

Virgin Atlantic response: Review of price regulation; policy update



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## Contents

Introduction .....	3
How should the CAA approach a strategy for airport licensing? .....	5
How can the CAA ensure that its review of economic regulation is passenger-focused? .....	7
How can regulatory incentives towards service quality be improved?.....	9
What is your view on the rationale for economic regulation at Heathrow, Gatwick and Stansted?.....	11
Virgin Atlantic's Overall View .....	11
What do you think is the most appropriate form or model for price regulation at each of the airports?.....	13
Heathrow .....	13
Gatwick .....	14
What are the priorities for improved efficiency incentives within the price control settlements?.....	15
Capital incentives.....	15
OPEX incentives.....	19
How should the CAA interpret its new financing duty? .....	20

## Introduction

Virgin Atlantic (VAA) is pleased to respond to the CAA's consultation on the policy framework for Q6. Since it was founded in 1984, VAA has become Britain's second largest long-haul carrier serving the world's major cities. From its inception, VAA's aim has been to provide high quality, innovative services offering excellent value for money for all classes of traveller.

In the UK VAA operates from London Heathrow, London Gatwick, Manchester and Glasgow airports. The efficient economic regulation of airports is therefore critical as two of our four home airports are deemed to have significant market power.

VAA has been broadly supportive of the constructive engagement process set out to date and has been an active participant in community work and discussions to drive a common understanding of requirements and transparency of costs for Q6. However, in order to be successful, it is essential that the process provides the maximum transparency on key aspects such as opex, WACC and commercial revenues that will help to build up a collective view of where the opportunities and value for the customer lie, which will be key if the CAA is to meet its new primary duty in Q6. To date, this transparency has not always been provided.

It goes without saying that the primary focus for any airline is delivering the service required by customers at a price that they can afford. Discussions around value for money and affordability in Q6 are therefore a critical point for both VAA's operations and passengers. Recent price rises are simply unsustainable and are in sharp contrast to the efficiencies made by airlines over the same period.

VAA believe the previous regulatory structure failed to protect its passengers from the market power held by the airports and are therefore hopeful that the new powers and flexibility being introduced by the Civil Aviation Bill will deliver more effective and efficient regulation going forward. A Q6 settlement with a much more reasonable opening and price path must be an essential objective for Q6, given the economic context.

As well as questions over the transparency offered to date, VAA believe the CAA must also note and take account of the high degree of uncertainty going into Q6 discussions. This is made up of three main factors:

**Regulatory uncertainty:** the Civil Aviation Bill is still working its way through Parliament. VAA would like clarity over how these risks will be managed during constructive engagement and in this policy development work for Q6.

**Policy uncertainty:** The Government had just published a consultation on its framework for aviation which will set the policy direction for aviation. It will also be consulting on options for increased capacity in the South-East later in the year. These options have the potential to have a significant bearing on Q6 discussions.

**Economic uncertainty:** Significant economic uncertainty, particularly in the Eurozone, means that making a judgement now for the next seven years is extremely challenging.

VAA judge this uncertainty means it is impossible to agree the market context, set out on page 63, for the airports.

VAA therefore believe it is worth urgently considering how regulatory and capital incentives can be modified to protect passengers, airlines and the airport for the inherent risks (economic, policy and operational) associated with forecasting seven years out and the subsequent effects on airport development and costs. It is also important that the regime drive competitive equivalence to ensure passengers pay for the same quality of journey and so airlines are able to compete effectively.

This is especially important because, given this degree of uncertainty, across the piece in Q6, VAA is being asked to put a lot of trust into a process that, as outlined, has previously led to inefficiency, poor value and high costs to passengers.

Consequently VAA are happy to work with the CAA to understand how these issues can be managed in Q6 and this response sets out our thoughts and suggestions across the seven questions put forward for consideration. VAA is happy to discuss any of the ideas in more detail with the CAA.

## How should the CAA approach a strategy for airport licensing?

VAA is broadly supportive of the changes currently being made to airport regulation. The current economic regulatory system is inefficient, burdensome, out-dated and in clear need of improvement and a more flexible and tailored licensing system is welcomed.

The efficient economic regulation of airports with market power is necessary in order to constrain any potential abuse of their dominant position and is incredibly important to VAA as two of the four UK airports it operates from are deemed to have significant market power. However, there are a number of considerations VAA believe need to be taken into account both in putting the new regime into practice and the content of the proposed licences.

On process, the Civil Aviation Bill is currently making its progression through Parliament. It is anticipated that the Bill will achieve Royal Assent in early 2013. However, at the moment this does not provide enough clear certainty that this progression will be achieved in time for the commencement of Q6 which creates a degree of regulatory risk.

VAA understands that in the unlikely event that there is failure to achieve Royal Assent the CAA may have to make reference to Part 4 of the Airports Act 1986 (AA86). However, it is important that the CAA in this event is fully able to exercise its responsibilities to undertake the price control reviews under the existing act. Furthermore, assurance is sought from the CAA that the relevant protections are in place for passengers, airlines and wider stakeholders if the Civil Aviation Bill does not achieve Royal Assent in the relevant timeframe.

In the event that the Bill does achieve Royal Assent within the suggested timescales it is important to highlight that this still results in an extremely pressed schedule for constructive engagement and subsequent activities, for example in drafting licences, to take place.

Given that the Bill puts the interests of users (passengers and those with rights in cargo) of air transport services at the heart of the regime VAA would like to understand how our views will be considered in ensuring that the initial licences meet the CAA's duties. VAA believe that there is a need to make full reference to airlines given the alignment of interests with their consumers, the passenger.

On the approach to strategy for airport licensing, VAA fully supports the reference to Better Regulation and appropriate targeting of powers. VAA also agrees that the flexibility being brought into the current system is utilised where it can deliver benefits. Therefore, there is a need to ensure that the CAA delivers its assessment of Market Power in a timely manner to ensure that all debates that underpin this are transparent, accountable, proportionate and consistent.

However, VAA believe there are currently some risks with the "evolutionary approach" to airport licencing proposed. It is detailed that:

*“There may be merit in the CAA adopting an evolutionary approach by ensuring that the first licences are fit for purpose but then reviewing its position on certain aspects in light of experience and how the sector responds to operating under a licence based framework” (CAA Review of Price Regulation at Heathrow, Gatwick and Stansted Airports (“Q6”) – Policy Update, May 2012, p 19)*

VAA remains sceptical of a ‘trial and error’ approach, and not one which fully evaluates the risks involved prior to the implementation of the licence. The utilisation of such a method could be detrimental to the passenger, and there is a need to ensure that any potential passenger harm is mitigated where possible. VAA is concerned it may potentially be too late in the process to retrospectively change a licence, once in practice, to fix an issue that may have arisen during its implementation and seek assurance from the CAA that this is possible.

Finally, VAA believe it is important that the development of a licence is subject to extensive stakeholder engagement and consultation and lessons are learnt from other sectors who have implemented a similar regime to ensure efficiency.

## How can the CAA ensure that its review of economic regulation is passenger-focused?

The CAA highlights, in its document, four elements that will be pursued to ensure regulation is passenger focussed. These are:

**1. Taking account of where airline and passenger views will be aligned:** VAA welcomes that the CAA recognises the alignment of airline interests with their consumers, the passenger. Airlines are best placed to represent the needs of passengers and are the primary consumer of airport services. VAA is committed to offering the highest levels of service for all its passengers and will be doing its utmost to represent their views during constructive engagement.

**2. Undertaking an independent process of assurance and validation:** VAA agree there is a strong role for the CAA in undertaking independent analysis and assurance to feed into its Q6 decisions. Sound analysis of passengers' interests and thorough testing of the basis and assumptions in airports' business plans will be crucial to ensure that the decisions are robust and grounded in evidence. This is something airlines are committed to testing and carrying out further analysis of through constructive engagement subject to having the appropriate level of transparency of information from the airports.

However, it is for that reason that VAA were concerned to learn that the Q6 process will have less resource than in Q5 and that this is in addition to the loss of the resource of the CC who previously carried out further analysis. VAA is concerned that this creates a risk that thorough analysis is not carried out in all areas and this could impact on the passenger particularly as new and innovative ideas are being considered in Q6, in line with the more flexible approach.

**3. Formulating the most appropriate regulatory levers at each airport:** As stated, VAA believe the previous regulatory structure failed to protect its passengers from the market power held by the airports and are therefore hopeful that the new powers and flexibility being introduced by the Civil Aviation Bill will deliver more effective and efficient regulation going forward. VAA is therefore supportive of working with the CAA to ensure the most appropriate regulatory structure is in place at each airport but notes that in practice this will likely cause some confusion and uncertainty given the compressed timetable to the start of Q6 and would welcome clarity on the timeline for this work.

**4. Improving service provider collaboration at the airports and the transparency of information to passengers:** Finally, VAA believe there is a need for further clarity on the publication requirements to be imposed on airports and airlines by the CAA. It is essential that a publication provision does not create unnecessary bureaucracy or cost for the aviation industry.

As well as the points raised by the CAA in the consultation document, VAA consider there are a number of other areas that are important to ensure regulation is passenger focussed and that it adequately protects passengers from the market power the airports hold:

**Value for money:** Discussions around value for money and affordability in Q6 are a critical point for both VAA's operations and passengers. Recent price rises are simply unsustainable. In previous Qs passengers have borne the brunt of sharp price increases and inefficient operations this is not in their interest.

Through constructive engagement VAA will be representing views on what its passengers would be prepared to pay for. Investment in the airport passenger experience can only be justified where customers value the enhanced experience to the extent that they are willing to pay a premium.

Finally, to ensure potential passenger benefits are identified, there is a need to focus on a move towards a clearly defined benefits framework where an agreed and robust business case and gateway framework process is undertaken for all investment decisions, ensuring value is maximised for passengers.

**Flexibility:** Given the level of uncertainty going into the Q6 period (economic, regulatory and policy) VAA judge it is worth urgently considering how regulatory and capital incentives can be modified to protect passengers, airlines and the airport for the inherent risks with forecasting seven years out and the subsequent effects on airport development and costs. Regulation needs to be flexible enough to maximise value for passengers whilst taking account of the economic and commercial realities of the industry it operates in, or risk serious mis-alignment with the passenger interest over time.

**Equivalence:** It is also in the passenger interest that airlines are able to compete effectively. Competition amongst airlines drives lower prices, innovation and improved service for passengers and is therefore very much in the consumer interest. Moreover promoting competition is one of the CAA's core objectives.

In order to be able to compete, out of the same base, airlines need like for like airport products and facilities with their rivals as any benefits derived from newer facilities such as operational efficiencies or an improved passenger experience drive an unfair advantage for one airline over another.

## How can regulatory incentives towards service quality be improved?

Innovation, quality, value for money and great service is key to VAA for all customers. VAA has pioneered a range of innovations that set new industry standards of service. It is therefore paramount that the passenger experience on the ground delivers for customers.

VAA, along with other airlines holds the principal contractual agreement and relationship with passengers. However, the airport services provided is one which the airport operator is obliged to provide through their contract with airlines. VAA is reliant on the airport operator to provide the most efficient infrastructure to enable our passengers' journey through the airport which is an objective that does not always marry with the commercial interest of the airport operator.

The use of a Service Quality Regime (SQR) at Heathrow and Gatwick during Q4 and Q5 has therefore been welcome and has driven improvements in performance. However, VAA believes, there is now a need to adjust how the SQR is measured to ensure that meaningful results that drive the right behaviour are achieved resulting in further improvements in service quality.

In developing the service proposition for Q6, VAA considers that there is a need to build on what has already been developed during past regulatory price review processes making it more appropriate for passengers today, and in the future, by taking an output based holistic approach to airport service operations.

There are a number of principles that need to be taken into account in order to improve the service quality regimes for Q6:

- VAA judges it important that service quality measures cover a wide range of measures across the services and facilities provided by the airport, including those not directly seen by passengers on their journey. Any delay or loss of quality in any of the areas used by airlines in providing services could start to immediately impact on passengers, for example in delays.
- VAA believes that in order to promote passenger interests there is a need to analyse the passenger experience through a relevant matrix, one which recognises the passenger experience delivered by the airport operator, equivalence between airport terminals as well as hard measures on service delivery.
- In considering the Service Quality Regime, it is important to think about equivalence across terminals. Airlines operate in a very tough competitive environment and equivalence between terminal facilities and passenger experience is essential.
- It will be important to ensure that the final set of Q6 service propositions accurately reflect the role and responsibility of the airport in the delivery of the services and facilities used by the airlines in the transportation of their passengers. In this context the airport is the supplier of services to the airline

community and is subject to the regulatory controls established. Airlines are the airport's customer, so it is entirely appropriate that a certain standard of service delivery is required. However, it is not the Airport Authority's business to manage how airlines deliver their service; they are a supplier. Moreover airlines operate in an extremely competitive environment and one which enables consumers to base their purchases on the level of service they expect.

- VAA do not believe bonuses are appropriate. The fees paid to an airport are for use of the facilities and a given level of service.
- It is also important to ensure targets are effective (e.g. on security passengers not time periods) and based on actual passenger journeys rather than averages.

Whilst VAA have given a flavour of expected developments for a Service Quality Regime, in practice these views are likely to evolve as constructive engagement continues.

## What is your view on the rationale for economic regulation at Heathrow, Gatwick and Stansted?

### Virgin Atlantic's Overall View

During the preliminary assessment period VAA contributed to the CAA's Market Power Assessment process through engaging with and submitting formal evidence to the Authority. VAA continue to argue strongly that both Heathrow and Gatwick airport currently hold and will continue to hold significant market power (SMP) beyond April 2014 and are therefore pleased that this view is supported by the CAA in the publication '*Summary of the CAA's initial views – January 2012*'.

However, the lack of a definitive outcome by the CAA on the Assessment of Market Power at Heathrow and particularly at Gatwick is impeding the extent that Constructive Engagement (CE) is able to take place fruitfully.

Given that there are extremely restricted timescales, VAA believe for CE and the Q6 discussion process to progress effectively, it would be beneficial for all involved if the CAA had a definitive timetable for the publication of Test A 'substantial market power'. It is stated that the CAA will publish updates on Heathrow and Gatwick market power assessments in early 2013; however, it is not detailed whether or not this will formally constitute Test A.<sup>1</sup>

Alongside the above an indicative timetable for Test B 'general competition law versus economic regulation' and Test C 'benefits and costs of economic regulation' should also be clearly established for use once the CAA acquires the powers under the Civil Aviation Bill.

### The Tests for Continued Economic Regulation

Under **Test A** - VAA welcomes the position taken in assessing the requirements of a long-haul base network carrier at Heathrow and a long-haul carrier at Gatwick, along with the attempt to define the market within which they operate. VAA's continued view is that adverse switching costs, substitutability, yield premiums and airport capacity all have a significant part to play in defining why both Heathrow and Gatwick continue to retain significant market power.

VAA understands that the CAA currently does not have the power to undertake Tests B and C until the Civil Aviation Bill becomes law, however, VAA continues to believe that under **Test B** relying solely on competition law will not provide certain enough safeguards against the potential risks of abuse by either operators at Heathrow or Gatwick beyond April 2014. Sectoral tailored regulation is necessary in order to effectively minimise this potential abuse. Providing reference only to competition law leaves passengers and airlines open to potential regulatory risk and 'game playing'.

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<sup>1</sup> *Review of Price Regulation at Heathrow, Gatwick and Stansted Airports ("Q6") – Policy Update, May 2012, p. 43*

Under **Test C** and the consideration of whether regulation has potential benefits and costs, VAA understands that with all regulation there are possible cost and benefit implications. However, it becomes extremely difficult to evaluate the effects of implementing a regulatory regime without knowing the specific details that sit behind it. As previously highlighted, VAA agrees that the Bill will provide a clear improvement to the current system which is inefficient, burdensome and out-dated. Reserving the right to comment on the final Bill once it achieves Royal Assent and the subsequent licencing regime implemented, our view is that we consider that economic regulation and its benefits are likely to outweigh the costs at both Heathrow and Gatwick.

**What do you think is the most appropriate form or model for price regulation at each of the airports?**

As discussed, VAA broadly agrees with the overall messages in the CAA's market power assessments. These point to significant market power at both airports for the services VAA operate. On-going regulation will therefore be needed in Q6 and likely beyond to protect VAA's passengers from the market power held by the airports. It is also crucial that the form of regulation protects passengers from the degree of market power held by Gatwick and Heathrow over VAA's services and this is discussed in more detail overleaf.

VAA believes it is also worth the CAA urgently considering how the regulatory models used at both airports can be made more flexible to deal with the high degree of uncertainty going into Q6 discussions. This is made up of three main factors:

**Regulatory uncertainty:** the Civil Aviation Bill is still working its way through Parliament. VAA would like clarity over how these risks will be managed during constructive engagement and in this policy development work for Q6.

**Policy uncertainty:** The Government recently published its framework for aviation which will set the policy direction for aviation. It will also be consulting on options for increased capacity in the south east, later in the year. These options have the potential to have a significant bearing on Q6 discussions.

**Economic uncertainty:** Significant economic uncertainty, particularly in the Eurozone, means that making a judgement now for the next seven years is extremely challenging.

VAA judge this uncertainty means it is impossible to agree the market context, set out on page 63, for the airports. If flexibility is not delivered, the regime may fail to protect passengers, airlines and the airport from the inherent risks (economic, policy and operational) associated with forecasting seven years out and the subsequent effects on airport development and costs. Flexibility of proposed changes should therefore also form part of the assessment criteria.

On questions on the scope of the till, as previously stated, VAA believe a single till approach is the most appropriate for Q6. It is not clear what the rationale is for some of the potential changes raised by the CAA on page 62. In particular, it is not clear how allowing the airport to keep benefits of innovation for longer than five years is consistent with protecting passengers as this is the very opposite of what would happen in a competitive market.

### **Heathrow**

VAA continue to believe that Heathrow does withhold significant market power and there is overwhelming evidence for continued economic regulation.

VAA agrees that, at Heathrow, only a RAB based approach can provide the right framework for regulation and adequately protect passengers. However, there is

need for considerable adjustments to be made to the current approach to ensure consumers are protected in Q6.

In particular:

- CAPEX and OPEX incentives need to be considered to ensure an efficient and flexible price cap;
- Governance within the quinquennium needs to be considered to ensure the efficient delivery of capital projects.

Whilst VAA understands the benefits the CAA see in setting out a longer regulatory period, further work would be needed to quantify the benefits of this in reality. Moreover, unless the right flexibilities and incentives are put in place for Q6, VAA is concerned that, the effect of a longer period could simply be to lock inefficiency in for passengers.

### **Gatwick**

The CAA's initial assessments of market power also flagged the significant market power still held by the airport. It is therefore critical that the form of regulation used at the airport adequately protects VAA's passengers from any harm arising from this market power.

VAA notes that the CAA do not believe that a 'one size fits all' approach would necessarily be the best approach given the different airline models that operate. However VAA judge, it is not clear how any alternatives would work in practice. In particular there would seem to be significant difficulties with the operation of different service levels due to the amount of shared facilities that exist. This needs to be urgently worked through in practice if the CAA is considering this option so any operational impacts can be understood.

As highlighted in previous submissions, Virgin Atlantic is open to discussing the benefits of bilateral contracts, but there would need to be a balancing of risk on both sides prior to an agreement being achieved. Additionally, it would be important to understand the counterfactual to a bilateral contract would be. Without knowing what type of outcome could be achieved through a regulated regime, it is difficult to assess the appropriateness of a bilateral contract.

It would be helpful if the CAA is able to provide clarification for why it would like to consider a shorter regulatory price cap at Gatwick, as it did with a longer price cap at Heathrow. This would enable VAA to consider the potential benefits and understand the rationale.

In summary, whilst thinking on alternative forms of regulation is welcome, VAA remains sceptical that anything other than a RAB based price control will be effective in dealing with SMP at this current time. Moreover, there are considerable practical issues with alternative approaches, for which time is rapidly running out to overcome. However, VAA remain happy to continue work with the CAA to see how some of these issues could be overcome for Q6.

### What are the priorities for improved efficiency incentives within the price control settlements?

Discussions around value for money, affordability and efficiency in Q6 are a critical point for both VAA's operations and passengers. These price rises are simply unsustainable.

VAA is therefore pleased to offer suggestions for capital and operating cost incentives for Q6 which it is hoped will be the basis of a more efficient regulatory approach for Q6. VAA believe the previous regulatory structure failed to protect its passengers from the market power held by the airports and are therefore hopeful that the new powers and flexibility being introduced by the Civil Aviation Bill will deliver more effective and efficient regulation going forward.

#### **Capital incentives**

To ensure the benefits of investment in capital are maximised for passengers, the regulatory controls need to be in place to incentivise BAA and GAL to develop robust business cases that are delivered in an efficient manner - on time, to budget, to the scope defined, at a market rate.

The current regulatory regime, based on the regulatory building blocks, incentivises the quantity of CAPEX rather than its quality, delivery of valuable benefits, or value for money. At the heart of this approach is the idea that monopolistic companies tend to restrict investment to the detriment of their customers. Therefore, the regime has been designed to incentivise investment as the lack of investment is arguably a greater detriment than inefficient CAPEX.

However, this approach means that, in reality, despite some existing controls in the form of CAPEX triggers, airlines and their passengers inevitably end up paying for the cost of inefficiencies when projects are delayed or costs increase.

As a result VAA consider it is timely to revisit regulatory CAPEX incentives, to ensure the balance is struck within Q6 between incentivising investment in a timely manner and the delivery of capital efficiency and value for money.

In order to consider reform it is appropriate to consider the incentives that currently exist:

- 1) Quantity over quality – the current RAB framework incentivises the airport to bring forward as much capital build as possible, resulting in business cases that are often poorly defined with benefits and risks that are unclear or unmitigated. Investing millions in projects without fully developed business cases is not a practice that airlines or business in competition would accept, as there is little confidence a project is affordable, and delivers value for money.
- 2) There is a further incentive for Airport Authorities to front-load the plan before the cap is set and then to back-end load delivery. The timing of when

projects are delivered can have a significant impact on their business case. Airport Authorities can benefit from this overstatement (underspend) and re-profiling in two ways:

- they enjoy a cash-flow benefit at the expense of airlines and passengers, as the level of return and depreciation in Q5 charges is based on the higher (front-end loaded) forecast plan. In practice the airport benefits at the expense of passengers who have paid for projects that are not delivered to time.
- it retains the difference between the allowed return on the higher forecast plan and the lower actual plan.

3) There is a lack of incentives to deliver projects to time and cost once the business cases have been included within the price settlement.

There are a number of principles by which VAA believes CAPEX should be judged for Q6. These principles generally reflect the views developing within the LACC at Heathrow:

**Principle 1:** Only CAPEX that is efficient, offers value for money, and is desired by our passengers should be considered for delivery

VAA supports the proposal for 'core and development' (previously named "Fixed/Flexible") approach to CAPEX, complimented by a gateway governance process to manage and progress the development of projects in their early stages.

This would enable airlines to take much better informed business case based decisions, and reduce the current uncertainty associated with taking decisions on projects based on limited information and with considerable uncertainties about future requirements, whose, scope, time, and costs are likely to change over time, as well as more accurately manage cash flow in relation to project delivery.

The intention is that the Core and Development pots would both be included within the Q6 price settlement, however that the Development pot would be managed ex-post, and the Core pot managed ex-ante.

VAA look forward to discussing in more detail how the governance and gateway proposals could work.

**Principle 2:** Airports should be fairly rewarded for the efficient undertaking of CAPEX projects;

VAA are firmly committed to airports being fairly rewarded for the efficient undertaking of CAPEX, through the current regulatory building block approach, where this reward comes from the allowed WACC. An appropriately set WACC should provide sufficient incentive and reward to undertake efficient CAPEX.

However, there is a need to ensure only efficient CAPEX is constructed to maximize passenger value i.e. that the baseline cost is correct, and that risk is appropriately

addressed. Having set a proper CAPEX baseline, it is still possible for Airport Authorities to outperform the project and deliver below the anticipated cost. Efficiency should be rewarded in this context.

**Principle 3:** Those incentives should be stronger for the efficient and timely delivery of projects than for delivering a project under budget;

Incentives should be appropriately focused on the delivery of projects to time and scope, to ensure cost is not the only incentive driver for Airport Authorities.

**Principle 4:** Inefficient CAPEX – either in terms of cost or timing should not be rewarded and yield diminishing returns.

Airports should not be rewarded for inefficient CAPEX projects that are delivered late, not delivered to the agreed outcomes to standard; and/or they can be over cost.

Capital Triggers are a helpful mechanism to help reclaim some of the Airport Authorities cash flow benefits resulting from a failure to deliver projects, however HAL, for instance still received a substantial new gain. A mechanism therefore needs to be developed to ensure cash flow is neutral across the quinquennium, so that inadvertent advantage, or disadvantage is not gained by the Airport Authority.

VAA understands that the current system of striking CAPEX from the RAB is difficult to operate. This is not the case in other regulated industries. In their treatment of gas distribution OFGEM use three pots for the ex post evaluation of CAPEX.

Pot 1 – defined as ‘wasteful and unnecessary’ – expenditure here is outside the RAB, and not rewarded;

Pot 2 – defined as ‘efficient overspend’ – no allowances are given for depreciation or returns. After 5 years, the depreciated asset is placed in the RAB and earns returns as normal;

Pot 3 – ‘re-opener’ – CAPEX included in the RAB, all allowances paid (including for under-recovery).

VAA, in-line with the airline community believes that such a system could be introduced in airport regulation and that it would provide a strong incentive towards CAPEX efficiency.

**Principle 5:** Projects undertaken should be supported by a proper governance structure, which ensures transparency and delivers sound financial assurance

A key aspect of ensuring CAPEX efficiency is to ensure that projects are properly specified and costed before they begin. A number of mechanisms are available to help uncover true baseline costs. At one end of the spectrum is OFGEM’s menu approach, that does support transparency however can be complex and administratively demanding. VAA is most interested in what seems to be a more

streamlined approach of using independent CAPEX specialists, to provide a focused assessment of costs and timelines in key projects. VAA understand that this is similar to the approach adopted by other regulators including ORR, NIAUR, WICS and currently, OFWAT, in their Reporter regimes.

CAPEX projects could be subject to scrutiny by the Reporter, which would allow the community assurance through the audit of capital costs, the milestones, and benefits of the project to ensure that delivery is being achieved to maximum efficiency. This would include auditing the project plan and benchmarking costs against a relevant industry index.

VAA believe that having a stronger Governance structure in place will increase confidence that capital projects are delivered to plan, and that it will allow the whole of the Heathrow and Gatwick community's to pro-actively manage risk.

VAA would welcome working with airlines, the CAA and the airport during constructive engagement to develop mechanisms that deliver these principles for Q6 and look forward to continuing discussions with HAL, GAL and airline committee's to positively encourage the delivery of valuable benefits to passengers through more effective incentive mechanisms in the next regulated period.

## OPEX incentives

The current arrangements provide a strong incentive on airports to reduce the costs of running the airport but through an irregular and un-commercial fashion. This is due to the airports retaining all OPEX reductions achieved after the pricing has been set. This incentivises the airport to drive up cost so that it may then have a higher price set before seeking to reduce such OPEX in order to keep the savings.

In practice this has produced mixed results. Consequently it is the view of VAA that a challenging target for OPEX reductions will be required in Q6. There also needs to be a mechanism such that the regulatory structure reflects economic reality. Therefore, VAA would actively support an incentive mechanism for OPEX in Q6 based on the following criteria:

1. Any baseline of total OPEX is not set artificially high, so efficiencies are then easily achieved, for the airport authority to earn a gain share;
2. It is simple to administer and calculate;
3. For any incentive paid out to the airport authority the specified service levels must be reached for the period in question before the incentive pay out can be considered;
4. The incentive should not necessarily be linked to the Qs defined period of time. In addition the incentive should not pay out for longer than a Q i.e. 5 years. Defined periods may drive behaviour to only reduce cost at certain points in the Q;
5. A link should be made to cost per passenger, rather than a total OPEX value. This would mean the airport authority are not at risk to a rise in passengers numbers driving a higher total OPEX value and equally they are encouraged to cut OPEX if passenger numbers decline. The true airline concern is cost per passenger and not a total OPEX value;
6. Any OPEX incentive should be linked in with service incentives and CAPEX incentives, so that objectives are aligned. This way, an airport would need to maintain a focus on all aspects, not just the one that would be either easy to earn or provide the largest windfall; and,
7. There should be an incentive for the airport to keep within business case OPEX numbers. This is an area that can have adverse impacts on pushing charges up as business cases have been signed off, on the proviso of a certain level of OPEX, only for the OPEX spend to come in much higher. However, there is currently no accountability or pressure on the airport to curb this.

**How should the CAA interpret its new financing duty?**

VAA welcomes the open and collaborative approach the CAA is taking to consult on the interpretation of its new financing duty and broadly agrees with the interpretation set out.

VAA agrees that the CAA needs appropriate financing tests to control financing levels. It is important however that these are based on pure financing drivers and not overall commercial drivers.

Finally, VAA agrees with other airlines at Heathrow that discussions around the cost of capital methodology are needed, during constructive engagement, to drive a common understanding. The proposal from the CAA to have discussions around these issues in 2012/13 is therefore welcomed.