quality. Regulation also supports investment by providing increased certainty over returns to shareholders, who have collectively received more than £4bn of dividends since 2012, including £100m in 2020, at the height of the Covid pandemic.

This shows that despite this regulation, Heathrow's operator (Heathrow Airports Limited, HAL) has been able to achieve significant returns, partly enabled by a system that incentivises HAL to request substantial price increases in each regulatory period – both in absolute terms and relative to other hub airports. As we approach the decision point on regulated prices for the remainder of the 2022 – 2026 period:

- Faced with incentives almost diametrically opposed to consumers' interests, HAL requested an increase in per-passenger charges of 117% in 2021.
- CAA approved the introduction of an interim 'holding cap' for 2022, which has already increased regulated charges by 56%.
- The CAA are now deciding whether to allow them to remain at this level at the start of the 2022-2026 period.
- Being inflation-linked, charges are also certain to rise beyond this level after 2022.
- The CAA's initial proposals leave open the possibility that the rise could be increased – potentially meaning charges over a five-year period will be up to 75% higher than in 2021, even before inflation is considered.

All this also comes at a time when:

- The recovery of the UK's global airline industry and the whole economy is fragile, and consumers are being faced with a cost of living crisis.
- Heathrow is geared at close to 90%,[7] and shareholders have injected no permanent capital over the course of the pandemic. Together, this means that consumers are left to foot the bill for paying for HAL's investment and recovery, while shareholders bear little of the risk themselves.
- Airline shareholders have collectively invested billions of pounds in response to the pandemic.[8]

How was an increase of this scale possible?

The CAA calculates per-passenger regulated charges by estimating the **total income** needed to cover the running costs of the airport and provide the operator with a **fair return on their investment**, after accounting for **income secured from ancillary charges and commercial activities**. This is then translated into a maximum allowable charge per passenger by using **forecasts of passenger numbers**. Given the uncertainty of these, the CAA needs to make a judgement as to the likely course of each of these factors over the regulatory period.[9]

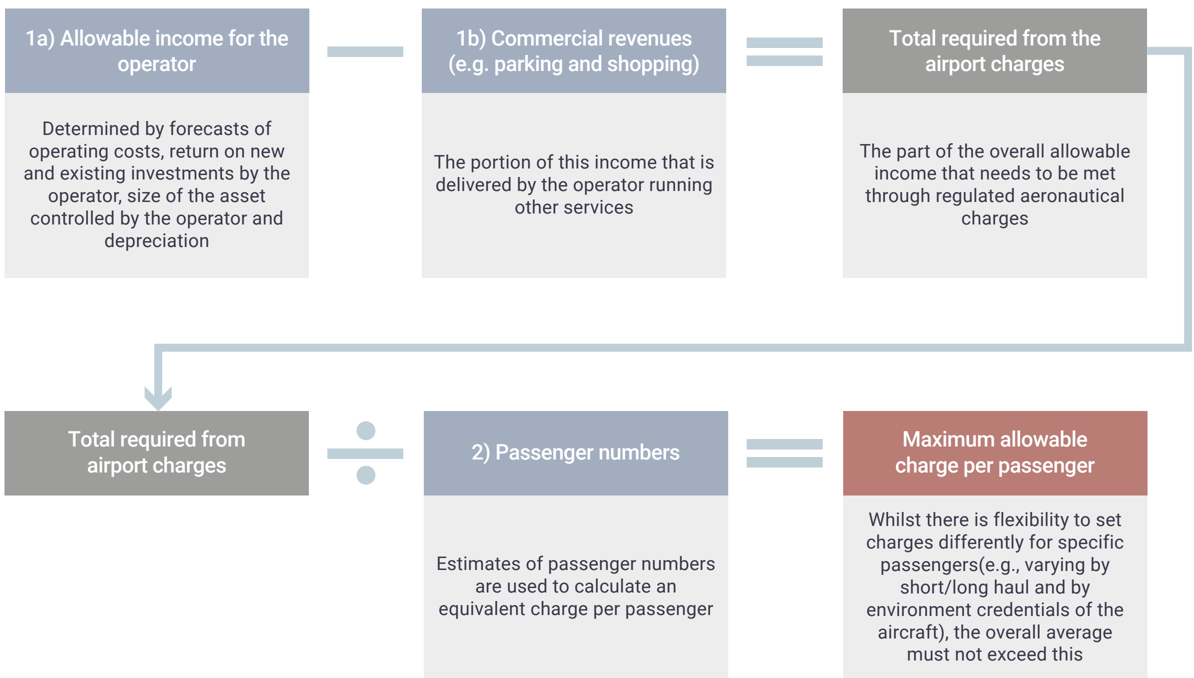
The process begins with the CAA taking evidence from Heathrow on their views of each of these factors. **In essence, this amounts to asking shareholders of Heathrow to suggest the level of profit they should be allowed to make. In 2021, HAL put forward figures to the CAA which argued for a 117% increase in the per-passenger charge at Heathrow.**

This incredibly high suggestion was driven by estimates for each of the building blocks, which independent analysis suggests are unreasonable. The key is that HAL are incentivised to do this by the regulatory system and that their extremely high level of debt finance and decision not to inject permanent capital means that airlines and consumers are being asked to pick up the bill for their recovery and investment.

After HAL has submitted its proposals, airlines are asked for their views, based on partial information (as HAL is not required to disclose a level of detail that would support transparent decision-making). It is then the regulator's job to take an independent, evidence-based view, which meets its primary duty of furthering the interests of consumers of air transport services. However, judging by their determination for 2022 charges, the CAA appears to be exercising this duty by finding a midpoint based on unreasonable figures from the operator, rather than taking on independent advice and assessing the credibility of the respective proposals.

The result is a set of proposals for an airport charge that is elevated by consistently pessimistic assumptions for the number of passengers, commercial revenues and required operational expenditure put forward by HAL. The net effect is to put the interests of HAL shareholders above the interests of consumers and Global Britain; allowing shareholders to benefit to the tune of £5bn compared to the charges external analysis suggests would be reasonable.

Figure 1: Simplified articulation of how the CAA determines maximum per-passenger charges at Heathrow



Consumer costs of consistently pessimistic assumptions

Analysis from a range of sources in this report shows a £5bn collective difference between the CAA's assumptions and external and / or independent analysis. This results in a direct cost to airlines and consumers and a benefit to HAL shareholders. In the longer term, these are also significant costs to the whole of the UK, in terms of lost competitiveness for airlines using Heathrow, and a loss of connectivity from the UK's only airport that is capable of hosting an airline hub.

Passenger numbers forecasts:

- Do not take account of rebound in passenger numbers following removal of Covid travel restrictions.
- Are out of line with those of Eurocontrol and IATA, and airlines (who have better visibility of actual bookings).[10]

Impact: CAA estimates 58m fewer passengers over the regulatory period than independent forecasts.[11]

Potential impact on total charges: £200m cost to consumers and airlines.[12]

Projections of commercial revenues (e.g. parking and retail)

- £1bn lower than independent advice.[13]

Potential impact on total charges: £1bn cost to consumers and airlines.

Projections of operating costs

- £750m more than independent advice indicated would be necessary.[14]

Potential impact on total charges: £750m cost to consumers and airlines.

Required returns on investment (WACC)

- Compared to external research, the CAA's proposals suggest returns some 2.05 percentage points higher.[15]
- Well above returns suggested in other regulated sectors.
- All despite significant new mechanisms proposed by the CAA to de-risk Heathrow.

Potential impact on total charges: £3bn cost to consumers and airlines.

What needs to be done

It does not need to be like this. A thriving hub airport for the UK is a key plank of international competitiveness and future growth. Other countries have already realised this and are using their hub(s) to attract business, with tightly regulated airport charges serving as a magnet to their country. For example, in Spain, the regulator determined that charges at the hub airport in Madrid should still fall by 3% even after allowing costs for provision of health protection measures to be included.[16] This clearly demonstrates an attempt to strengthen and expand a strategic national asset, with the Spanish Government commenting that this "…places AENA's tariffs among the most competitive and will therefore contribute to attracting new companies."[17] The CAA's approach in the UK will do the opposite.

Based on the evidence presented in this report, we believe that Heathrow's initial unreasonable request for a 117% increase in charges has led to a significant bias in the CAA's proposals. This means that the charges outlined by the CAA are too high, and should be reduced. There is still an opportunity for the CAA to do this. If this does not happen, we believe that the Government must intervene to ensure that its Global Britain and Levelling Up agendas are not undermined by the regulator's actions.

Charges lower than those already suggested would mean lower overall income for the operator. However, HAL has a range of ways to manage this. For example, unlike their response to the pandemic, where no permanent equity was injected, HAL's shareholders could be asked to put more capital in to build financial resilience and secure long-term returns, as shareholders in any other business would be asked to do. Capital investment should be more cost-effective and could also be more carefully targeted. The operator and airlines could work together to ensure that passenger numbers rebound more quickly than forecast.

Recommendations

For the CAA – its final proposals for per-passenger charges over H7 should be reduced to those suggested by external analysis. This can be achieved by:

1. ***Urgently reviewing its forecast of passenger numbers*** to ensure they reflect the most recent actual passenger numbers, and independent forecasters. In doing so, they must ensure that the downward bias in the figures is removed.

2. ***Listening to its own independent advice and the latest evidence from industry*** to ensure that less pessimistic (and more realistic) projections of commercial revenues and operating costs are produced. Calculations for the WACC also need to be reduced to fully take account of new measures being proposed by the CAA to de-risk Heathrow.

3. ***Putting consumers first***. If there is any remaining uncertainty, which leads to a range of possible figures, the CAA should put consumers first. This would mean setting charges based on the lower bound of any ranges produced. This would be directly in line with the statutory obligations of the CAA to fulfil its **primary duty to consumers.**

For the Government:

4. If this opportunity is not seized by the CAA, the Government should consider **changes to the formal objectives of the CAA** to ensure that consumers and UK competitiveness are put ahead of the financeability of the incumbent operator.

5. In the longer-term there is an option for the **Government to reconsider how Heathrow, the UK's most important airport, is operated and regulated**. This must ensure that consumers and the UK, not shareholders, reap the maximum benefits.

CHAPTER 1 Introduction

Heathrow is the largest and most important airport in the UK. Modern aviation operates as a "hub and spoke" system, where there are a small number of hub airports that support a wide range of onward destinations to other cities and regions. This leads to lower consumer prices and greater connection opportunities. For a place that is not a hub, worldwide air connectivity largely depends on access to one.

Airline operations at Heathrow make it the UK's only hub airport; one of only four major established hubs in Europe. Individuals and businesses across the UK's nations and regions need high quality affordable access to this unique national asset to provide connections to the rest of the world and provide the growth and jobs needed to achieve levelling up. And we need people and businesses from the rest of the world to connect to and through Heathrow to drive the vision of Global Britain.

But this is all at risk. We are in a global race for connectivity and this is centred around how competitive and attractive the UK's only hub airport is. Heathrow and other major European hubs are increasingly in competition with hubs in the Middle East and, in recent years, in Turkey, offering global connections. The countries that win will attract more passengers and more businesses to their hub. In turn, this will support more routes, from more airlines and more opportunities for businesses to reach new markets and for investors, tourists and businesses to reach their country.

The problem is that Heathrow is already Europe's most expensive airport and this situation stands to get worse.[18] Despite charges at Heathrow being capped by the Civil Aviation Authority (CAA), Heathrow's operator (Heathrow Airport Limited, HAL) has already been allowed to increase regulated charges by 56% in 2022.[19] The CAA are now deciding whether to allow them to remain at this level between 2022 and 2026 – with HAL having initially requested an increase of 117%. The CAA's initial proposals also leave open the possibility that the rise could be increased – potentially meaning charges over a five-year period that are up to 75% higher than in 2021, even before inflation has been considered.

We cannot let this happen. This report shows the significant risks this presents to the competitiveness of the UK's global aviation industry, connectivity, businesses and individuals. This is true not just in London - but right across the UK, as businesses and consumers in all parts of the UK benefit directly from the connectivity provided by airlines at Heathrow and indirectly from the growth and business that this facilitates.

Fewer routes, with lower frequencies, attracting fewer global airlines and businesses to the UK's only hub will damage the UK's position in the world and reduce growth, productivity and living standards. That means that, left unchanged, the CAA's decision stands to undermine the Government's Global Britain and Levelling Up ambitions.

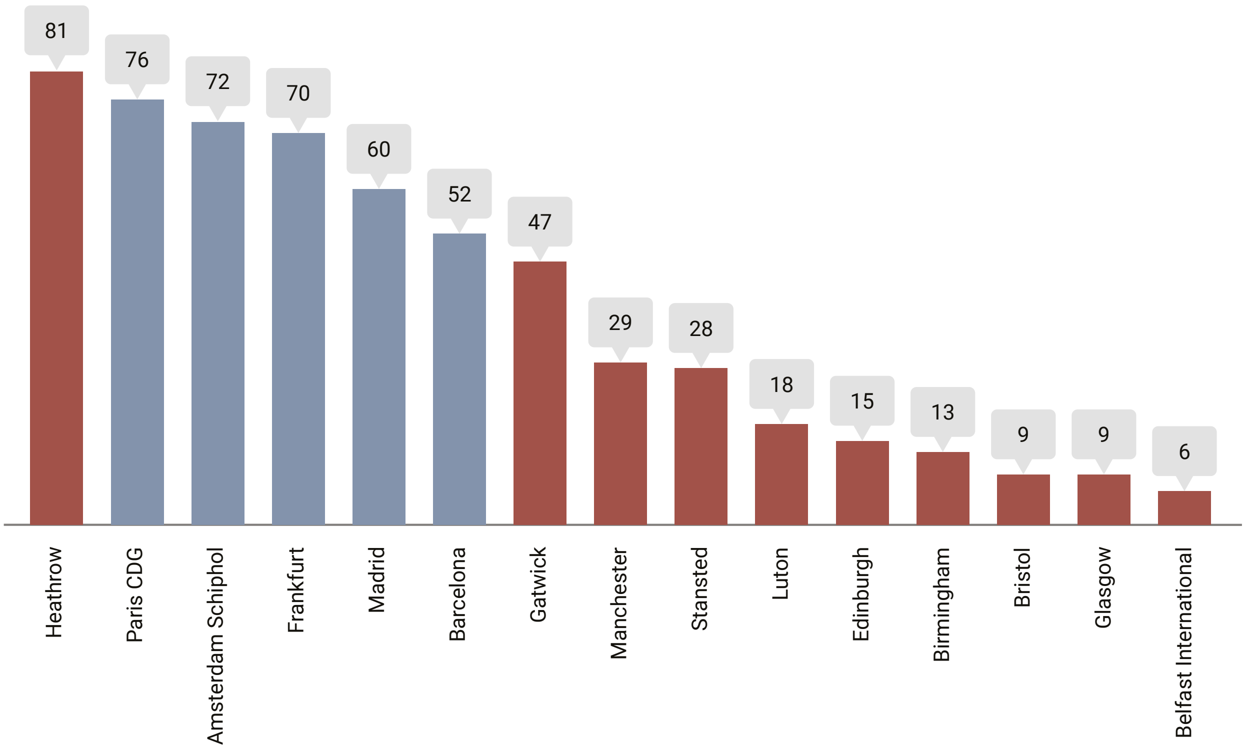
CHAPTER 2 The value of connectivity at Heathrow

Heathrow is the only UK airport that can effectively host airlines capable of forming a hub operation. This means that it is the biggest route for UK citizens and businesses to access the world and the biggest gateway for leisure and business passengers to the UK, and the largest cargo port by value.

Prior to the pandemic, Heathrow was the busiest airport in Europe. **Airlines operating at Heathrow were used by 81 million passengers:**

- 73% more passengers than the second busiest London airport (Gatwick).
- 110% more passengers than the busiest airport in the rest of the UK (Manchester).

Figure 2: Millions of passengers, 2019



Source: CAA, Airmundo

1.5 million tonnes of freight, worth more than £130bn, passed through Heathrow – more than all of the UK's other airports combined.[20]

More than 8.4million UK passengers used Heathrow for business travel in 2019, with 84% of those using the airport for international business travel.[21]

11.9 million international business travellers used Heathrow in 2019.[22]

Given these stark statistics, it is easy to see how important the connections provided by airlines at Heathrow are for the UK. And as the Government targets an economic recovery from the global pandemic that has weighed down the economy, the effective and competitive operation of the airport will be vital to the Government achieving its objectives. Nowhere is that clearer than in the Government's ambitions on Global Britain and Levelling Up.

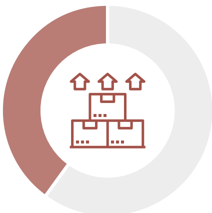
Connectivity from Heathrow is crucial to building Global Britain

We live in a global economy where trading and transport links are increasingly important to the economic success of cities and regions. Post Brexit, the nations and regions of the UK will need good quality connections to the rest of the world in order to continue to build strong, thriving economies.

> **"…by 2025 [the value of freight] could grow to over £204bn, creating economic opportunities that are key to achieving the Government's own Global Britain ambitions and levelling up goals – as long as Britain's vital trade links are restored and strengthened."**
> **Heathrow**

Airlines at Heathrow, including two British flag carriers, account for 75% of the UK's long-haul flights and provide connections to 238 destinations.[23] For three in ten (30%, 71) of these, Heathrow is the only UK airport directly serving the destination. These include Tokyo Haneda, Johannesburg, Riyadh and Kuala Lumpur.[24] And with a wide range of domestic connections, it links all of the UK to all of these places.

Some 40% of UK exports by value are handled through Heathrow, with 94% carried in the bellies of passenger aircraft.[25] The composition of passengers at Heathrow is also significantly more weighted towards business travellers than any other UK airport.[26] For example, in 2019, more than 25% of passengers using Heathrow were on business, compared to 15% at Gatwick and 14% at Stansted.[27] This highlights the uniqueness of Heathrow and its centrality in driving forward the UK's economic recovery.

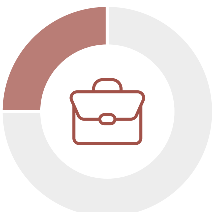


The UK's biggest port – with **40% of exports by value** handled through Heathrow.

CEBR

Airlines operating flights from Heathrow account for **75% of UK long-haul flights** and **provide connections to 84 countries and 238 destinations**.

Heathrow, VAA



With close to **25% of Heathrow passengers being on business**, this share is nearly **50% higher than the average** across other UK airports.

WPI Economics, CAA

Connectivity from Heathrow is vital to the Government's plans to level up the economy and unleash the potential of the whole country

The unparalleled level of global connectivity provided by airlines at Heathrow ensures the country is well connected with every part of the world. At the right, affordable, cost, this connectivity is vital to towns and cities right across the UK. As a major part of the UK's overall aviation sector, Heathrow is equally important in:

Boosting employment: A 10% increase in air passengers to regional airports has been found to cause a 1% increase in service sector employment.[28]

Attracting more external investment: Good regional air connectivity boosts economic activity in the vicinity of regional airports, and this drives higher inward investment.[29]

Increasing tourism: Regional air connectivity can increase tourist related activities.[30]

Providing links for exporters to global markets – which will be particularly important in areas with a strong manufacturing base (e.g. Midlands and North East), where access to new and existing global markets, facilitated by new trade deals, will provide the exporting opportunities they need to grow.[31]

The vanguard of the UK's aviation sector – as the UK's most important airport, Heathrow is a significant contributor to the more than 500,000 British jobs supported by the aviation sector, and the fact that more 60% of constituencies across Britain have over 500 residents in employment supported by the aviation sector.[32]

Driving future growth - Looking to the future, the Airports Commission found that around 60% of the overall boost to GDP due to a new runway at Heathrow would be focused on areas of the UK outside the South East of England, worth approximately £70-80 billion over 60 years.[33]

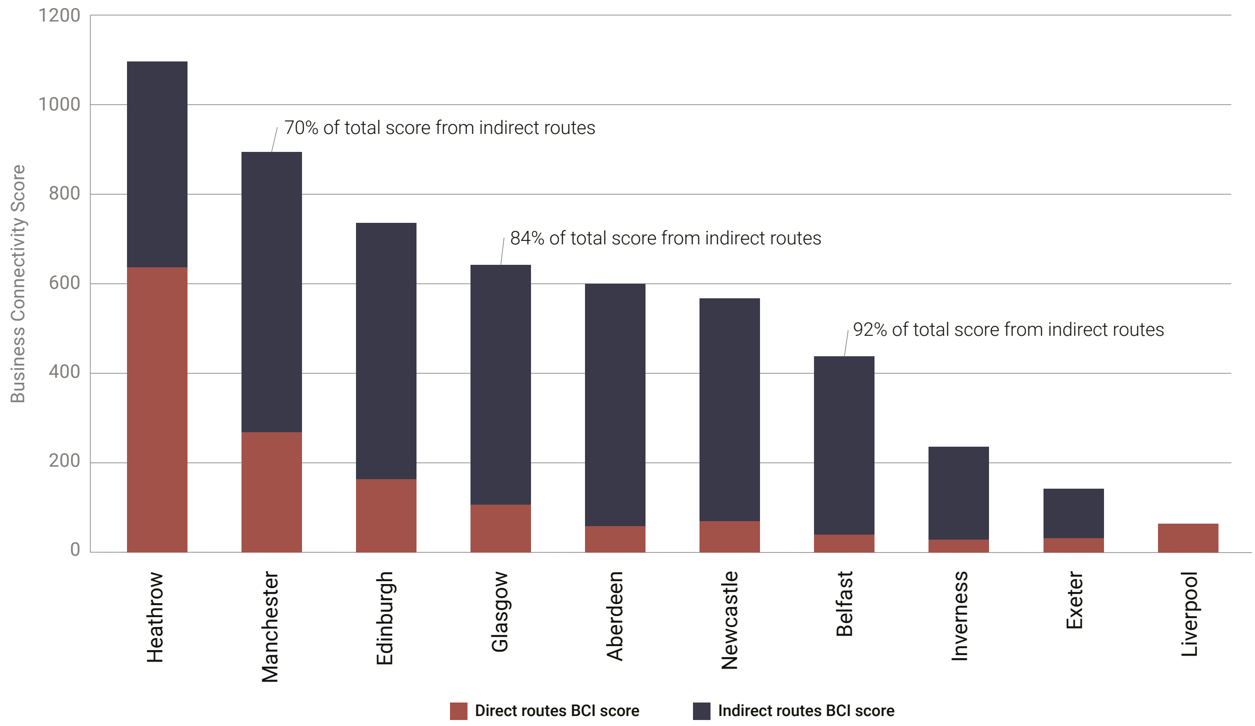
Benefiting from innovation - new industries like Sustainable Aviation Fuel (SAF), are set to contribute close to £1bn annually and 6,500 jobs, mostly in regional and coastal areas across the country.[34]

These benefits are driven by the strength of connectivity provided by airlines from Heathrow, which is demonstrated by York Aviation's Business Connectivity Index (BCI).[35] This measures how well a city is connected to major cities around the globe. Heathrow has the highest index score of any UK airport (1,098).

While other airports like Manchester (892) and Edinburgh (734) also have a relatively high score, they are, in contrast, **heavily reliant on indirect connectivity** – connections through hub airports - to drive their overall business connectivity. For example, just 22% of Edinburgh's score comes from its direct routes.

York Aviation say that their analysis highlights "…the importance of hub services for UK regional airports, even major intercontinental gateways such as Manchester, in serving both UK business and overseas business seeking to trade with the UK".[36] To ensure that the UK's connectivity is protected and grown over time, and that passengers and businesses can continue to enjoy the benefits of this, it is essential that the share of hub connectivity that is served through Heathrow is not eroded over time.

Figure 3: Non-London UK airports derive a significant proportion of their business connectivity from indirect links through hub airports, particularly Heathrow



Source: York Aviation (2018).[37] Notes: A higher score for an airport represents more regular connections to higher status cities, and faster connections in the case of indirect routes.

Why these benefits are only available through the UK's only hub

Hub operations such as those provided by airlines at Heathrow create significant benefits by pooling passengers together to create high demand routes. This allows passengers to benefit from increased connectivity to a wide range of destinations at reduced prices. Airlines providing hub connectivity at those airports benefit the host country with significant numbers of jobs and contribution to economic activity.

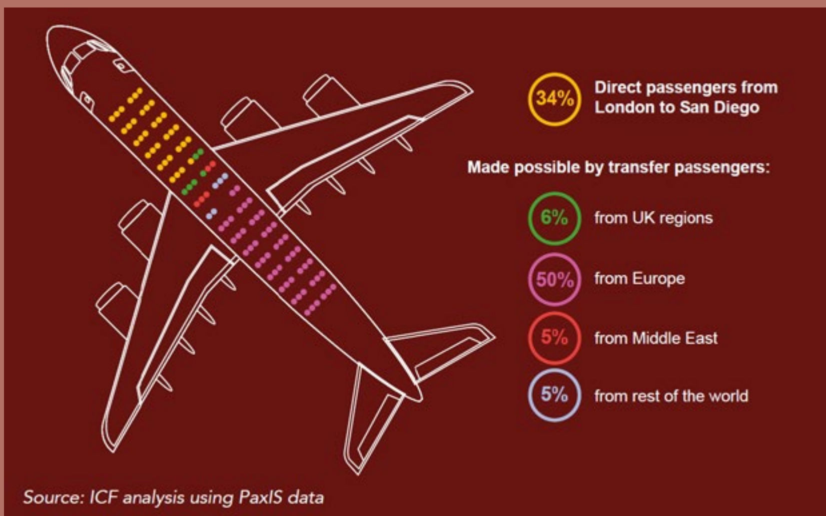
> **"Heathrow is able to support a level of connectivity that simply cannot be replicated at other airports in the UK."**
> **York Aviation**

Because of the scale and concentration of connectivity needed to make this work, no other airport in the UK can provide these benefits and associated range of routes and lower costs to passengers and for freight. The lack of alternatives in the UK and airlines' consequent inability to move their hub operations gives Heathrow the monopoly power and makes economic regulation essential. However, UK (and international) passengers do have a choice to use hub airports outside of the UK. As we show later, significant numbers of UK passengers already choose to transfer through hubs in other countries, rather than Heathrow. This underlines the fact that global connectivity is a battle between Heathrow and other hubs, not other UK airports. Ultimately, airlines and passengers will choose a hub that meets their needs – whether that is Heathrow or one of our European competitors. For UK prosperity, and for Global Britain's current and future success, Heathrow must be cost competitive.

Airlines operating hub-and-spoke connections pool passengers from a range of short-haul services through to their long-haul services and vice-versa. This creates hub airports with benefits:

- Airlines need to be able to meet the costs of basing aircraft and staff at the airport and, as the scale of the operation increases, the average of these fixed upfront costs falls;
- Combining passengers and cargo from many locations allows airlines to fly larger aircraft that come with lower unit costs;
- It allows airlines to offer more frequent flights to a larger range of destinations; and
- Flying with fuller aircraft improves efficiency and sustainability.

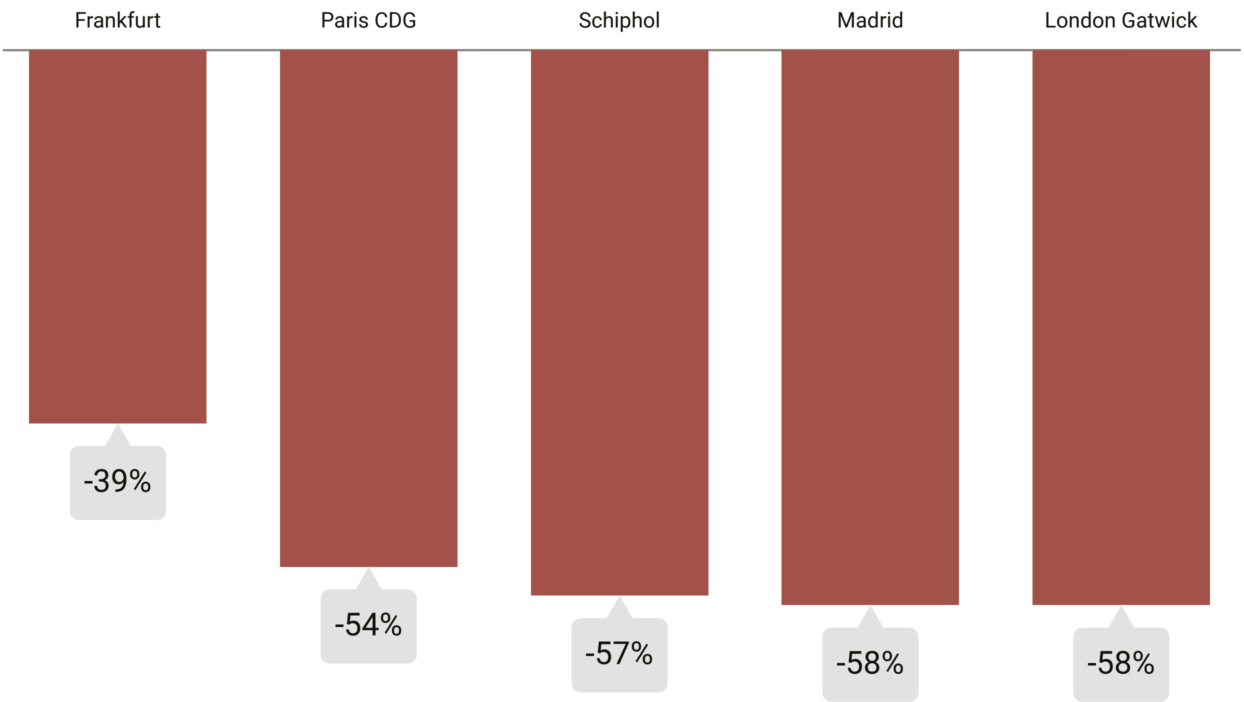
These benefits make more routes economical for airlines to run, increasing connectivity for passengers from a wide range of destinations and reducing prices. The figure shows how passengers transferring on to a flight can increase the financial viability of a route.



CHAPTER 3 The most expensive airport in Europe

This need to be more attractive than other European hubs becomes a major problem when we consider that Heathrow is the most expensive airport in Europe, even before the significant increases in charges seen in 2022. Between 2014 and 2020 it was the most expensive airport in the world.[38] Figure 4 replicates findings from the most recent annual report on airport charges from Jacobs, and shows that per passenger charges at Paris CDG were less than half (54% lower) of those at Heathrow. Those at Schiphol were 57% lower.

Figure 4: Amount that each airport's charges are cheaper, compared to Heathrow.



Source: Jacobs

This situation has arisen despite charges at Heathrow being regulated by the CAA. Some form of regulation is needed because of the monopoly position enjoyed by Heathrow as the UK's only airport where hub operations are feasible. The need for regulation is further accentuated by the severe capacity constraints that the airport currently operates under.

The regulator's role, therefore, is to replicate the effects of a market so that consumers (and the UK more widely) have access to the benefits of the hub, without being subjected to inflated monopoly pricing. Regulation of pricing also makes investment possible for the operator. Delivering infrastructure requires a large up-front investment, which is only viable for private investors if they can recoup these costs through charges once the infrastructure is built.

In broad terms this means that the CAA sets maximum allowable charges per passenger that are supposed to promote consumer (including passenger and freight) interests, whilst balancing the commercial needs of the airport operator. In making their decision, the CAA also need to pay regard to the potential impact that its decisions could have on economic growth.

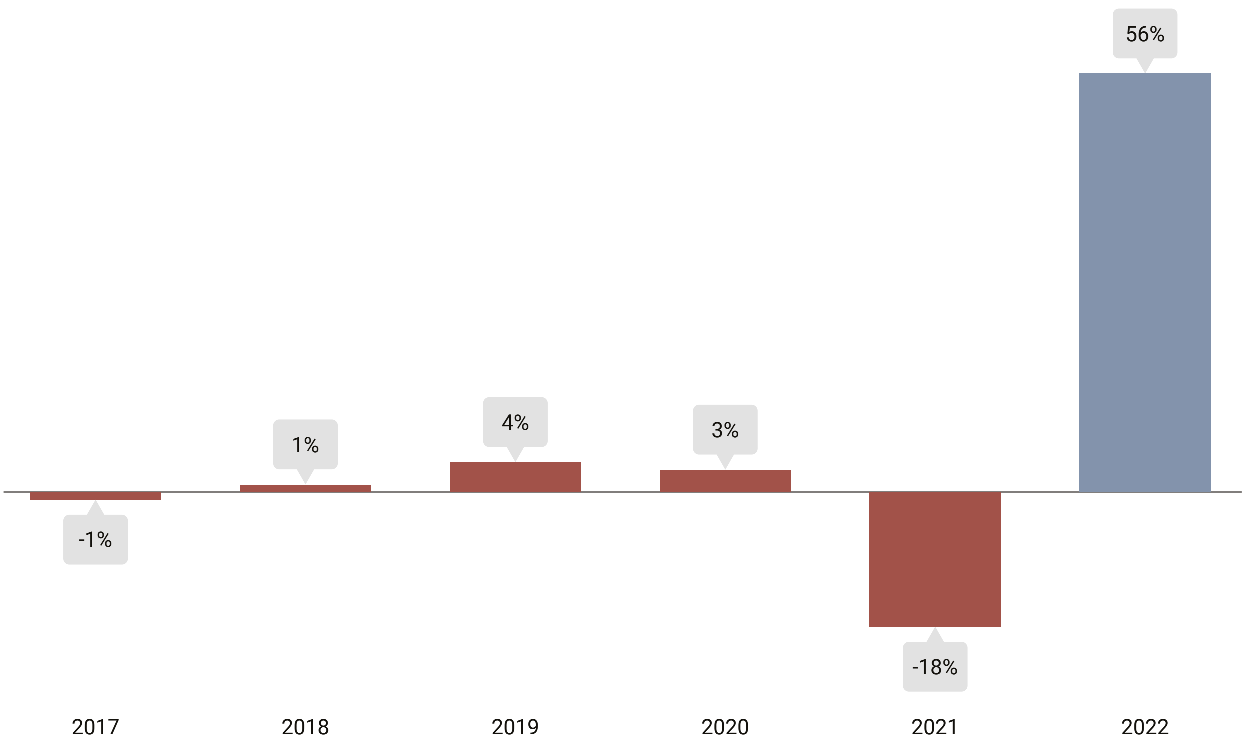
The problem is that over a number of years, the charges which have been set have led to Heathrow becoming increasingly uncompetitive. As we explain later, there is a real risk that, if this continues, the significant benefits associated with the UK's only hub airport will be undermined. We also demonstrate later how this is a result of the way in which the regulatory system is structured and the incentives this provides to the airport operator and its shareholders, including incentives to increase debt-financing, overstate operating costs and underplay forecasts of passenger numbers and commercial revenues.

And it's getting worse

In 2021, HAL proposed to increase its passenger charges by 117% for the whole of the 5-year regulatory period. These proposals are currently under review by the CAA. In a process tagged as "H7" (the seventh five-year control period), the CAA published its initial view on HAL's proposals in October 2021. After failing to take on its own independent advice, the CAA put in place a provisional charge of £30.19 for 2022 (a rise of 56%). The CAA is due to determine the maximum allowable charges for the remainder of the 2022-2026 period in June 2022. The risk is now that the CAA continue to disregard vital evidence and enforce the continuation of this very large increase in charges. It also comes alongside increase in other charges levied by HAL in recent months, including the introduction of a new passenger drop-off charge and increase in parking charges.

These increases in charges are also well out of line with current international practice where increases of anywhere near this scale are not seen.

Figure 5: Year-on-year increase in regulated charges (2022 provisional)



Source: Heathrow Airport Limited[39]

After failing to take on its own independent advice, the CAA has allowed charges to rise by 56% in 2022. This comes alongside increases in other charges levied by HAL, including the introduction of a new passenger drop-off charge and increases in parking charges.

CHAPTER 4 Why increasing charges will hurt Britain

Such a large increase in prices in Europe's most expensive airport, particularly when many other competitor airports are not doing the same, risks undermining the benefits that accrue to the country from the UK's only hub airport.

Ultimately, this rise in charges will be borne by passengers and airlines, and each will be pushed to make decisions that will undermine the UK's hub operation.

For some passengers, the increase in costs as a proportion of ticket price might be relatively small. However, even where this is the case, connecting passengers are particularly price sensitive. This is because they are typically seeking the cheapest way of getting to their final destination and have relatively weak preferences over the airport through which they connect. Thus, even small increases in price could lead to passengers choosing to connect through hubs outside of the UK.

For airlines, increases in charges are completely fixed. In short, unlike increases in fuel prices (which are typically largely hedged by airlines) and staff and other operating costs (which can be managed by improved efficiency and productivity), airlines have no way of mitigating the increase in charges seen. Given the level of competition between the 80 airlines operating at Heathrow, it is also unlikely that they will be able to pass the increases onto passengers. In this situation, the attractiveness of Heathrow as a base is eroded and airlines will have to make commercial decisions both over the routes they fly from Heathrow (by prioritising and consolidating around existing profitable routes, rather than taking a risk on new and / or marginal routes) and the balance of their fleet based at Heathrow as compared to other European hubs.

For both passengers and airlines, we also show later that even if per-passenger costs are relatively small, the collective costs could amount to £5bn or more over the course of four years. It is undoubtable that a cost of this scale, which airlines have to bear, will have a significant impact. We show below what the implications for Global Britain and Levelling Up might be.

Global Britain and global standing

The Government has clearly signalled the importance of post-Brexit opportunities for expanding the UK's reach into existing, new and emerging global markets. Such expansion is heavily reliant on airlines providing connecting services at hub airports to make these long-haul destinations viable. The problem is that UK businesses, freight and passengers do not need to travel through Heathrow. Rather, they can choose alternative hubs in Europe or, perhaps, the Middle East.

This pressure on Heathrow can already be seen in the pattern of flights from a range of UK airports. Table 1 shows that 3.8m UK passengers from seven of UK's regional airports connected through Heathrow or one of the EU's three biggest hubs in 2019. This means more than half (56%) chose to do so through hubs in mainland European airports, rather than Heathrow, in 2019.

Table 1: UK passengers travelling to three EU hubs in 2019

	London Heathrow	Paris Charles de Gaulle	Amsterdam Schiphol	Frankfurt		
UK airport	Total connecting passengers	Total connecting passengers	Total connecting passengers	Total connecting passengers	Total connecting other than LHR	Proportion connecting other than LHR
Edinburgh	0.4m	0.1m	0.3m	0.1m	**0.5m**	**57%**
Manchester	0.4m	0.1m	0.3m	0.3m	**0.7m**	**65%**
Glasgow	0.3m	0.0m	0.2m	0.0m	**0.3m**	**44%**
Aberdeen	0.2m	0.1m	0.2m	0.0m	**0.3m**	**60%**
Newcastle	0.2m	0.1m	0.2m	0.0m	**0.3m**	**57%**
Belfast City	0.1m	0.0m	0.0m	0.0m	**0.0m**	**20%**
Inverness	0.1m	0.0m	0.1m	0.0m	**0.1m**	**49%**
Total	**1.7m**	**0.3m**	**1.4m**	**0.4m**	**2.1m**	**56%**

Source: PAXIS

Given the price elasticity of connecting passengers, there is a substantial risk that increases in charges of the level proposed by the CAA will mean more passengers choosing other European hubs.

This presents a problem given that many new routes to new and emerging markets are initially on the margins of commercial viability and are only made possible by the pooling of passengers through the hub. So the fewer passengers that choose to connect through Heathrow, the greater is the risk to new global routes becoming available from Heathrow.

At best, this risks a maintenance of current global connectivity from the UK. At worst, it could lead to a loss of connectivity as airlines are pushed to consolidate around more profitable routes and move more of their operations to EU hubs.

Some might argue that this does not limit the ability of UK businesses and consumers to access these global markets; they can simply hub through another country. However, building the scale and reach of a country's hub airport brings much wider economic benefits. The most obvious point is that global freight destined to and from the UK would be unviable without a world-leading hub at Heathrow. The hub also attracts visitors, businesses and investment, helping to increase the UK's global standing and position in the global economy. Further, hub activity in the UK means economic activity remains in the UK – for example, direct employment in airlines and airports: airlines operating to Heathrow as a spoke on their network create employment at their home hubs. As the UK's aviation sector and Government seek to maintain a global lead in the decarbonisation agenda,[40] there are also potentially significant benefits to UK R&D, innovation and commercialisation, as well as the creation of new businesses, industries and high-skilled green jobs that will support the decarbonisation of aviation in the UK and abroad.

Passengers connecting through Heathrow make more regional routes viable at a higher frequency; supporting businesses and connectivity right across the UK

In short, a thriving hub airport for the UK is a key plank of international competitivity and future growth. Other countries have already realised this and are using their hub(s) to attract business, with tightly regulated airport charges serving as a magnet to their country. For example, in Spain the regulator determined that charges at the hub airport in Madrid should still fall by 3% even after allowing costs for provision of health protection measures to be included.[41] This clearly demonstrates an attempt to strengthen and expand a strategic national asset, with the Spanish Government commenting that the freeze "…places AENA's tariffs among the most competitive and will therefore contribute to attracting new companies."[42] The CAA's approach will do the opposite.

Levelling Up

This is not just about the success of Heathrow and the surrounding areas. The success of airlines at the UK's hub airport is also central to the future for businesses in nations and regions across UK. This is particularly true of the UK's flag carriers based at Heathrow. Unlike overseas carriers, whose Heathrow operations are only a fraction of their total network, these airlines base the large majority of their fleet at the airport. This means that the rise in charges cannot be spread more widely across their non-Heathrow operations. As such, increases in charges of this degree risk fundamentally undermining these UK airlines in a way which will damage their, and the nation's, global competitiveness.

The impacts of this will be seen in the Government's levelling up agenda. In part, as demonstrated earlier, this is simply not about the economic value that these airlines and, collectively, the UK's aviation sector bring to communities across the UK. It is also about the connectivity provided by these airlines and how this benefits all of the UK. By pooling connecting and point-to-point passengers, airlines are able to run more regional routes at greater frequency than would be possible in a non-hub airport. The scale of the support for regional airports provided by connecting customers is clearly shown in Table 2. Close to 4m passengers from seven of the UK's key regional airports flew to Heathrow in 2019. Nearly half (44%) of these were connecting on to further destinations. It is this 44% who help to make the routes for the remaining 56% viable.

Table 2: Estimated passengers travelling between 7 regional UK airports and Heathrow, January – December 2019

UK airport	Total passengers	Proportion connecting onto further destinations
Edinburgh	0.9m	38%
Manchester	0.5m	70%
Glasgow	0.8m	41%
Aberdeen	0.6m	34%
Newcastle	0.4m	56%
Belfast City	0.4m	30%
Inverness	0.1m	39%
Total	**3.8m**	**44%**

Source: PAXIS

Some UK passengers could manage a reduction in connectivity at Heathrow by using alternative EU hubs. However, with more than half of UK-departing connecting passengers already choosing hubs outside of the UK, any further losses of connecting passengers will weaken airlines 'hubbing' at Heathrow, reducing their competitiveness in a way that could fundamentally undermine the viability of regional routes, airlines and airports within the UK. If Heathrow's charges are too high, EU based carriers will still connect regional airports to their global networks, but UK domestic routes that benefit from this pooled connecting/point-to-point traffic will be threatened. The likely outcome is weaker Union connectivity with reduced frequencies between Scotland or Northern Ireland and London and less consumer benefit.

The wrong choice at the wrong time

In normal times, HAL's suggested increases and the CAA's current proposals for charges would present a significant headwind for UK passengers and businesses looking to connect to the world and airlines looking to service these customers from Heathrow.

However, the increase needs to be seen in the context of the last two years and significant challenges in the future. These include the long-term financial impacts for airlines of the collapse in passenger numbers seen during the Covid-19 pandemic, the cost of living crisis, rising aviation fuel prices, significant financial commitments made by airline shareholders both in terms of injecting new equity and requirements to pay back Covid loans.

Together these mean that increases in charges of this scale could have a very significant impact on the UK's global aviation industry, the UK economy and the Government's ambitions for Global Britain and Levelling Up.

CHAPTER 5

How did the CAA get into this situation?

Given the scale of the potential economic damage that could arise from increasing charges at Heathrow by up to 75%, it is vital to understand why the regulator is in this position. The starting point is to understand how regulated charges at Heathrow are determined. In simple terms, this is based on a formula, comprised of a number of key elements used by the CAA.[43]

Box 1 shows that the formula is made up of four components. These are the allowable net income to the operator, the returns allowed on investment (WACC) and forecasts of commercial revenue and passenger numbers. The challenge facing the regulator is that none of the elements above can be determined with certainty. This means that the CAA needs to make a judgement as to the likely course of each of these factors over the regulatory period.

The process is started by the CAA taking evidence from Heathrow on their views on each of the elements. **In essence, this amounts to asking shareholders of Heathrow to suggest the level of profit they should be allowed to make**. In 2021, HAL put forward figures to the CAA which argued for an extremely large, 117% increase in the per-passenger charge at Heathrow.

This suggestion was driven by estimates for each of the building blocks, which independent analysis suggests are unreasonable. The key is that HAL are incentivised to do this by the regulatory system. Figure 6 shows how these aspects impact on the charges that can be levied by the operator and summarises the incentives for the operator.

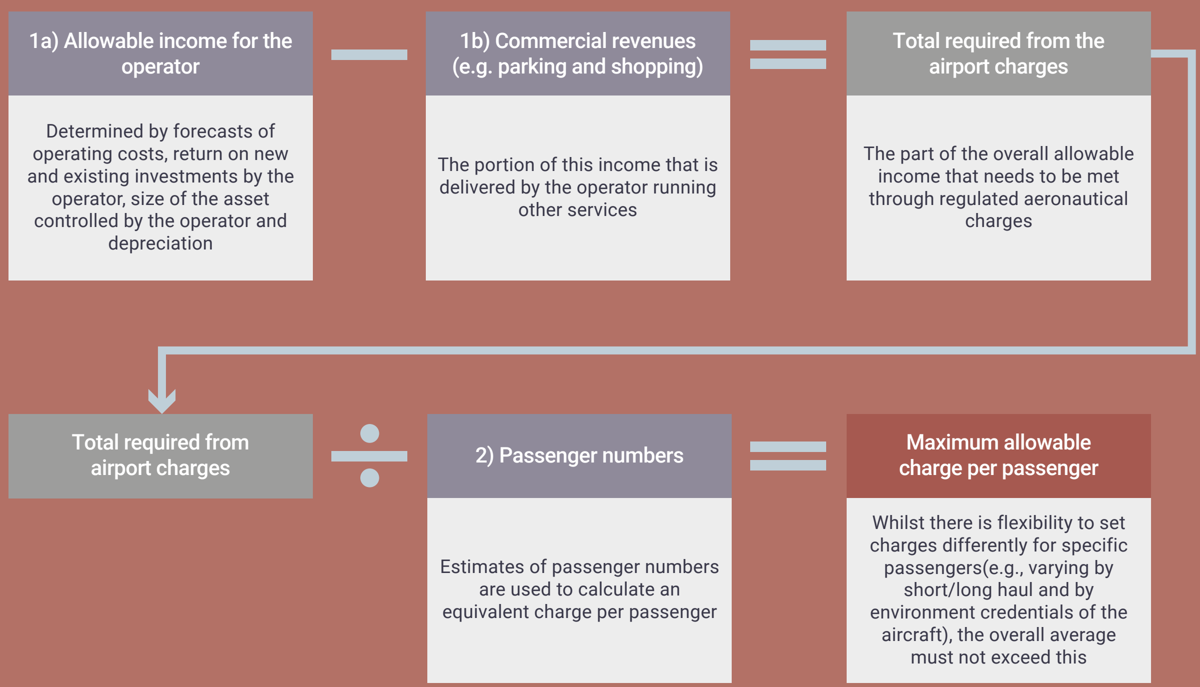
Figure 6: How elements of the CAA's approach impact on charges

Factor	Movement	Impact	Commentary	Operator has the incentive to...
Allowable income	An increase leads to	A rise in the charge	All else equal, a need for higher income will increase charges to airlines and passengers	Provide forecasts that overstate investment needs and operating costs.
Commercial revenue forecast	A reduction leads to	A rise in the charge	With lower revenues, more needs to be made through aeronautical charges to achieve a given level of return	Provide forecasts that underestimate revenue (both per passenger and against the number of passengers)
Passenger number forecast	A reduction leads to	A rise in the charge	Lower forecasts mean that a given level of aeronautical charges will be spread across fewer passengers	Provide forecasts that underestimate passenger numbers
Weighted average cost of capital (WACC)	An increase leads to	A rise in the charge	With higher required risk / returns, a given level of investment will require higher charges to provide fair return	Overstate risk and / or suggest lower financial appetite from global markets

Box 1: Simple articulation of the CAA's charge calculation for Heathrow

Stage one: calculating income needed from per-passenger airline charges (aeronautical charges)

The regulator needs to protect consumer interests, while ensuring that the operator of Heathrow has sufficient incentives (return on investment) to invest in providing the services and infrastructure that are needed to meet consumer needs. This is supposed to be achieved by assessing the level of income that would be needed to provide a fair return on the operation of the asset and associated investment, after accounting for revenues that can be captured by the operator through day-to-day operation of the airport (e.g. parking fees and revenue associated with retail outlets). The remaining amount is the total aeronautical charge required for the operator to achieve the income needed for a fair return.



Stage two: calculating what this means for allowable per-passenger charges

Once the total requirement from aeronautical charges has been calculated, forecasts of passenger numbers are used to calculate and equivalent charge per passenger. These can be varied according to type of passenger – but the overall average cannot exceed this level.

After HAL has submitted its proposals, airlines are then asked for their views, based on partial information (as HAL is not required to disclose a level of detail that would support transparent decision-making).

Faced with this situation, rather than simply splitting the difference, it is the regulator's job to take an independent, evidence-based view, which meets its primary duty of furthering the interests of consumers of air transport services. However, judging by their determination for 2022 charges, they appear to be exercising this duty by finding a midpoint based on HAL's unreasonable position, rather than taking on independent advice and assessing the credibility of the respective proposals. Given HAL proposed that the charge should rise to £41.95 (an increase of 117% compared to 2021),[44] this approach will unavoidably lead to a very significant rise in charges.

The CAA argue that, even if the holding cap and initial proposals turn out to be too high, mechanisms have been put in place that will mean that the costs will be evened out by future decisions.[45] However, this fails to understand that it is consumers who will ultimately be paying upfront, to the benefit of HAL shareholders, and that even a short-term price hike will affect demand and could lead to losing connectivity in the longer term.

This position becomes all the more concerning given that the CAA has already commissioned external consultants CEPA / Taylor Airey to undertake an independent review of some of these factors, but has so far chosen to ignore this independent advice. We show below that the effect is to put the interests of Heathrow's shareholders above those of consumers and the UK economy, to the tune of £4bn.

Allowable income

The first stage of assessing allowable income is determined through a number of key elements, outlined below.

Allowable income	=	Operating costs	+	Return on investment made by the operator	+	Depreciation
The total income that is needed to achieve a fair return on the investment made by the operator		Forecasts of day-to-day running costs		Calculated by applying the Weighted Average Cost of Capital to the existing Regulated Asset Base (RAB) and investment expected over the course of the regulated period		Accounts for the reduction in value of the asset over time

Operating costs

Operating costs form a key part of determining the allowable income for Heathrow. For any given level of fair return, the more efficient the operating costs, the lower aeronautical charges will need to be. However, HAL has little incentive to provide an accurate basis for operating costs or for efficient operations – as increases in these lead directly through into the allowable income and charges. In contrast, lower forecasts of operating costs place significant pressures on HAL to deliver efficiency savings. Perversely, through the regulatory process, HAL are incentivised to propose higher operating costs over the five-year settlement where any savings achieved will give greater dividends to shareholders at the expense of higher charges for businesses and consumers.

As such, it is hardly a surprise that there is a divergence between the operating costs forecasted by HAL, and the equivalent independent forecasts. Nevertheless, the scale of the difference is significant, with the CEPA/Taylor Airey projection suggesting operational expenditure some £801m (13%) lower than HAL's forecast.

Table 3 shows what this means in terms of operating costs per passenger, based on HAL's central forecast of passenger numbers (which we show later are significantly below those of independent forecasters). It shows that, under HAL's forecasts, real-terms per-passenger operating costs are higher in 2026 than close to a decade previous, in 2019.

Table 3: Average operating costs per passenger – HAL versus CEPA/Taylor Airey

	2019 baseline	2022	2023	2024	2025	2026
HAL	£14.51	£24.36	£19.44	£17.32	£16.46	£16.21
CEPA/Taylor Airey		£21.44	£16.89	£14.84	£13.80	£13.28

Source: HAL, CEPA/Taylor Airey. Notes: 2018 prices. Based on HAL mid passenger forecast.

This seems unlikely given that passenger numbers will likely have returned to pre-pandemic levels by the end of the H7 period, and restructuring during the course of the pandemic should have led to significant cost savings.

The CAA's initial proposals have suggested a range of between £5.55bn and £6bn for operating costs over the period (compared to the CEPA/Taylor Airey midpoint projection of just over £5bn). Ultimately, the **difference between these midpoints (£750m) will be borne by consumers**, leading to lower connectivity and the diminishing of the Government's objectives on Global Britain and Levelling up.

Return on investment made by the operator

In common with many other regulated utilities, the method used to determine a fair return is based on an assessment of the **Regulated Asset Base (RAB), Weighted Average Cost of Capital (WACC) and forecasts of investments** to be made over the regulated period.

The RAB is the RPI inflation-protected value of the asset including the investments that a service provider has made – currently the RAB for Heathrow stands as £17.5bn.[46] The value of investments (capital expenditure) over the regulatory period are added to the RAB. This means that the operator does not face true commercial decisions over the need to invest, nor pressure to do so in an efficient manner. The operator simply has the incentive to maximise investment and attempt to increase the RAB. This is clearly reflected in HAL's capital expenditure plans, which suggest some £4.3bn investment over the course of the regulated period. In contrast, customers (the airlines, who use the services to provide flights to end consumers), suggest that a maximum of £2.5bn should be invested.

It is also important to recognise that this would come on top of the £300m RAB adjustment that HAL has already benefited from. Made by the CAA in 2021, this was supposed to support HAL's credit ratings and debt covenants through the impacts of the pandemic so that it could, in part, invest to ensure readiness for the rebound in passenger numbers as travel restriction were removed. However, Terminal 4 remained closed for the Easter travel peak.

Given this, it is essential that the CAA continue to challenge HAL's proposals on an unjustified increase to the RAB. Failure to hold firm on this would imply a significant transfer from consumers to HAL shareholders.

The rate of return

Once the RAB has been calculated, the owner of the infrastructure is then allowed to earn a return on the asset, which is governed by the regulator calculating the WACC, reflecting the balance between how much equity and debt financing the company would be expected to use. The current proposals from the CAA suggest a WACC of between 3.6% and 5.6%.

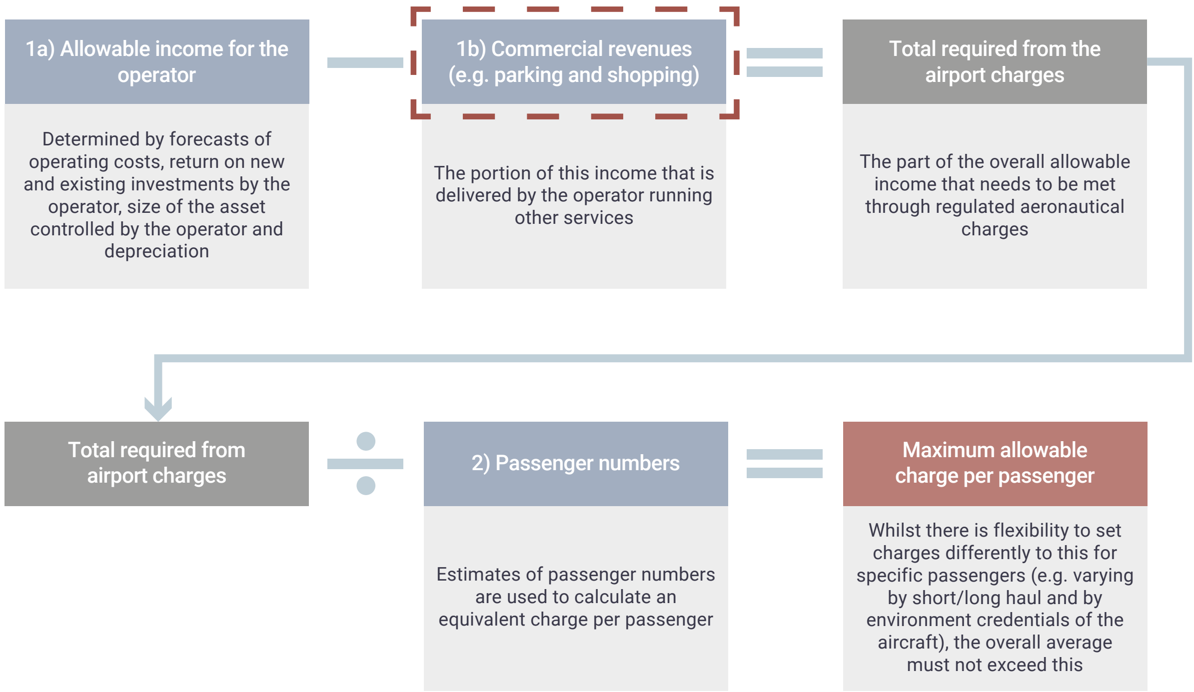
The difference between these two figures highlights the apparent lack of certainty that the CAA has over the true figure. A two percentage point difference in returns to HAL over the course of H7 would represent a significant difference in overall returns.

There are also strong arguments that the WACC should be lower, as there are a number of factors that should have reduced the WACC. These include the RAB adjustment already agreed by the CAA, Traffic Risk Sharing, Asymmetric Risk Allowance and a passenger forecast shock factor.[47] This means that, overall, the balance of risk around passenger numbers has shifted from the operator towards airlines and it is clear that these factors have not been played into the calculations of the WACC, meaning that it is overstated.

Estimates by CEPA, on behalf of the airline industry, that take account of these factors place the range of the WACC as being between 1.3% and 2.8%.[48] These estimates are also more in line with the downward trend in WACC seen across a range of regulated sectors.

The difference in returns to HAL between the mid-range of the CEPA assessment and the mid-range of the CAA stands at £3bn. If allowed to proceed at the higher level, this would represent a direct transfer from consumers to HAL shareholders.

Commercial revenues



Forecasts of commercial revenue, including income from retail premises and parking charges, are critical to calculating the level of aeronautical charges. In essence, they show incomes that can be achieved through other regulated and commercial activities, and the remainder needs to be made up through regulated charges.

The operator has a significant incentive to underestimate the potential scale of commercial revenues through the settlement period as any difference between forecasted and actual commercial revenues are kept by the operator. The upshot of this is that there is no penalty for submitting low estimates of potential commercial revenues.

So again, it is no surprise that HAL's forecasts of commercial revenues and the independent projections from CEPA/Taylor Airey differ to such a large degree. Table 4 shows the difference in per-passenger commercial revenues forecasted by HAL and CEPA/Taylor Airey. Again, it shows that HAL believe that its performance in 2026 will remain below that seen in 2019, even though passenger numbers are due to have returned to pre-pandemic levels by then.

Table 4: Average commercial revenues per passenger – HAL versus CEPA/Taylor Airey

	2019 baseline	2022	2023	2024	2025	2026
HAL	£12.10	£10.63	£9.71	£9.41	£9.28	£9.11
CEPA/Taylor Airey		£14.51	£13.33	£12.56	£12.67	£12.66

Source: HAL, CEPA/Taylor Airey. Notes: 2018 prices and based on HAL mid passenger forecasts

The CAA's initial proposals have suggested a range of between £4.7bn and £5.4bn for commercial revenues over the period (compared to the equivalent inferred CEPA/Taylor Airey midpoint projection of just over £6bn). Collectively, the difference between the CAA and CEPA/Taylor Airey central estimates amount to **£1bn over the course of the H7 period**. These are costs that will be borne by consumers and represent a direct transfer of benefits to HAL shareholders. In the longer term, it could lead to lower connectivity and the diminishing of the Government's objectives on Global Britain and Levelling up.

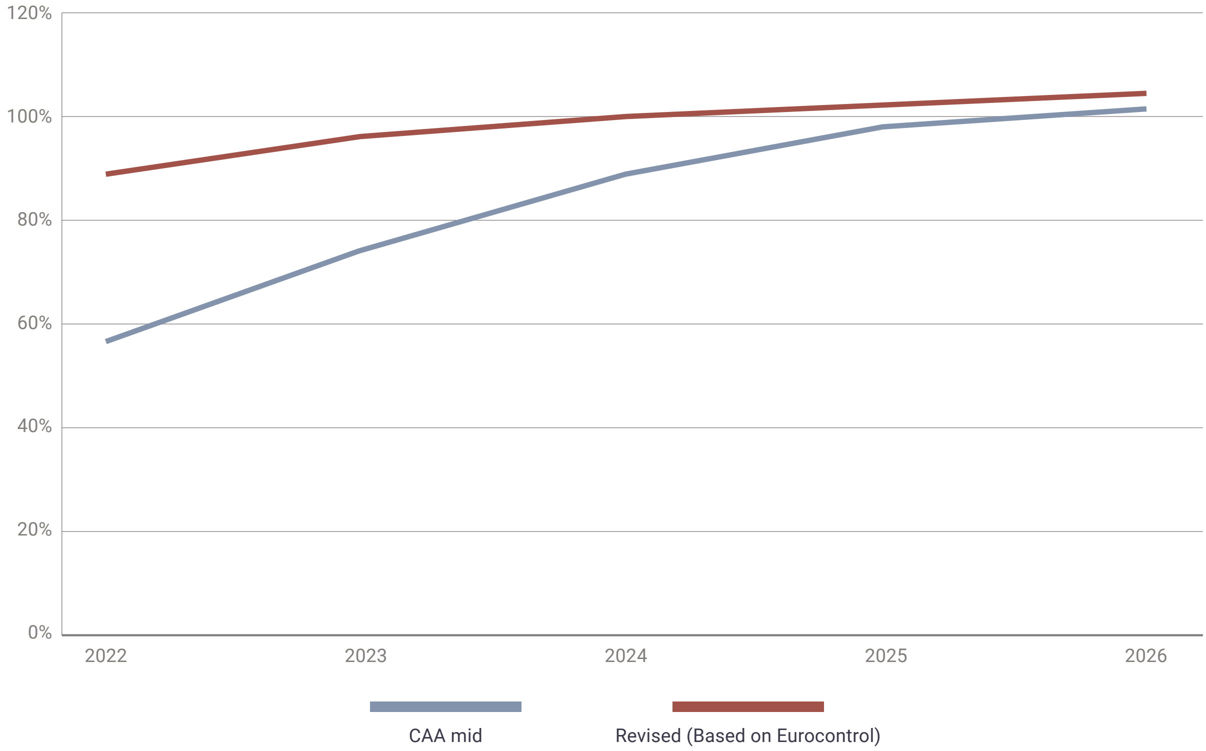
Passenger numbers

One of the most apparent challenges identified by the CAA is the uncertainty around forecasting passenger numbers as the aviation sector and wider economy recovers. Whilst a degree of uncertainty is unavoidable, based on HAL proposals, the CAA have created an extremely pessimistic forecast of passenger numbers. Even at the time, these were not in line with independent forecasts and, since then, there have been a range of significant developments, which would point toward the need to change the underlying forecast to reflect those of airlines and independent forecasters. For example:

- Covid travel restrictions have been removed across the UK and many key markets have reopened to UK travellers;
- The Government has launched a tourism strategy to encourage visitors to the UK, coinciding with the Queen's Jubilee and hosting of the Commonwealth Games; and
- Direct evidence from forward bookings show more positive movements than the original CAA forecasts suggest, and airlines are increasing capacity.

The result is forecasts from the CAA that have 2023 passenger numbers 23% lower than more recent forecasts from the independent Eurocontrol. As a practical demonstration of the issues, even with operational disruption that airlines have experienced around Easter, the vast majority of flights continue to be operated as planned; showing that both HAL's and the CAA's forecasts are unnecessarily pessimistic.

Figure 7: CAA passenger forecast levels (as proportion of 2019), compared to Eurocontrol



Source: CAA, Eurocontrol

To put this into context, the difference between the CAA and revised forecasts amount to 58 million passengers over the course of the H7 period. This means that, if the CAA went with their current forecast, but the outturn reflected the revised forecast, these mistakes in forecasts would lead to a **direct transfer of close to £200m from consumers to HAL shareholders in passenger service charge alone**, before adding income from significantly higher commercial revenues.

Whilst the Traffic Risk Sharing arrangement[49] might even out these costs in the long term, consumers will still be asked to pay for this misjudgement upfront – with potential impacts on demand and competitiveness of the UK's only hub.

At the heart of many of these issues is the regulatory system itself

The sections above have shown how proposals by HAL and failures from the CAA have led to significantly inflated proposals for charges. However, this is not just a criticism of the CAA, but of the whole approach to regulation based on RAB and WACC, which is used across a range of sectors. **There are at least four substantial problems with this approach, which at their heart mean that the operator of the asset is provided with incentives that are almost diametrically opposed to the interests of the consumer.** Each of these can clearly be seen in the actions of Heathrow and the CAA. For example, the regulatory system can:

- **Over-incentivise capital investment.** The infrastructure operator has the incentive to add as much as possible to the RAB, regardless of the actual benefits to consumers and the associated costs, as it earns a certain return on this. The regulator must therefore rigorously scrutinise any plans to invest in expensive capital to ensure it is justified. This is particularly clear in the current situation, where capital investment should be constrained. The CAA already agree that HAL's projected spending is too high, but there is no reason why it could not be reduced further. To its credit, Heathrow's results on the ACI's Airport Service Quality metric are always strong. However, the point here is that there is no evidence they need to invest significantly more when their service levels are already amongst the best. Conversely, there are significant incentives for HAL to overstate the need for investment.

- **Over-reward investors for risk they do not bear.** The calculation of the WACC makes an assumption that investors are taking some of the risk by distinguishing between debt and equity finance. However, regulators view the actual split between debt and equity finance as something for company boards and shareholders to determine. This has meant that investors can finance capital investment through lower cost debt whilst receiving the higher weighted average cost of capital. This has resulted in increased financing through lower cost debt (for example, the water sector changed from 42.5% equity finance to 30% between 2006 and 2013[50]). Heathrow is currently geared at close to 90%,[51] meaning that consumers are left to foot the bill for paying for their investment, while shareholders hold little of the risk themselves.

- **Mean that new infrastructure investment often has to be financed through "Pay-as-you-go" charges to consumers now, rather than by investors.[52]** The impact of the high level of debt undermines a key supposed benefit of the regulated model – reducing upfront costs of infrastructure investment to current consumers through investors financing infrastructure investment. The use of the RAB and WACC process results in highly indebted companies that struggle to raise the capital needed to fund necessary infrastructure projects.

- **Breed an unrealistic fear of failure.** As well as a primary duty to the consumer, the CAA are also required to consider the impact of actions on the financeability of the operator. The legislation makes it clear that the CAA must consider the financeability of the incumbent (or licensee), rather than to pay regard to the overall financeability of any potential operator of the airport. This is an important distinction as it provides an incentive for the operator to present a negative picture of financeability and for the CAA to pay significant regard to this pessimistic picture.

  In the context of a high level of debt finance, this fear is also bred by capital investment plans which may not be robust to external shocks (shocks such as a global pandemic) because debt must be repaid. In other industries, and indeed as seen by airlines through the pandemic, shareholders take on risks such as these because, in the long run, they see higher returns. **This highlights the fact that the CAA should not be protecting equity holders against the realisation of this risk (by suggesting higher charges), at the expense of passengers.**

  This is particularly true given that the CAA proposals have put forward a number of risk mitigation measures following the Covid-19 pandemic. These already amount to an insurance against such risks, paid for by passengers, meaning that if airlines also see elevated per-passenger charges, HAL shareholders are being protected twice.

- More broadly, given the profitability of Heathrow, and regulated returns into the future, it is inconceivable that even the most stringent changes to charges would lead to an issue of financeability that would mean that no operator would be willing to take on the license. However, the current legislation puts the regulator into a weak and difficult position.

The sections above highlight the real challenges with the regulatory system as it is currently set up. In the context of Heathrow, guaranteed returns for shareholders, and the complex nature of the RAB and WACC have brought significant incentives for the HAL to engage in behaviour that puts consumers at risk of significant price inflation, whilst rewarding their shareholders. On the part of the regulator, an unrealistic fear of HAL's failure has deepened the issue as it has led to the CAA placing too much emphasis on the arguments of the HAL. This comes with significant risks of undermining the competitiveness of the UK's global aviation sector and leading to lower connectivity from the UK's only hub airport.

CHAPTER 6 So what does this mean?

The potential damage to consumers and the UK economy of the CAA's current plans are clear to see. Doing anything other than reducing charges towards those proposed by independent analysis would result in direct cash transfer from passengers to HAL shareholders, while making the UK less competitive, less able to sustain global connectivity and world class UK airlines and less attractive to businesses, investors and tourists.

It should not be like this. The CAA's primary duty is to further the interests of passengers ("users of air transport services"), including a consideration of the range, availability, continuity, cost and quality of air operation services.[53] The CAA also has a Growth Duty, requiring it to consider the economic consequences of its actions.[54] Together, these duties mean that the needs of consumers, Global Britain and the Government's objectives around levelling up should clearly be put first, and certainly ahead of Heathrow's shareholders.

Currently, the primacy of the consumer and Britain's growth does not seem to be clear. Instead, the CAA's stance seems to be to minimise the small possibility of the current operator meeting financial difficulties, at the cost of consumers and Global Britain. This misplaced emphasis on financeability is actively promoted by HAL, who mischaracterise the CAA's duties repeatedly, including in its recent trading statement, which argued that the CAA "…has a duty to ensure Heathrow is financeable and this will be one of the key issues for the H7 regulatory settlement".[55]

This is not true. The CAA's primary duties are to consumers and UK growth meaning that, ultimately, the financeability of HAL while it is licensed to operate the UK's most valuable airport, should not be something that consumers are required to support.

Therefore, given the potential detriment to consumers and growth, there is a clear need to act. In the short term, the CAA should fundamentally revise its proposals for H7 and ensure that they put consumers and the UK first. In the longer-term, the approach to the H7 process, unwarranted increases in 2022 and unreasonable requests from HAL suggest that it is time to think again about the whole approach to regulation of one of the UK's most important economic assets.

Short term actions needed

It is important to highlight that there is still an opportunity to get H7 right. This would take a fundamental shift in view from the regulator, where its final proposals put forward a level of per-passenger charges that is in line with external analysis. Recommendations for how it could do this are below.

Short-term recommendations

For the CAA – its final proposals for per-passenger charges over H7 should be reduced to those suggested by external analysis. This can be achieved by:

1. ***Urgently reviewing its forecast of passenger numbers*** to ensure they reflect the most recent passenger numbers and updated forecasts produced by the industry and independent forecasters. In doing so, they must ensure that the downward bias in the figures is removed.
2. ***Listening to its own independent advice and the latest evidence from industry*** to ensure that:
    a. Accurate forecasts of commercial revenues and operating costs are taken on board;
    b. Capital expenditure is curtailed to a level that consumers of Heathrow's services think is needed and appropriate; and
    c. Calculations on the returns on investment (the WACC) are based on an accurate assessment that includes downward revisions to account for the RAB adjustment already agreed by the CAA, Traffic Risk Sharing, Asymmetric Risk Adjustment and a passenger forecast shock factor, which have all already benefited the operator.
3. ***Putting consumers first.*** Where there is uncertainty around calculations, the CAA should put consumers first. This would mean setting charges based on the lower bound of any future ranges produced. This would be directly in line with the statutory obligations of the CAA to fulfil its primary duty to consumers, whilst also paying regard to the operator's financeability.

The Government should also play a role by:

- Strongly re-emphasising the primacy of the CAA's consumer duty.
- Considering a change in the regulator's objectives to introduce a primary global competitiveness duty alongside its consumer duty.

Of course, changing the view on H7 would have financial implications for Heathrow Airport Limited. However, there are a range of ways in which these could be managed. For example:

- **Investors could inject more capital:** Heathrow has proven to be a significantly profitable operation and, ultimately, shareholders have done well out of Heathrow, with dividends totalling £4 billion being paid out since 2012, including £100 million in 2020.[56] With that in mind, if the fallout from the pandemic and future risks, coupled with a lower financial settlement in H7 present financeability concerns, investors could be asked to put more in to guarantee their long-term profits from this treasured UK asset. This is what would happen in other private sector organisations and has been the response of airlines, whose shareholders have collectively injected billions of pounds over the course of the last two years. Any injection would also work alongside the £300m RAB adjustment that has already benefited shareholders, and would reduce the need to rely on ensuring short-term financeability solely through increases in regulated charges.

- **Capital investment could be targeted more carefully:** This would reduce financing requirements now and would also reflect what customers are actually asking for. On behalf of themselves and their passengers, airlines have been consistently clear that they believe that HAL's capital investment plans are too high. Reducing these would reduce the income required and therefore the amount needed in aeronautical charges.

- **Deliver quicker rebound in passengers:** By working together with the aviation industry, HAL could seek to ensure that passenger numbers rebound much more quickly than they have forecast. Doing so would increase commercial revenues for HAL, as well as ensuring that total aeronautical charges are spread over more passengers; in effect reducing charges through two mechanisms. Given the fact that lower prices will attract more passengers, the first step in delivering on this would be to set a lower charge through the H7 period.

To do this, the Government should:

- Strongly re-emphasise the primacy of the CAA's consumer duty.

- Consider a change in the regulator's objectives to introduce a primary global competitiveness duty alongside its consumer duty.

From 2012, the airport has paid out more than £4bn of dividends…to investors including sovereign wealth funds from Singapore, Qatar and China…
The Times, 2020

Medium term actions needed

If the CAA fails to take the recommended steps and chooses to set charges that would clearly be at odds with their primary duty to the consumer, and their duty to promote UK growth, the Government should act to ensure that its objectives around Global Britain and Levelling Up are not undermined. Even if the CAA does reduce charges to an appropriate level, the process has clearly demonstrated the need for the Government to consider whether other options for the regulation of Britain's only hub airport could deliver better outcomes.

Medium-term recommendations

To ensure Heathrow works for the benefit of the UK, the Government should consider regulatory reforms that:

- ***Judge HAL proposals against a third party:*** At one end of the scale, the Government could change the legislation around the CAA's duties to make it clear that it should pay regard to the financeability of any operator at Heathrow, rather than the incumbent operator (licensee). By focussing on financeability for an operator, rather than the incumbent (licensee), the CAA would need to take views on financeability from other potential operators when setting charges. This would add an element of competitive power to the process. For example, if HAL argue that the CAA's actions put their financeability at threat, the CAA could judge this against external views of other potential operators. Should the incumbent then feel charges are unworkable, they would have the option of exiting the market, with the CAA confident that others could step in. This would, of course, require time and careful management of any changes – however, this has been managed in other regulatory environments and ensures that incumbent operators are not able to game the regulatory system by arguing that they are "too big to fail".
- ***Open up operational competition at Heathrow:*** Bolder moves could see the Government considering different regulatory options to open up competition at Heathrow. These include requiring the breaking up of the HAL monopoly at Heathrow, thereby allowing other operators to enter as service providers, such as operating terminals. This would provide incentives to increase efficiency and keep airport charges in check as terminals would be competing for airlines and their passengers. It would also have the additional benefit of ensuring no one operator of the airport is "too big to fail".

Box 2 provides examples from other markets, alongside a range of other ways in which the CAA might learn from other regulated markets.

Box 2: Regulatory alternatives

- ***Rail and the operator of last resort:*** The CAA is obviously (unduly) concerned about HAL becoming unfinanceable. However, Government and other regulators have dealt with similar situations in different ways. For example, in the rail industry the Government has been prepared to step in as a temporary "operator of last resort" if needed (e.g. Northern[57], Southeastern[58] and Connex[59]). In such circumstances services continue to run and passengers continue to travel. Without this kind of approach, there is a risk that incumbent operators are perceived as being "too big to fail", and too great a weight given to ensuring their financeability. In practice, this would be even more attractive in the Heathrow case, as it would be very likely that another operator would be willing to step in to take advantage of the very significant returns.
- ***Competition in the energy market:*** a regulated market, where operators are allowed to fail by Government and the regulator, as there has been the development of a failsafe for consumers. This means that operators are penalised for financial mismanagement and / or overstating their capacity, whilst consumers are protected.
- ***Water and equity funding:*** The financing of the Thames Tideway tunnel illustrated the dangers of utility companies with high levels of debt. In 2006 Macquarie Group purchased Thames Water, which resulted in a fundamental change in the company's business model with long-term company debt increasing from £1.6 billion in 2005 to £10 billion. Dividend payments to shareholders continued, totalling £1.9 billion (Plimmer, 2016).[60] This strategy meant that by 2010 it was clear the company no longer had the reserves of capital to be able to construct the Thames Tideway tunnel, a major project (now estimated to cost £3.8bn[61]) developed to reduce the instance of storm water and sewage discharges into the River Thames. Sir Ian Byatt, the former director general of Ofwat, argued that Thames Water's reluctance to finance the tunnel itself arose from its strategy to increase its borrowing and pay substantial dividends to its owners.[62] As Thames Water could not fund the project, an independent infrastructure provider, Bazalgette Tunnel Ltd, was established to allow equity investment directly in the project.[63] Annual bill increases for directly funding the project from customer bills were initially estimated to be £70–80; however, the financing mechanisms put in place have reduced average increases to roughly £20–25 per annum.[64]

Conclusion

This report has shown the clear importance of Heathrow to people, businesses and places right across the UK. Connectivity from the UK's only hub airport needs to be central to the UK's collective ambitions around Global Britain and levelling up and, more generally, to our ambitions to ensure that the post-Covid economy is stronger, fairer and more resilient than it was before.

However, with HAL proposing an increase in charges of 117% and the CAA allowing charges to already rise by more than 50% in 2022 (with the threat of a further increase to 75%), the competitiveness of a key UK asset and the UK's global aviation industry is fundamentally undermined. This report shows the very high degree of uncertainty around some of the key elements of HAL's proposals and the risk of the CAA's approach to calculating an appropriate level of charges. Unsurprisingly, opinions differ between HAL, independent analysts and the airlines that use Heathrow.

It is the CAA's job to come to an unbiased, independent and robust assessment. However, its conclusions to date seem to be designed to protect the interests of HAL shareholders, providing a £5bn transfer from consumers and putting shareholder interests above Global Britain. We have outlined key steps that the CAA should take to rectify its existing conclusions. We also believe that the Government must act to protect the critical national asset that Heathrow represents as the UK's only hub airport and gateway to the world.

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