

Our ref: 0012/LPD/TT/L

5th June 2020

Dame Deirdre Hutton
Chair
Civil Aviation Authority
11 Westferry Circus
Canary Wharf
London, E14 4HD

Dear Deirdre,

In fulfilling its duty to consumers of airport services at Heathrow, the CAA aims for Heathrow Airport to have rational economic incentives to make the right long-term decisions. Heathrow is expected to act in a prudent commercial way as a private firm where our choices are powerfully shaped by your regulation. Successful regulation in terms of your primary and secondary duties is when Heathrow's incentives align with long-term consumer, airline and national interests.

As you know, aviation is experiencing unprecedented challenges in the Covid-19 pandemic. Closed borders, quarantines and locked-down societies have meant passenger numbers falling by 95% for an extended period, with no certainty of how and when they will recover. As you also know, Heathrow is fully financially exposed to passenger numbers so that our revenue is also down over 90%. Our costs are unfortunately more fixed. The business shock is huge, far beyond what we have seen even in previous extreme events such as 9/11 or the global financial crisis.

Our immediate priorities have been safety, staying open for vital cargo and repatriations and ensuring liquidity and business survival. We have acted fast and radically, for example by:

- Consolidating our operations to a single runway and limited areas of two terminals.
- Cutting costs by over a third already including by furloughing nearly 4,000 colleagues, making 500 redundancies so far, making pay cuts of 10-25% across all colleagues, reviewing every single contract and cutting all discretionary spend to zero.
- Reducing our 2020 capital plan by two thirds to the minimum for safety and compliance.
- Accessing all possible sources of immediate liquidity, amounting to over £3 billion, stopping dividends and engaging financial markets closely on our financeability.

The extreme business pressures that Heathrow now faces are placing us in a position where we may have urgently to take short-term decisions that could be against the long-term interests of consumers. The impact of Covid-19 is the most recent and significant example of the unsustainable balance of risk and reward in Heathrow's regulatory settlement, where the airport has not covered its cost of capital for 20 years. Asymmetry of risk underlies this – where Heathrow has unlimited downside exposure but limited upside, in contrast to airlines for example who can hope to capture the full upside of recoveries. This imbalance doesn't just affect Heathrow as a business, it will impact

our passengers by limiting our ability to secure the timely and appropriate enhancement and development of Heathrow and to ensure that we can do this economically and efficiently¹.

For consumers, our financial reality means that we may be unable to return suspended capacity in a timely way with the level of service and resilience that users will need in recovery. It also makes it very difficult to pursue future new capacity. It may limit our ability to adapt quickly and at scale to new post-Covid requirements for safe flying. Consumers will also lose out on savings from efficiency investments that are neither financeable nor economically rational under these conditions. Our ability to invest, as consumers tell us they want us to do, in sustainability and technology that improves the passenger experience is also likely to be compromised.

Airlines too are under huge financial pressure. They will want Heathrow to take a long-term view of supporting them commercially in recovery, which we will not be able to do to the extent we ourselves lack a viable regulatory settlement in the short and long-term. Our ability to invest in automation to reduce airline costs and introduce the measures necessary in a post-Covid world is significantly constrained. Without a viable financial framework, we may also not be able to reintroduce the resilient airport capacity needed to meet airline demand.

Financeability is an important CAA duty for both debt and equity finance. Investor perceptions of Heathrow risk are increasing. Ratings agencies have begun to downgrade Heathrow's debt. Bond spreads have increased by 0.7%, or around 70-140 basis points, compared to other corporate debt, and listed airport asset betas have increased by around 0.3 since the CMA analysis for NERL. Together, these represent an increase to Heathrow's WACC of around 3.0%. Moreover, short-term movements do not fully capture the imbalanced risk-adjusted returns as shareholders are disproportionately impacted after debt is fully serviced, harming confidence and appetite to invest. Consumers ultimately pay for restricted access to finance and higher financing costs.

Heathrow's unsustainable current settlement also has wider impacts for the UK. We are at risk of being forced to make large numbers of skilled people redundant, impacting local communities and harming the aviation skill base. Our capacity to invest could be permanently reduced, harming the wider supply chain. Above all we will be less able to fulfil and enhance our role for the UK economy from cargo exports to supporting recovery in business, tourism and other services.

We believe that the key to unlocking the right long-term decisions in the interests of consumers and airlines is to reopen the current price control to recalibrate Heathrow's incentives. Your Q6 decision states that Heathrow's price control could be reopened through Section 22 of the Civil Aviation Act 2012 if required as a result of exceptional circumstances². If these are not exceptional circumstances, then what are? My Board is therefore requesting that reopening.

¹ Heathrow Licence Condition B3.1

² In its Q6 Initial Proposals, the CAA asked for stakeholder feedback on whether a specific reopener provision should be included in Heathrow's Licence and the form it should take. In its Final Proposals, rather than an automatic trigger or risk sharing mechanisms as implemented by other regulators in the UK and Europe, the CAA instead decided to use the mechanism under Section 22 of CAA 2012, stating: *'The CAA therefore intends to rely on the modification mechanism in section 22 of the Act to make any necessary changes during the period covered by the price control. Any party materially affected by a price control could request that the CAA uses its powers under section 22 to modify the licence in such circumstances and the CAA will consider each request on its merits'*

In coming to this decision, we have considered the impact of the current situation on our passengers, on our ability to meet our Licence obligations, and on the CAA's obligation to meet its statutory duties. It is clear that reopening the price control has become necessary for the CAA to carry out its primary duty to the users of air transport services:

'The CAA must carry out its functions in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services'³

We are not asking for special favours, any public money or a bailout. We understand the strains other companies in aviation are facing. We are not asking for unsustainable increases in airport charges in 2020 or 2021. We are simply requesting the process the CAA designed in the Q6 settlement to address exceptional circumstances with a long-term solution. iH7 regulation issues need to be addressed to allow the private sector to develop the pragmatic solutions which will be necessary to get the industry back on its feet.

We would therefore ask that your Board carefully consider our request. It is in the interests of both consumers and the UK economy as a whole to ensure that we have a strong aviation sector with a strong hub airport to support our recovery from this economic and social shock.

We will separately set out more details of our request and potential mechanisms for a reopener to your Chief Executive. We also seek discussions on how we can urgently move to implementation as delay is not in the interests of consumers or other stakeholders.

As always, I am available to further discuss this request with you and your Board.

Yours sincerely,



Lord Paul Deighton
Chairman

³ <http://www.legislation.gov.uk/ukpga/2012/19/section/1/enacted>