Consumers and Markets Group

Civil Aviation Authority

Jamie Hobbs
Chair
Airport Consultative Committee
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23 December 2020

Dear Jamie

Economic regulation of Gatwick Airport Limited: Consultation on new commitments

I am writing in response to the ACC's request, repeated in several individual airline responses, that the CAA shares with the airline community the analysis that supports its conclusion that it is in consumers' interests to accept GAL's proposals.

As a general point, I would stress that the CAA had regard to a wide range of different sources of information, and that our view is formed based on what we consider will further our statutory duties. The range of sources of information includes (among others):

- the arguments and evidence accompanying GAL's proposal;
- our own analysis of GAL's current and possible future performance;
- comparisons with the performance of other UK airports (both regulated and unregulated); and
- reports by financial analysts and ratings agencies.

I would also note that we have regard to the potential broader strategic benefits of a regulatory framework that promotes and facilitates bilateral contracting between the airport and airlines, which help to allow requirements to be better tailored to each parties' interests. Reflecting the wider strategic value in a lighter touch regulatory framework means that it is not necessarily intended to replicate the outcome of a full RAB-based building blocks approach.

The appendix to this letter provides some examples of our internal analysis of GAL's possible future performance, which we reviewed alongside the other sources of evidence. This analysis is based almost entirely on public information,[1] and has not been discussed with either GAL or other stakeholders. We are providing these examples to assist your understanding of the situation. We recognise that individual assumptions could be debated, particularly in the current circumstances that create a particularly high level of uncertainty about future developments. The projections are intended to be useful and illustrative, rather than a firm set of predictions.

The effects of Covid-19, including both the very large reduction in passenger numbers and the potential enduring macroeconomic impacts even if vaccines or other developments

[1] The main exception is GAL's shadow RAB, which GAL calculates every year and supplies to the CAA. We used this to calculate regulatory depreciation.

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reduce the severity of the pandemic sometime next year, have strongly influenced our approach to the current review. It seems clear that GAL is likely to face a further particularly difficult year financially next year, and very possibly the following year too. Since the next regulatory period is only four years long, the chances of GAL earning what might be regarded as excessively high profits over the period as a whole are much less likely than might have been the case prior to the current crisis. And there are plausible scenarios that would see GAL's profits remaining at a relatively low level throughout the whole period.

I hope this information is helpful. We would be happy to discuss this, and other aspects of your consultation response, further if that would be useful.

I am copying this letter and the appendix to Lorenzo Rebel, so that GAL is aware of the information that we are now sharing with you.

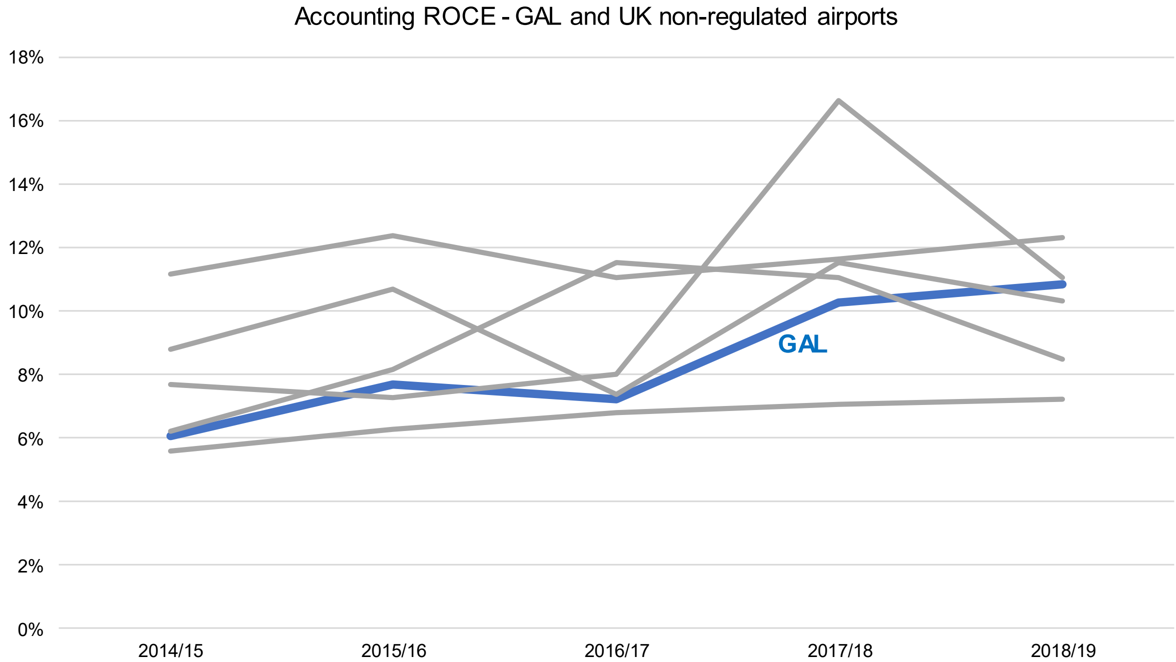
Yours sincerely

Stuart Holder
Head of Economic Analysis

Appendix

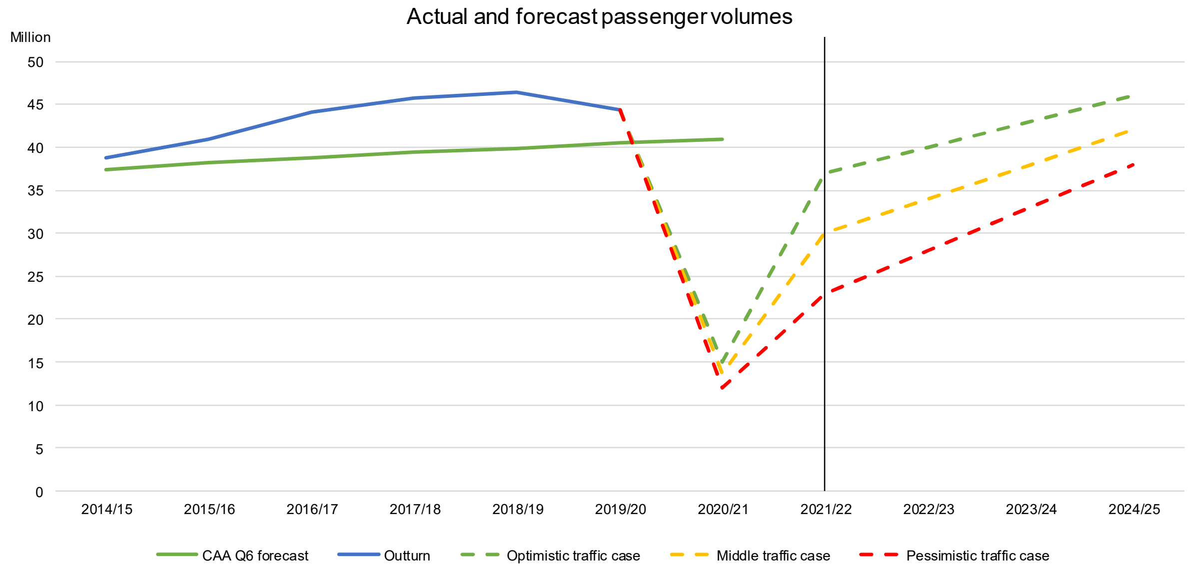
The charts below show examples of the CAA's internal analysis to assess the potential impact of different traffic scenarios on GAL's profitability. The analysis was completed in August 2020, but we believe that the results for the four years of the next regulatory period (2021/2 to 2024/5) remain broadly relevant.

To provide some context for our assessment of GAL's current and future performance, we had regard to several different analyses. One of these was an initial comparison of GAL's recent accounting returns (and other aspects of its performance) with those of large UK airports that are not subject to economic regulation. We recognise that such comparisons may be affected by many different factors,[2] so we looked at a number of different indicators and treated the results with strong caution. The chart below shows one example, in this case a comparison of return on capital employed (ROCE) with those airports for which we considered the data to be broadly comparable.



For our forward-looking analysis we used a number of illustrative traffic scenarios, some of which are shown in the chart below. Although the outlook for the current financial year (2020/21) has deteriorated significantly since we carried out this analysis, we note that the traffic levels shown for 2021/22 are similar to those used by GAL recently alongside its annual airport charges consultation (though we note this was before the new variant of Covid-19 became widespread in the UK).

[2] These include differences in accounting practices and one-off changes, such as an increase in current liabilities which boosted the results for one particular airport in 2017/18.

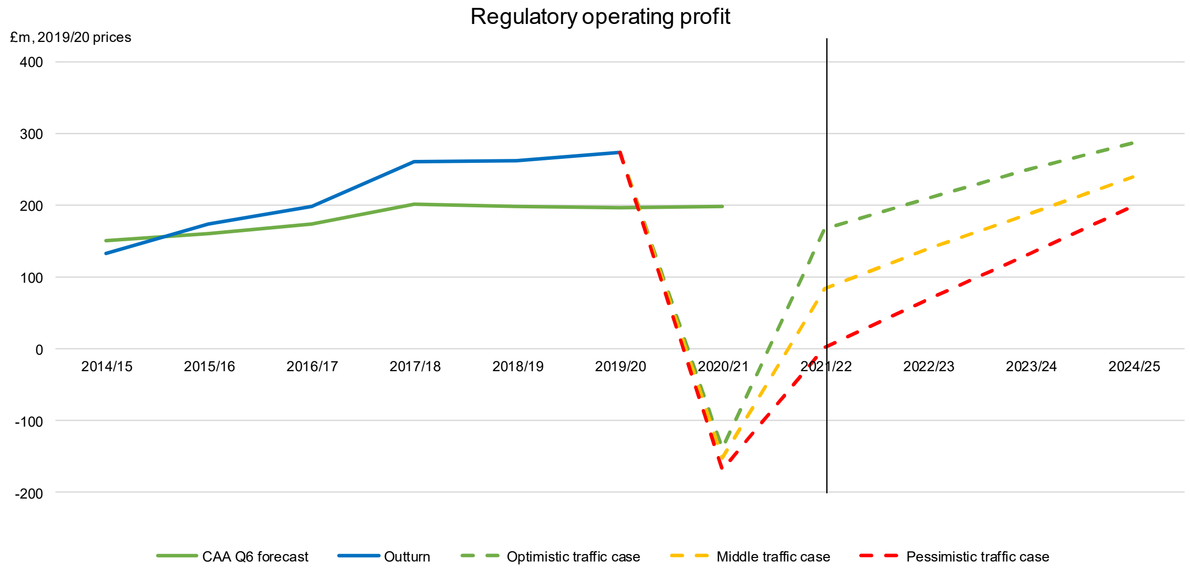


To estimate the impact of these different traffic scenarios on GAL's profitability, we needed to adopt a number of detailed assumptions. These were informed by CAA's forecasts for and GAL's performance during the current regulatory period, and also calibrated against information provided by GAL (for example in recent investor presentations and calls). The intention was to provide a plausible set of overall projections, rather than a reliable forecast of each individual element that contributes to GAL's profitability. The main assumptions we used included the following:

- GAL sets airport charges at the cap each year,[3] and maintains average discounts at the 2019/20 level of 9%;
- retail and car parking revenues per passenger fall by 1% a year in real terms,[4] while other non-regulated revenues remain constant in real terms;
- in a 'normal' environment (with traffic growth of around 3% a year) real opex per passenger would decline by 3% a year. The impact of traffic changes on opex was then modelled by assuming a traffic elasticity of 0.5;
- capex in the optimistic case is based on GAL figures (from its August 2020 investor presentation and call), and in the pessimistic case is the minimum required to comply with GAL's investment commitment. This has only a very small impact on the profitability projections (through regulatory depreciation, which is assumed to be 6% of the shadow RAB in each year).

Applying these assumptions and the traffic scenarios shown above generates the projections of regulatory operating profit[5] shown in the chart below.

[3] This assumption now appears optimistic, as GAL is proposing to set charges 5% below the cap in 2021/22.
[4] Our analysis was completed before GAL's announcement of a proposed £5 charge for vehicles using the forecourt to drop off passengers directly outside its terminals.
[5] This is the same as accounting operating profit, except that regulatory depreciation is used instead of accounting depreciation.



The above examples illustrate the CAA analysis that, alongside other sources of information and evidence, informed our view of GAL's proposed commitments following the impact of Covid-19. We examined other scenarios and the impact of changing some of the assumptions listed above, but these did not significantly change the overall picture.

It is important to note that these projections show only the impact of lower traffic volumes. They do not reflect the impact of further risks that GAL may face following the impact of Covid-19, such as:

- a need to offer airlines increased discounts in order to attract and retain business as airlines look to re-establish routes and while capacity is potentially available at a number of different airports;
- a failure to retain the benefit of recent opex savings as traffic levels build up again; or
- a significant decline in commercial revenues per passenger, for example reflecting changes in passengers' willingness to visit shops and food and beverage outlets while Covid-19 is still a potential risk, or the impact of changes to UK tax free rules.