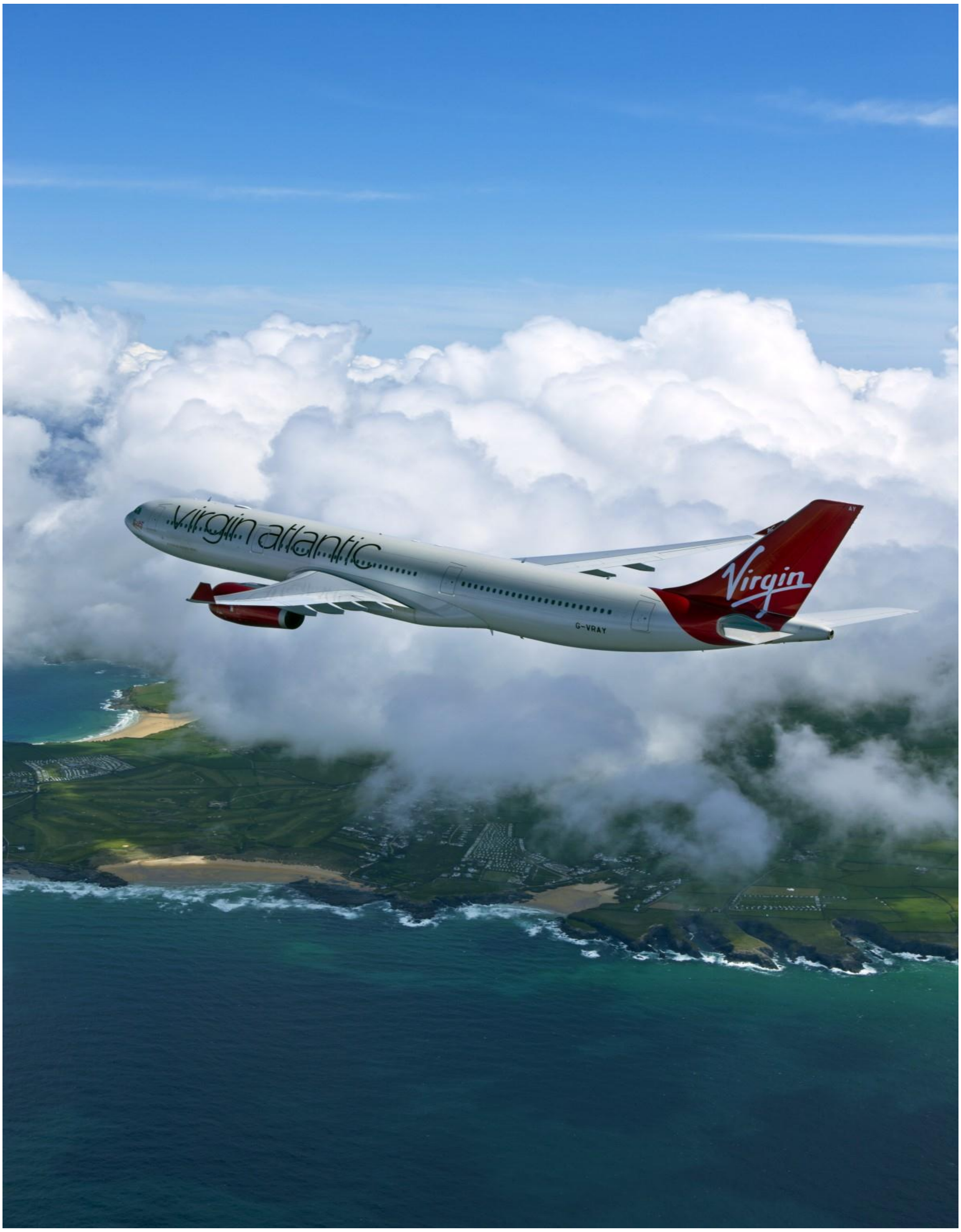
Virgin Atlantic response the CAA's initial price settlement



virgin atlantic

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Introduction

Since it was founded in 1984, VAA has become Britain's second largest long-haul carrier and operates 10 per cent of all long haul slots at Heathrow; serving the world's major cities. From its inception, VAA's aim has been to provide high quality, innovative services offering exceptional levels of customer service and value for money for all classes of traveller.

Virgin Atlantic welcomes the assessment published in the CAA's initial position, and has worked with the airline communities at Heathrow and Gatwick to provide a detailed, evidence based assessment of these proposals. Whilst there are a number of areas where airlines are aligned with the CAA's thinking, VAA believes the initial proposals from the CAA do not go far enough to address the significant operating cost inefficiencies identified both by airlines and the CAA's consultants.

VAA is totally committed to improving the customer experience at our airports. However, we have long argued, in substantial evidence to the CAA, that this is fully achievable with a significant reduction in charges - in the current climate most organisations across the public and private sectors are having to deliver the same level of service more efficiently and the CAA should not protect airports from this economic reality.

VAA recently released its financial results, in 2012/13 the airline made a loss of £93m despite higher loads factors and continuing to grow revenue year on year. There is a clear plan to return to profitability, essential to this - especially in the immediate term - is a continuing strict control on costs. We expect all of our suppliers to focus on efficient delivery for our customers with the same intensity as we do. Airlines have identified significant scope for efficiency gains in HAL and GAL, and we believe the CAA must address these.

Clear, credible and evidence based airline community positions have emerged. This document supports these community positions as well as highlighting VAA priorities for Q6. VAA looks forward to further discussions with both the airports and the CAA in 2013 to ensure that regulation delivers airport services and investment that our passengers value.

Heathrow

This section sets out VAA's views on the CAA's initial proposals to reach an affordable, passenger-focussed settlement at LHR, which addresses equivalence and enhances competition between airlines.

VAA believed the proposed price put forward by HAL in their business plan was entirely unrealistic and too high. Therefore, VAA, along with the rest of the airline community provided a substantial amount of evidence to the CAA for its initial proposals which outlined both the extent of the efficiency savings that existed and how these could be achieved in a sustainable manner by HAL over the Q6 period. However we believe the proposals put forward by the CAA will only compound the huge increases of recent years with prices at Heathrow already triple the level they were ten years ago. Under the CAA's proposals, the amount of charges paid by passengers over Q6 will increase by around £600m, taking Heathrow's charges even further out of line against its comparators.

This submission therefore makes the case for further savings over and above those outlined by the CAA in their proposals and the ways in which these could be achieved by HAL over the next regulatory period. ✂

VAA is committed to improving our passengers' experience and continues to believe that airlines are best placed to represent passengers' interests throughout the regulatory process. Our approach to Q6 has therefore been driven by the needs of our passengers and ensuring that service levels and proposed capital projects deliver these outcomes. It is also important to remember that investment is not the only route to improved passenger experience. Airlines have showed evidence to the CAA about how passenger experience can be improved by driving change through operational processes. These can also be done at the same time as becoming more efficient. In the current economic climate organisations are having to deliver the same or increased levels of service more efficiently - airports should not be exempt from this.

This submission also supports the comments and response to the other regulatory building blocks put forward by the LACC. As well as substantial further opex savings, this includes:

- A higher traffic forecast than that used by the CAA, taking out the shock methodology which we see as a double counting of risk;
- A capital plan of up to £3bn, covering improved resilience and key passenger priorities across all terminals;
- A correction of the over generous WACC to one that is more balanced in terms of the risks faced by the airport; and,
- A commercial revenue forecast that drives commercial behaviour by HAL.

Finally, we have been shocked by the reaction of HAL to the CAA's proposals. Our view, as set out in this submission, is that not only does the CAA's proposal offer a generous return to HAL's shareholders but that significant further efficiency savings are fundamentally necessary over Q6. ✂

Traffic forecasts

VAA welcomes the CAA's Initial Proposals on passenger forecasts. However, this section outlines a number of areas where we agree with the LACC that the CAA should have taken a different view. This is particularly in relation to:

1. the inclusion of adverse demand shocks and the use of asymmetric variables;
2. the nature and scale of shocks;
3. the use of the capacity model.

1. Adverse demand shocks and the use of asymmetric variables

VAA supports the work done by the Heathrow Airline community that the CAA has not made the case for changing the way in which it accounts for demand risk. We also believe that there is a strong risk of double counting this risk, together with the risk arising from truncation, and so do not support the CAA's proposals in this regard.

In the Q5 settlement, both the CAA and the Competition Commission made a specific adjustment to the asset beta to account for volume risk, which was then re-levered to calculate the equity beta. The CC in its advice also recommended that the CAA should not include any term to account for the divergence between actual and forecast traffic volumes.

The airline community believes that the CAA has not provided any evidence or rationale as to why it should depart from the accepted way of dealing with volume risk. In addition, the CAA itself recognises that the inclusion of the adverse demand shock term in the passenger forecasts should reduce risk in the equity beta. It is therefore curious that the CAA also concludes that there has been no material change in HAL's equity beta since it was set in Q5. This seems odd given the significant volume adjustment made to the forecasts, and given that the CAA has made no comment on any features that would present a countervailing upward pressure on the HAL beta.

VAA therefore believe that the CAA's current proposals double count the issue of volume risk and are, therefore, not in the passengers interests. We would also like to have further discussions with the CAA on the inclusion of truncations to the economic variables in the forecast.

2. The nature and scale of shocks

VAA does not accept that an adverse shock generator should be included in the passenger forecast. However, we thought it would still be helpful to respond to the points in the CAA's initial proposals on the nature and scale of any such shocks.

One of the problems with any calculation of adverse demand shocks is the effect of the time period chosen, and the arbitrary selection of any period. The airline community agrees with the CAA that as the airport is not full, then a longer time period than that chosen by HAL would seem appropriate. However, the selection of 1991 by the CAA would in itself seem arbitrary and add a significant negative bias to scale of the shocks.

Furthermore, we believe the CAA has indicated that it recognises that shocks can be separated into those 'large' shocks which occur rarely, and over which the airport operator has little control, and the smaller shocks whose magnitude can be influenced by the operator's response to the shock. The airlines believe that the former category of shock is the only type which should ever be considered a passenger risk. It does not appear that this type of risk has become more common or more severe since 2001 when the airport became 'constrained'.

Furthermore, the response to any shock needs to be considered. Arguably the response to any shock will depend on the time period chosen. N. Njegovan (2006) performed a statistical analysis of UK air passenger volumes over a 50-year period, concluding that the large shocks in demand over this period did not satisfy the unit-root condition. His analysis indicates that all of the shock events were followed by a recovery in demand within a two to three year period, indicating that shocks to air travel are likely to experience significant 'recapture' of lost demand within a five year period. Although Heathrow will be more constrained in Q6 than the UK aviation market has been since 1960, we believe that the frequency and magnitude of shocks which might be included in passenger forecasts are not dependent on capacity constraints. It therefore follows that the likelihood of almost complete 'recapture' from such shocks is high – VAA believes this further undermines their inclusion in the forecast.

Moreover, the CAA has provided no rationale as to why the airlines should cover these risks themselves, and then cover all of HAL's risks too. This is especially true if the airport's response is not optimal, as the traffic response to an incident can therefore be larger than would otherwise be the case. Requiring the airlines to pay for the airport's inefficient response would not set an incentive for the airport to be more efficient, and would seem to run counter to the CAA's statutory duties. Consequently, the airlines believe that in this regard only passenger volumes lost from an efficient airport operator response should be considered.

3. The Use of the Capacity Model

The airline community has followed the development of both the econometric model and the capacity model. We believe, given the inherent uncertainty involved in forecasting, that adopting multiple techniques should give a better triangulation on forecast volumes for Q6. However, where the models disagree, we believe that the CAA should give preference to the capacity model as that is based on airlines actual plans, strategies and aircraft orders. This is especially true in the short –term.

VAA notes that this approach has been used by GAL and the CAA at Gatwick where airlines have even provided forecasts to the CAA to ensure the robustness of the assumptions taken. VAA considers it appropriate that the same short-term methodology is used at both airports and therefore that the CAA use a bottom-up, capacity based forecast for the first three years at Heathrow.

Finally, Heathrow appears to have been achieving strong traffic growth in recent months[1] so the CAA should ensure that its base year forecast remains appropriate ahead of its October proposals.

[1] http://mediacentre.heathrowairport.com/Press-releases/Heathrow-traffic-and-business-commentary-May-2013-58a.aspx

Operating costs

VAA is disappointed with the efficiency savings proposed for HAL in the CAA's initial proposals. ✂ VAA believes that the CAA have ignored the striking areas for improvement. The CAA has a statutory obligation to ensure that regulated airports operate efficiently and effectively.

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However, the airlines have continually outlined, in this and previous evidence submitted, the extent of the efficiency savings that exist and how these could be achieved in a sustainable manner by HAL over the Q6 period; substantial areas of these savings have been overlooked. This submission therefore makes the case for further savings than those outlined by the CAA in their proposals and the ways in which these could be achieved by HAL over the next regulatory period.

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The rest of this section focuses on individual opex lines within HAL's business and the CAA's initial proposals[2].

Security

Security opex represents a significant cost at Heathrow which should drive an extraordinary increased focus to manage and maintain the cost base.

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VAA believe the CAA's initial proposals have not dealt with this issue

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These savings exclude on-going efficiency initiatives which should be sought on a year to year basis to manage cost, as in any efficiently run business.

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[2] The opex targets set out by Virgin for maintenance, frontier shift, other opex and pensions have been calculated in reference to the CAA's IP analysis issued to Virgin.

Other opex savings

The rest of this section outlines savings from areas other than security.

Frontier Shift

HAL, the CAA and the airlines are more or less in agreement in relation to the frontier shift in efficiency savings over Q6, with a target of between 0.87% and 1.0%.

However, VAA and the airline community believe that this efficiency should be the target once the re-baseline of opex cost has been implemented, therefore once all the savings worked through have been implemented i.e. once the operation is efficient.

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Pensions

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Maintenance Costs

The CAA have set a target of £28m over Q6, which is short of the benchmarks identified by its own independent consultancy studies. If the gap to the benchmark was closed by 50%, this would provide a target of £90m over Q6 (with a glide path) as proposed by the CAA consultant studies. However a target of closing 100% of the gap should be set on HAL as they are already achieving savings on projects to this degree e.g. baggage maintenance. It is clearly a realistic and achievable target.

T1 Accelerated Closure

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T2 - Opening

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Other Opex Costs

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Central Support/Service Costs

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Salary and Staff Turnover

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Summary

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This is clearly not in the passengers interest and has not been addressed fully by the CAA's initial proposals. Moreover, the CAA has commissioned a number of studies by experts on targeted Heathrow cost bases.

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Commercial Revenue

VAA supports the position set out by the LACC.

WACC

VAA welcomes the assessment of the cost of capital presented by the CAA in its initial proposals, and recognises the importance of this calculation to the overall price cap in Q6. A cost of capital which is too high would lead HAL to make significant windfall gains.

In the limited time available to respond to the CAA's initial proposals, VAA was unable to commission any external advice on the cost of capital. However, we have used relevant experts within the business to assess the work put forward by PwC and the CEPA paper previously submitted to the CAA, which are both judged to be robust pieces of analysis.

We note that further detailed evidence will be submitted to the CAA by the LACC and by BA and therefore wish to make a few high-level comments.

VAA agrees with the CAA that there are strong arguments that Heathrow's cost of capital has reduced over the last five years. This recognises the fall in returns seen in global markets (which for example have led to pension funds being required to forecast lower returns); the significant falls in interest rates; and the reduction in corporate tax rates.

The final cost of capital for Heathrow is built up from a series of estimates of the individual elements of the cost of capital calculation. The CAA has used PwC's estimates of the potential numerical ranges of each of these elements to determine a point estimate for each element, which are then used to determine the final cost of capital.

In doing this, the CAA has used point estimates from the top quartile of PwC's recommended ranges, on the basis that it mitigates the risk that Heathrow will underinvest or reduce service quality. However, VAA believes that the CAA's approach will not mitigate these risks, and instead will simply create windfall profits for HAL. We therefore disagree with the CAA's approach to determining the point estimate.

Capital

The exact amount of capital that is affordable and desirable in Q6 will depend on both the strength of the overall business cases presented and, moreover, as the LACC has previously set out, on the overall affordability of the price path presented by the CAA. It is critical that any capital plan also enhances airline competition by ensuring access to equivalent airline facilities.

VAA maintains that driving equivalence between terminals is crucial and should be the driver to prioritise terminal investment based on airline priorities. VAA has therefore been an active participant in supporting T3 projects in the airlines' prioritised plan, ✂ . Within a settlement that delivers value for money for our passengers by reducing charges in Q6, VAA's top priority is to address the in-equivalence our customers face in terms of passenger and operational facilities at Heathrow airport, our main base.

T3 Q6 Investment

VAA continue to support the LACC's position on T3 Q6 investment. Passenger experience issues remain despite some improvement and VAA's investment in our dedicated, bespoke facilities, partly to compensate for historically poor facilities and customer experience, especially relative to T5.

Q6 may be the last realistic opportunity to invest and make a step change in T3 infrastructure, in light of HAL's master planning assumption that T3 will close in 2030 (subject to affordability). VAA supports the airline community and believes strongly that T3 projects deserve funding and investment to support the passenger experience, to address the existing in-equivalence between terminals, and ensure there is an acceptable level of basic infrastructure in place to support T3 operations for the next 20 years.

In particular, VAA support:

- Passenger technology –Self-bag drop developments are advancing at pace, and are likely to be become common-place at other airports in the Q6 period, to support fast and efficient check-in for passengers, efficient use of infrastructure, and operational efficiency. While the scope of this project needs to be fully determined, as a minimum we would like to trial bag drop technology and continue to work towards improvements in passenger technology as the market and products develop.

- Arrivals improvements - Improvements to the ambience/first impressions and ease of wayfinding are supported. Common sense dictates that improved lines of sight and ease of onward connection justifies this area of investment, and for an appropriate "welcome to London". Terminal equivalence should be aspired to in terms of customer ease of use and "last impressions".

- Facades – South Wing Offices, and T3 Main Façade - improved “first impressions” through cost-effective investment in cladding the rear and end of South Wing is strongly recommended, to prevent T3’s image as a poor cousin and inferior to the shiny new T2 and T5. This also applies to a cost effective make-over of the front of the building, as it is important that T3 holds its own as a key part of LHR for at least the next 20 years.

- Pre-conditioned air and FEGP on Pier 7 - Operational competitive equivalence in terms of efficiency

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Form of regulation and other regulatory issues

In this chapter we set out our views on the CAA's proposed approach to regulatory issues outside the price cap, form of regulation and licence.

Form of regulation

VAA agrees with the CAA that, given the extent of HAL's market power, single till regulation, based on a building block, RAB based approach remains the most appropriate way to regulate HAL for Q6.

Service Quality

VAA supports the work carried out by the LACC.

Capex efficiency

VAA would like to acknowledge the CAA's initial proposal, that supports many of the principles and mechanisms jointly agreed between airlines and HAL through the Constructive Engagement process, consolidated within the Capex Efficiency handbook. This improved approach to capex efficiency, building on Q5, should ensure more effective project controls and assurance is applied, to incentivise the delivery of project benefits on time, to cost and quality.

VAA fully support the LACC's submission, so we will focus on restating a few key supplementary points as follows:

- Core and development – on the basis that airline priorities form part of a balanced and agreed HAL programme
- IFS - with the need to have these experts in place before the end of the year, as they should also add value in reviewing the suite of integrated parameters that make-up the capex programme, currently drafted in the capex efficiency handbook and new gateway process - which the airlines have not been consulted on as a result of HAL's disengagement.
- Effective incentives such as the Capital trigger mechanism to support delivery of customer benefits-with enhanced project definitions, and without the unnecessary 3 month trigger lag. This aligns with the need to ensure timely delivery of airline priorities
- Effective Governance to ensure there are effective processes in place to ensure HAL accountability to its customers (both passengers and airlines), financial control, and change management. Airlines would also wish to restate the need for monthly reports from the IFS, and an onus on clear and open dialogue between airlines and HAL, to managing effectively risks that should be far more transparent at an earlier stage.

Airlines wish to emphasize to the CAA that Capex Efficiency mechanisms reflected in the Capex Handbook are not designed to operate independently – their effectiveness depends on an integrated approach to project management and delivery.

In practice, airlines and our passengers demand that there are effective assurance and incentive processes in place, to ensure that only projects we are prepared to pay for, and that meet specific criteria, are supported and that projects are delivered on time, to cost, quality and scope.

Finally, airlines wish to highlight the important dependence upon Governance – it is essential that airlines are able to equitably govern the development and delivery of capex projects from inception to completion, so as to deliver value for money for airlines' customers, our passengers.

On the key outstanding issues from the CAA's perspective - the question of whether the FAB reviews proposed additions and changes to Q6 investment or whether the FAB approves proposed additions and changes, airlines are keen to avoid an unnecessary administrative burden on the CAA, airlines, or HAL. The second option the CAA propose, to require HAL to obtain airline sign-off for projects, costings and triggers in advance of the work being carried out, is essential for airlines and common practice between supplier (HAL) and customer (airlines). While the definition of airline sign-off needs to be well defined, this approach would ensure effective and appropriate customer involvement in projects. CAA involvement in this example would be mainly as a regulatory backstop.

An effective project gateway process is an essential part of any capital assurance process. HAL have yet to consult with the airlines on their new gateway manual and how it best aligns with our 360degree reviews and integrated sign-off's, and we would request the CAA's support to ensure this forms an integral part of the Governance process.

HAL Inflation and Acquisition Strategy

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Independent Fund Surveyor

The notion of the IFS was an airline concept, where assurance on the use of capex could be best monitored by project focussed independent experts, assisting, by objective reporting, to the airport, airlines and the CAA.

VAA are concerned that HAL is attempting to reduce the funding and scope of the IFS, and therefore its effectiveness to assure airlines and the CAA that value for money is being delivered.

The IFS function is a critical and integral element of the overall Capex Efficiency Handbook, and should not be undermined by stealth.

Capital Triggers

Airlines continue to strongly support the requirement for capital triggers, to incentivise the realisation of project benefits on time, to cost, quality and scope. Further detail regarding some specific principles, following joint discussion with HAL, are outlined in the LACC's submission.

VAA and airlines are concerned that unless there is a programme of jointly agreed triggers with HAL, agreed through the summer of 2013, this will result in limited accountability for HAL against Q6 projects and programmes. We therefore would urge the CAA to proactively support these discussions, recognising a defined capital plan, an associated programme and a focus on airline priorities is required. We are concerned that Draft Triggers definitions should by now be tabled and under discussion.

VAA & airlines have reiterated on a number occasions our focus on positively supporting the delivery of projects, and the associated beneficial use – this is no different with capex incentives. VAA would urge the CAA to recognize the impact of non-delivery on our businesses, as well as our passengers. The consequential impact on airlines of HAL's failure to deliver can be extremely significant, reflected for instance in airline opex, or a lack of competitive equivalence between terminals. While beneficial use of an asset is the objective, incentives need to consider the impact on airlines and their own cost bases.

Safeguarded Assets

VAA and the airline community has noted the major investment funds in Q5 that have gone into Safeguarded Assets. We define Safeguarded Assets as those capital investments where transition towards the Masterplan requires infrastructure which will not deliver actual benefit in the Q in which it is completed, but is reasonable and appropriate to support the agreed development plan for the airport. Examples of such expenditure in Q5 were the Tunnels and Baggage Halls in T2A and B. We understand that this is described as "efficient overspend" by some other Regulators

The current financial treatment of such assets is that they go into the RAB, earn a return on the cost of capital, and appreciate on a normal basis. However, depreciation is not charged until the asset goes into beneficial use.

We believe that it is unreasonable for HAL to earn a return on their investment before beneficial use ***and*** for the asset to appreciate in the RAB. We appreciate that further discussion is required on this issue with both HAL and CAA, but are concerned that it remains unresolved.

Transparency

Under the current regulatory arrangements, HAL is compelled to provide to the CAA and service providers information on the detailed costs and other factors it takes into account when setting charges for activities covered by the 1991 public interest finding.

We support the CAA's view that the current transparency condition has worked well, reassuring interested parties that these charges are based on appropriate criteria, and it has not imposed an unreasonable burden on HAL.

We also support the CAA's proposal to include the transparency condition in the licence. We would welcome further clarification from the CAA on how it proposes to manage this requirement over Q6 in light of the proposal that only those Specified Activities not covered by the AGR would be included in the licence.

We do not support the CAA'S proposal to remove the requirement to explain variations from the profit centre reports. We consider that this requirement provides an important safeguard and given that the systems are already in place to produce this information we do not agree that this creates an unnecessary additional burden.

Security cost claim mechanism (the s-factor)

We agree with the CAA that the risks arising from security requirements changing in the future should not be dealt with by making conservative (i.e. high) estimates of future security costs in the base case for setting the price cap.

We consider that it remains appropriate to include a pass through mechanism within the control period for dealing with variances in security costs. Our main concern is that while the current mechanism was designed to be symmetrical such that the price cap would vary for both increases and reductions in security standards, in practice our understanding is that hitherto it has only functioned in an upward direction i.e. all claims made under the S-factor have led to increases in charges. This is likely to be a function of the fact that the airport has no incentive to inform the CAA when security requirements may be relaxed and costs decrease, whereas it has a very strong incentive to make a claim under the S factor when the opposite happens. Other interested parties such as airlines are unlikely to be privy to the detail of changing requirements and not in any position to make a claim or to notify the CAA when circumstances change.

We consider that it would be desirable for the CAA to consider this anomaly further and to review the functioning of the mechanism in the future. One approach for Q6 may include the CAA undertaking a review of the position with the DfT on each occasion when the standards change.

As a minimum, we would expect the CAA to recognise that the S factor provides some protection for HAL in the event of the security environment changing and for that reason there is no need to build additional contingency into any security cost projections or to otherwise rely on conservative modelling of these costs.

Opex efficiency incentive mechanisms

We agree with the CAA's view that there are currently no grounds for introducing enhanced incentives on opex efficiency.

Traffic risk sharing

Similarly, in light of the lack of support for introducing traffic risk sharing arrangements we agree with the CAA that this should not be pursued for Q6.

Within period traffic mix forecast correction (K) factor

We support the CAA's proposal to retain the Q5 approach to correcting for in-period traffic variances

Inflation

VAA notes the work being carried out by the UK Statistics Authority and the ONS on RPI, in particular the decision to be made this summer on whether RPI merits continued designation as a National Statistic. If the RPI is no longer deemed fit for purpose because it overestimates inflation then there are obviously questions about value for passengers from its on-going use. We therefore believe this should be something that is under consideration.

Non-passenger flights

We support the CAA's proposed approach to dealing with non-passenger flights

Gatwick

Proposed price and VAA priorities

Virgin Atlantic has fed into the work carried out by the ACC at Gatwick and supports the work there to provide a bottom up, evidence based assessment of the CAA's initial proposals. This submission supports the updated ACC position as well as highlighting VAA priorities.

VAA's approach to Q6 at Gatwick has been driven by the needs of our passengers. VAA remains committed to working with GAL to continue to improve the airport for our passengers and to drive operational efficiencies and resilience. However, it is important to remember the context for Q6. Research shows that after around £1bn of expenditure in Q5, Gatwick already offers a good and improved passenger experience. VAA believes that this investment has brought the airport up to an appropriate standard. We therefore see less need for improvement and consequent investment in Q6, rather the priority should be on maintaining existing levels of experience and performance. We also expect that passenger benefits will continue to be realised in Q6 from projects that are already under development.

In the South Terminal where VAA's operation is located, a redeveloped departures forecourt with better passenger orientation, central search security improvements, international departure lounge and retail improvements, and gate room refurbishments have all helped to substantially improve the passenger experience. Operationally, a brand new departures baggage system is designed, and will be constructed through the remainder of Q5+1 and Q6 period, that will support punctuality, efficiency and equivalence between terminals.

As raised in previous submissions, VAA believes there were significant weaknesses with the CE process, in particular around information disclosure. GAL did not provide sufficient information on either operating costs or commercial revenues for meaningful engagement. VAA welcomes the initial proposals put forward by the CAA, in particular where additional information has allowed us a greater understanding of key building blocks. This submission welcomes the areas of alignment between CAA and airline views however VAA also believes the CAA's initial proposals fail to address a number of issues for our passengers:

- VAA is disappointed by the limited operating cost savings the CAA is proposing for Q6 – airlines have identified a number of areas where the airport could make significant efficiency savings, whilst continuing to offer an improved journey for passengers.
- With high passenger satisfaction and after an extremely large capital investment plan in Q5, we believe the capital investment plan for Q6 needs to be more targeted

and focused on the areas with strong business cases. In particular we cannot see a case for the investment in pier 6 south.

ACC building blocks

Traffic

VAA welcomes the analysis the CAA has presented on the traffic forecasts for Q6. Due to the way the forecasts were produced by SH&E, the ACC had little visibility over the assumptions made, particularly in the first three years, and we welcome the assessment the CAA has shown.

Since the ACC forecasts were produced at the end of 2012, traffic growth figures have been released for the end of the year at Gatwick which show higher growth than the forecast. Given the significant impact that changes in the first year have to the traffic numbers over the Q6 period, the ACC noted that its forecast would likely be revised up and the ACC has therefore reconsidered its traffic forecast in that context.

Furthermore, since the ACC submitted its previous forecast other factors have changed that will likely impact on the overall number:

- easyJet has announced the purchase of flybe's slots at Gatwick from 2014 – the ACC's conservative calculation is that this will add an additional 1.6m passengers per year and has a large impact on the overall traffic forecast as well as the ACC's estimate of the price. This is new information since the CAA's decision and the ACC has shown a transparent and cautious estimate of the impact in this section;
- the medium term GDP growth has edged up (see table 3.1 below); and
- the CAA has produced a bottom up assessment for the short term at Gatwick – higher than the one produced by SH&E.

All of these factors point to higher traffic forecasts from 2014 onwards over the Q6 period and VAA supports the assessment put forward in the ACC's paper.

Operating costs

VAA were disappointed with the proposed level of operating cost efficiencies in the CAA's initial proposals. VAA believe the CAA have failed to take proper account of the expert work it commissioned on security, frontier shift and staff remuneration, to name three activity cost bases, where the information was provided either by the airlines or the CAA's own commissioned consultancy studies.

VAA support the ACC submission on opex costs. However, some key points are set out below which underpin the ACC submission on the IP.

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Security

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Frontier Shift

The CAA have agreed with a frontier shift saving of 1.0% which is in line with the benchmark report. It is important to understand that this efficiency target is from the baseline point of when the airport is already efficient. Therefore, this target is the challenge on top of the identified savings.

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Other Opex Costs

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Summary

In summary, passengers have been burdened with paying for a high cost operation at Gatwick which has been augmented by the CAA setting a high opex forecast for Q5 which GAL has beaten.

The CAA has commissioned a number of studies by experts on targeted Gatwick cost bases. VAA believes that it is imperative that the CAA follows the expert direction. Failing to do so questions the integrity and intent of commissioning the studies. In addition, failing to do so would mean the CAA is not fulfilling its statutory obligation to ensure Gatwick runs an efficient and effective operation.

Commercial Revenue

VAA has contributed to the work carried out for the ACC by Javelin and fully endorses the conclusions and analysis presented in the ACC paper.

WACC

VAA welcomes the assessment of the cost of capital presented by the CAA in its initial proposals, and recognises the importance of this calculation to the overall price cap in Q6. A cost of capital which is too high would lead GAL to make significant windfall gains.

In the limited time available to respond to the CAA’s initial proposals, VAA were unable to commission any external advice on the cost of capital. However, we have used relevant experts within the business to assess the work put forward by PwC and the CEPA paper previously submitted to the CAA, which are both judged to be robust pieces of analysis.

We note that further detailed evidence will be submitted to the CAA by BA and therefore wish to make a few high-level comments.

VAA agree with the CAA that there are strong arguments that Heathrow’s cost of capital has reduced over the last five years. This recognises the fall in returns seen in global markets (which for example have led to pension funds being required to forecast lower returns); the significant falls in interest rates; and the reduction in corporate tax rates.

The final cost of capital for GAL is built up from a series of estimates of the individual elements of the cost of capital calculation. The CAA have used PwC’s estimates of the potential numerical ranges of each of these elements to determine a point estimate for each element, which are then used to determine the final cost of capital.

In doing this, the CAA has used point estimates from the top quartile of PwC’s recommended ranges, on the basis that it mitigates the risk that Gatwick will underinvest or reduce service quality. However, VAA believe that the CAA’s approach will not mitigate these risks, and instead will simply create windfall profits for GAL. We therefore disagree with the CAA’s approach to determining the point estimate.

Capital

VAA has supported the ACC’s in-depth consultation on its proposed projects. On the whole, we support the ACC’s recommendations and conclusions.

After significant analysis the ACC has concluded that whilst certain projects within the proposed capital programme (by value) provide value for money for our passengers, there are some significant elements that do not. We would urge the CAA to closely review and consider the value for money of projects in Q6, so that we do not invest in projects that deliver little passenger benefits.

3 key projects/areas VAA support in Q6 are

- the completion of the South Terminal Pier 1 and baggage project
- the asset maintenance programme
- £12m of upgrade check-in and bag drop investment: Airline / GAL trials have proven that bag drop machines offer passenger and airline benefits and the ACC is supportive of measured investment based on airline and passenger uptake in the Q6 capital plan. The concept of common user bag drop areas is not currently supported by VAA as this would represent a number of issues that would lead to a diminished customer and brand experience for airlines in competition, and additional operational costs of a split check-in operation. The airlines also do not support the complete reconfiguration of the check in areas as this does not offer passengers value for money.

Form of regulation and 'Price Commitments'

Introduction

Whilst this response focuses on the initial price proposals put forward by the CAA, the market power assessment published by the CAA is important context and VAA will respond to this in due course.

VAA continue to believe that GAL holds significant market power. Despite this, we have been open to considering the concepts being explored around alternative forms of regulation and in particular contracts and commitments at the airport. However, as initially defined by GAL we did not see these as a remedy to GAL substantial market power. Given this, a formal RAB based regulatory approach seems to be the most appropriate way to safeguard the interests of airlines and our passengers.

As such VAA provided detailed responses to the initial commitments proposal put forward by GAL. We welcome the extent to which some of these comments have been addressed by the CAA in its initial proposals. In particular that any commitments would need to be based on a lower price (although VAA believe it should be lower than proposed by the CAA) and that a regulatory back-stop, in the form of a licence, is needed.

Since the publication of the CAA's initial proposals, GAL has published an updated version of its commitments. This document provides some initial comments on these however, the proposal has come too late in the consultation process for a detailed response. VAA will follow up with further comments once it has had time to take advice.

This section sets out our views on the forms of regulation discussed by the CAA in its initial proposals document.

Alternative forms of regulation

The CAA focuses on two main types of regulation (RAB and price commitments), however, comment is provided on further alternative forms of regulation. VAA broadly agree with the conclusions that CAA has come to; these positions are summarised below:

Long run average incremental cost: VAA share the CAA's concerns that the implementation of a LRIC based control at Gatwick could undermine its primary duty to protect consumers. VAA agree that the practical difficulties in its calculation, the specifics of airport capacity in the south east of the UK that may render it inappropriate, the significant sensitivity of the calculation to regulatory judgement, and the data intensive nature of the calculation make this option unsuitable for regulating GAL's airport charges in Q6 given the risk it could undermine, rather than support, protection for users and the promotion of competition.

Price monitoring: VAA agree with the CAA's assessment that it would not be appropriate to set precise price caps based on comparator benchmarks. However, VAA also agree that benchmarks can provide a useful indication of the possible ranges for a competitive price.

'Price Commitments'

The CAA's initial proposals express a preference for a 'commitments' based regulatory model for GAL in Q6, with some suggested modifications from the proposal put forward by GAL in its business plan in February. If these modifications cannot be agreed the back stop regulation will be a traditional RAB based mechanism.

VAA welcome the assessment from the CAA that there were a number of issues with GAL's proposal. In particular the CAA highlights that the enforceability and the terms of the commitments are such that they do not offer sufficient protection to be in the passenger interest.

VAA agrees that the commitments proposal previously put forward was not workable. VAA provided evidence on this in its previous submission which centred around 6 main issues:

- The legal status of the commitments is inadequate – exposing airlines and passengers to significant risk;
- The proposed price in the Commitments is too high and does not represent value for money for passengers;
- There is too much uncertainty around future charges; for example, from potential runway 2 costs and service bonuses;
- The commitments do not encompass all the charges paid at the airport – exposing passengers to significant risk from residual charges;
- The service proposals do not address the concerns set out by the ACC with GAL's original proposals; and,
- The proposed Commitments do not remedy Gatwick's significant market power

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The CAA suggests a number of changes that would need to be made to the commitments proposals to make them a workable solution to protecting passengers from GAL's market power in Q6.

The first set of changes are new licence conditions that would need to be introduced to ensure the regulatory back-stop provides enough protection. The CAA's initial views are that a licence should include:

- A condition enabling the CAA to enforce the commitments. This would provide a direct response to concerns about enforceability and would allow enforcement in the interests of end users, rather than simply airlines.

- A condition preventing GAL from altering the commitments without good reason and from withdrawing the commitments. This would address the concerns that the conditions of use could allow the airport to unilaterally vary or withdraw the commitments.

- A condition allowing the CAA to direct changes to the commitments in response to a dispute where the commitments are operating against the user interest. This power would operate within quite narrowly defined circumstances.

- A condition allowing the CAA to introduce a freeze on charges if it is undertaking an investigation. This would prevent detriment during the time it takes to remedy the failure of the regime, for example while new licence conditions are introduced, or the MPT is being reassessed.

VAA agree with the CAA's assessment that any commitments framework would need to be backed up by a regulatory licence and broadly agree with the licence conditions the CAA would seek to introduce (although the statements above are too broad so the ACC would need to work with the CAA to understand the detail). However, there is some confusion as to whether the commitments would sit inside, or just be backed up by, a licence. If they were only backed up by a licence that simply contained the four points above, some airlines have identified significant problems with this approach and consider that the whole approach of having the Commitments simply backed by a licence is questionable as a matter of law. The ACC would need to be re-assured on this point and as any such licence is developed the ACC would seek to work closely with the CAA on the detail of this.

Other than the regulatory licence, the CAA's initial proposals also raise a number of other issues with GAL's proposals. These are around:

- **Price**: The CAA would want the commitments to offer a price that is fair.

- **Efficiency**: The amendment of the full pass through of the costs of changes to security requirements, to something similar to the Q5 arrangements, the removal of the pass through of taxation changes, and the removal of the pass through of development costs of a second runway.

- **Service quality**: The level of rebates and bonuses in the service quality scheme should prevent service quality from being reduced and provide bonuses only where there is significant outperformance of existing levels of service quality. The commitments should also include protection against repeated failures to meet service quality targets. Airline service quality targets should also not distort competition between airlines.

- **Capex**: A commitment to deliver any outputs resulting from the capex plan that are over and above the outputs that would be reflected in the service quality regime.

- **Consultation**: The commitments should include consultation requirements beyond those required by the ACD and address the significant information asymmetry between GAL and the airlines;

- **Transparency**: The commitments should provide sufficient information to airlines to allow them to understand whether charges are reasonable.

- **Operational resilience**: The commitments should provide clarity on what GAL will do and how it will interact with other operators at Gatwick to ensure the availability and continuity of airport operation services to further the interests of passengers, particularly during disruption.

- **Financial resilience:** The commitments should provide clarity on what GAL will do to ensure the financial resilience and continuity of service.

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VAA, along with the ACC, have therefore sought to engage with GAL during the CAA's consultation period to understand their reaction to the CAA's initial proposals and whether they would be providing an updated proposal on commitments.

GAL shared an updated version of its commitments on the 7th June and held a meeting with VAA on the 12th June. As this came relatively late in the consultation period, VAA have not been able to provide full comments on this updated proposal. However, we have some initial points about the updated proposal from GAL:

- GAL maintains that a regulatory, licence back-stop is not needed and as such this is not included in their updated commitments. The ACC continues to believe that only a licence backstop can provide sufficient protection for passengers;

- GAL has not included an updated price in its proposals – this makes it impossible to assess the commercial viability of any licence proposal;

- There remains uncertainty around future charges; for example, from potential runway 2 costs and service bonuses; and,

- There remains service standards on airlines which the ACC does not believe are appropriate.

We, therefore, currently do not view the creation of such commitments as an effective remedy for the substantial market power that Gatwick continues to hold. However, the ACC will follow up with detailed comments on the revised proposal put forward by GAL ahead of its session with the CAA board on the 17^{th} July.

Other regulatory issues

In this chapter we set out our views on the CAA's proposed approach to regulatory issues outside the price cap, form of regulation and licence.

Service Quality

VAA support the ACC paper on service quality.

Core and development capex

VAA welcome the steer from the CAA that they view core and development capex as an appropriate mechanism to be introduced at Gatwick in Q6. We look forward to continuing to work up the detail of how this could be applied.

Transparency

Under the current regulatory arrangements, GAL is compelled to provide to the CAA and service providers information on the detailed costs and other factors it takes into account when setting charges for activities covered by the 1991 public interest finding.

We support the CAA's view that the current transparency condition has worked well, reassuring interested parties that these charges are based on appropriate criteria, and it has not imposed an unreasonable burden on GAL.

We also support the CAA's proposal to include the transparency condition in the licence. We would welcome further clarification from the CAA on how it proposes to manage this requirement over Q6 in light of the proposal that only those Specified Activities not covered by the AGR would be included in the licence.

We do not support the CAA'S proposal to remove the requirement to explain variations from the profit centre reports. We consider that this requirement provides an important safeguard and given that the systems are already in place to produce this information we do not agree that this creates an unnecessary additional burden.

Security cost claim mechanism (the s-factor)

We agree with the CAA that the risks arising from security requirements changing in the future should not be dealt with by making conservative (i.e. high) estimates of future security costs in the base case for setting the price cap.

We consider that it remains appropriate to include a pass through mechanism within the control period for dealing with variances in security costs. Our main concern is that while the current mechanism was designed to be symmetrical such that the price cap would vary for both increases and reductions in security standards, in practice our understanding is that hitherto it has only functioned in an upward direction i.e. all claims made under the S-factor have led to increases in charges. This is likely to be a function of the fact that the airport has no incentive to inform the CAA when security requirements may be relaxed and costs decrease whereas it has a very strong incentive to make a claim under the S factor when the opposite happens. Other interested parties such as airlines are unlikely to be privy to the full detail of changing requirements and are not in any position to make a claim or to notify the CAA when circumstances change.

We consider that it would be desirable for the CAA to consider this anomaly further and to review the functioning of the mechanism in the future. One approach for Q6 may include the CAA undertaking a review of the position with the DfT on each occasion when the standards change.

As a minimum, we would expect the CAA to recognise that the S factor provides some protection for GAL in the event of the security environment changing and for that reason there is no need to build additional contingency into any security cost projections or to otherwise rely on conservative modelling of these costs.

Opex efficiency incentive mechanisms

We agree with the CAA's view that there are currently no grounds for introducing enhanced incentives on opex efficiency.

Traffic risk sharing

Similarly, in light of the lack of support for introducing traffic risk sharing arrangements we agree with the CAA that this should not be pursued for Q6.

Within period traffic mix forecast correction (K) factor

We support the CAA's proposal to retain the Q5 approach to correcting for in-period traffic variances.

Inflation

VAA note the work being carried out by the UK Statistics Authority and the ONS on RPI, in particular the decision to be made this summer on, whether RPI merits continued designation as a National Statistic. If the RPI is no longer deemed fit for purpose because it overestimates inflation then there are obviously questions about value for passengers from its on-going use. VAA therefore believe this should be something that is under consideration.

Non-passenger flights

We support the CAA's proposed approach to dealing with non-passenger flights.

Licensing Issues

Virgin Atlantic welcome the CAA's ability to grant economic licences under the Civil Aviation Act 2012. Such powers will bring the CAA in-line with other economic regulators and update the way in which regulation is applied at each airport. We welcome sight of the draft airport licence proposals and the discussion of the conditions that should be included therein.

Our main interest with respect to the new licence relates to the price control and service quality conditions. With that in mind, we are somewhat disappointed that the CAA has provided only around 3 weeks for affected parties to comment on these critical areas. VAA believe that the CAA should provide further opportunity for airlines to make representations on these important issues prior to the CAA making its final decision later in the year and we welcome the CAA's proposals to discuss the draft licence in more detail with stakeholders over the summer.

With this in mind we note the CAA's intention to develop economic licences at both Heathrow and Gatwick that are fit for purpose when applied from April 2014 and ones which are likely to 'evolve over time'. Bearing this in mind it is imperative that any licence developed has the appropriate backstops in place to ensure that airlines and ultimately the passenger are protected from any potential abuse of market power by the airport operator.

Here we in turn outline our thoughts on the detail that sits behind the current proposals.

1. Fees

The CAA has stated any licences should be subject to a fee payable to the CAA. In common with other regulated sectors, the payment of fees condition would be enforceable using civil sanctions as well as the enforcement powers of the Act which we support.

2. Licence revocation conditions

This in our view is one of the more important attributes of the licence conditions. Licence revocation should be used as a last resort and as the ultimate option if fines, remedy notices etc. have failed to resolve any issues.

Revocation of a licence alone would probably not be sufficient in practice to compel an airport to close/cease operations and careful consideration should be given to what subsequent steps may be require in order to enforce this measure.

Furthermore, in the unlikely event that either HAL or GAL were to become insolvent it is nevertheless important that the regulator has the ability to revoke the licence due to insolvency of the business.

3. Price Control

This aspect of the licence is one of our primary areas of concern. The draft licences appended to each of the HAL and GAL reports do not contain any further detail on this. However, this submission highlights the approach to price control conditions that we think is appropriate and in the best interest for the passenger.

It is vitally important that the appropriate time is taken in developing and drafting such conditions, ensuring that they are as robust as possible.

4. Service Quality

We would like to see how service quality conditions will be further included in the licence to reflect airlines' concerns on the issues as mentioned earlier in this response. It is important that the SQR scheme continues to maintain and improve the service provided to our passengers, in the most efficient way possible.

Bearing this in mind, it may also be appropriate during the regulated period to adjust SQR scheme in the interest of the passenger. Therefore, we would support the inclusion of a mechanism that would allow such adjustments to take place.

5. Financial conditions/financial resilience

We note the detail about the various options here (e.g. prohibition on security over assets, certificate of adequate resources, parent undertaking, minimum credit rating, prohibition on cross guarantees) which represents a comprehensive list of items to be included.

Further to this we support the inclusion of a licence condition requiring the airport operator to produce a Continuity of Service Plan (CSP) in accordance with an initial licence condition. We agree that such a plan would increase the transparency of each airport's operating and financial structure and would assist an insolvency practitioner during a transitional period. Ensuring the on-going, safe and cost efficient operation and management of airport infrastructure is of upmost importance for passengers, airlines and the wider economy.

Finally, there is a focus on restricting business activities at both airports included in each licence. This is not a particular concern to VAA, although it should help ensure that both airports focus on their main business along with their associated obligations to passengers, airlines and the CAA which we would deem a positive emphasis.

6. Operational resilience

We note the importance of the inclusion of operational resilience within the service quality framework. However, there is a risk that putting too much emphasis on this area could lead to an airport over-investing in order to mitigate any associated risk.

It is important that the most appropriate and effective investments are made in a fair and transparent manner, one which best meets the passenger interest.

8. Passenger complaints handling requirements

We would like to further explore the prospect of including a passenger complaints handling requirement within the issued licence.

9. Consultation Protocol

We would welcome the inclusion of a clause requiring consultation with airlines on various matters, similar to that of 'Annex G – information disclosure and consultation' in the Q5 price settlement.

It is vital that from the outset there are clear parameters in place for information disclosure and consultation to underpin successful engagement during the regulatory period.

10. Liability

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