Virgin Atlantic Airways response to the CAA's consultation on *Economic regulation of capacity expansion at Heathrow: policy update and consultation* (CAP 1658)

Introduction

1. Virgin Atlantic Airways (VAA) welcomes the opportunity to respond to the CAA's consultation on CAP 1658, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, published in April 2018.

2. Our response follows the structure of the consultation document and covers the following issues in turn:

   - Affordability and financeability;
   - Evolutions to the regulatory framework;
   - Cost of capital and incentives;
   - Interim arrangements to apply after the end of the Q6 price control;
   - Early category C costs; and
   - Surface access

Affordability and Financeability (Chapters 1 and 2)

3. We re-iterate our support for capacity expansion at Heathrow to enable increased airline competition that would deliver more choice, lower fares and better service for passengers, but such expansion must be affordable. We note that HAL has stated that it understands stakeholders concerns over affordability and is *"committed to trying to deliver capacity expansion with airport charges close to current levels in real terms"*[1]. We would also refer to the CAA's oral evidence to the Transport Select Committee, in which it stated that it knows that keeping costs flat at Heathrow is possible and to the statement from the Secretary of State for Transport in Parliament during the debate on expansion on his *"ambition to keep airport charges as close as possible to current levels"* and having *"commissioned the Civil Aviation Authority to work with the airport to keep landing charges close to current levels."*

4. We also note, however, the CAA statement that "*airlines will need to accept that our assessment of cost efficiency and consumer interest may not always align with a cost profile that produces the lowest possible charges*"[2]. To be clear whilst we accept that there is a balance to be struck between costs and design, scope and service quality, we are firmly of the view that this balance can be struck whilst keeping charges flat in real terms.

5. The Frontier Economics Report[3] commissioned by HAL, and referred to by the CAA, refers to a premium paid by passengers because of capacity constraints at Heathrow, but fails to mention that Heathrow already has the highest airport passenger charges in the world and that, for example, despite the current Q6 RPI-1.5% price path, the long-haul passenger charge at Heathrow has increased by over 8% to £44.34 between 2017 and 2018. As an airline that

[1] CAP 1658, para 1.4
[2] Ibid: para 1.17
[3] CAP 1658, para 1.7

operates on competed routes at Heathrow, we do not accept that we are able to charge a premium to passengers.

6. We acknowledge the 'twin track' approach adopted by the CAA in assessing financeability and note that this modelling and assessment of credit metrics is for a notionally financed airport. Thus, the results will only be applicable to a notional airport, rather than HAL itself, and this is crucial as HAL will potentially be raising significant amounts of debt to finance capacity expansion. We note the CAA's comments that it intends to supplement the notional assessment with an analysis of a more highly geared structure and we look forward to that analysis. However, we support the AOC view that any additional costs arising from HAL's choice of financial structure should be borne by HAL and should the CAA not take this approach it would fail in its duty to consumers.

7. We also believe that the cost of capital assumption of 6%, as taken from the Airports Commission, is too high. The market returns and assumptions leading up to and during 2015, when the Airports Commission report was published, were very different from the returns post 2015. Interest rates on debt have dropped significantly. In our view, the cost of capital estimated by PwC takes into account more recent activity in the financial markets and provides relatively larger headroom for future uncertainties. This is more suited to modelling HAL's financeability than the 6% used by the Airports Commission.

8. In its initial assessment of affordability the CAA states that "there are credible assumptions that could lead to a path of prices that is broadly affordable"[4]. We appreciate that this work is in its initial stages and subject to further consultation and development. At this early stage of analysis we support the AOC view, from its examination of the model provided by the CAA. This being that whilst none of the current scenarios can be considered affordable, with further work on costs, assumptions and regulatory interventions, an affordable price path may be achievable.

Evolutions to the Regulatory Framework (Chapter 3)

9. As we noted in our response to CAP 1610, we are open to consideration of alternative delivery mechanisms or to proposals that encourage competition. We also remain interested in exploring the option of commercially negotiated arrangements, but HAL holds significant market power, which places airlines at a disadvantage when entering into such negotiations. In addition, there is also a big difference in scale between different airlines operating at Heathrow, which means there is likely to be a large disparity in negotiating power between different airlines.

10. The CAA states that "it is too early to take a final view on any particular form of alternative arrangements"[5]. We agree. But we remain open to possibilities and look forward to commenting further as and when specific proposals come forward.

11. With regard to enhanced engagement we note that the CAA has now published its final report on airport-airline engagement in April 2018 (CAP 1656). In this the CAA notes[6] that:

    "…there remain important areas which HAL must progress urgently to secure the confidence of stakeholders including:

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[4] CAP 1658,para 2.12
[5] CAP 1658, para 3.17
[6] CAP 1656, para 2.32

▪ *ensuring that consumers' interests are reflected in the design;*

▪ *demonstrating that it has properly considered alternative commercial and delivery arrangements;*

▪ *providing comprehensive information on programme costs and cost efficiency as a matter of urgency; and*

▪ *demonstrating the overall affordability and financeability of capacity expansion."*

12. We have repeatedly noted in previous responses that incomplete or insufficient information hinders meaningful engagement. The CAA states (para.3.33) that it expects HAL to publish relevant materials and provide more granular information. We agree and would expect the CAA to proactively follow this up and hold HAL to account on the provision of information.

Cost of Capital and Incentives (Chapter 4)

13. We provided detailed analysis on the cost of capital in our response to CAP 1610. We welcomed the work commissioned by the CAA and produced by PwC in providing an early and preliminary range for HAL's WACC. However, we also noted the CAA's cautious approach to the PwC work and that it represents no more than an early and preliminary estimate. This seems to remain the position and the CAA notes (para. 4.12) that it has still to consider all other representations received. We would again urge the CAA to be clearer on the thought process it is going through with regard to setting the WACC, and specifically what other advice or information the CAA intends to seek from other sources. We look forward to the CAA's future publication on parameters for the WACC referred to in para.4.11.

14. The CAA seems to be unsatisfied with the WACC estimated by PwC, stating that: *"In general, the premium for capacity expansion identified by PwC was not sufficient to offset the reductions it identified in the WACC resulting from its view of changes in market wide conditions*." We would point out that the intention behind the premium for capacity expansion was not to reverse the impact of the fall in market returns. A WACC uplift of 0.25% - 1% over and above the estimated cost of capital may initially seem to be small but when applied to the existing RAB and the significant additional capex required for the capacity expansion, could amount to large sums and may be sufficient to cover any additional risks. It is also worth noting that the WACC uplift would be fixed in each of the scenarios modelled in assessing HAL's financeability. So even in a slow build and higher cost scenario, HAL would still be compensated an additional 0.25%-1% through the WACC. The estimated uplift of 0.25% satisfies the additional risk HAL would be taking on and no additional premium would be required.

15. With regard to incentives, we note that the options suggested by the CAA are fairly symmetrical in the sense that the proportion of costs and benefits retained by HAL are identical in the context of capex over/under spend. It is the CAA's duty to ensure that HAL delivers the capacity expansion in the most efficient way possible. It should also be in HAL's best interests if it manages to achieve a 'faster build and lower costs' scenario as the amount of debt needed would reduce. This would further reduce the financial burden on HAL and also provide quicker financial returns from the capacity expansion, as the new runway would be built more quickly. As a result, HAL's shareholders would be rewarded earlier than predicted. The incentive for HAL to provide capacity expansion is the significant increase in the number of passengers from which it can derive aeronautical and commercial revenues.

16. We note that the CAA has not reached a final view on incentives and that further work is to be undertaken and working papers to be published. We look forward to the opportunity to comment on these in due course.

Interim Arrangements to apply at the end of Q6 (Chapter 5)

17. In our previous response to CAP 1610 we supported the logic in trying to align the regulatory control periods with the third runway extension and, accepting that this will never be perfect but that at some point practicality must prevail, Q6+2 should be confirmed as the basis moving forward to provide certainty to the regulatory regime.

18. We strongly opposed the application of the RPI-0% price path (or indeed the RPI-1.5%) to this further extension as we believe it would be contrary to consumer interests and would effectively make today's passengers pay more, so that tomorrow's passengers might pay less.

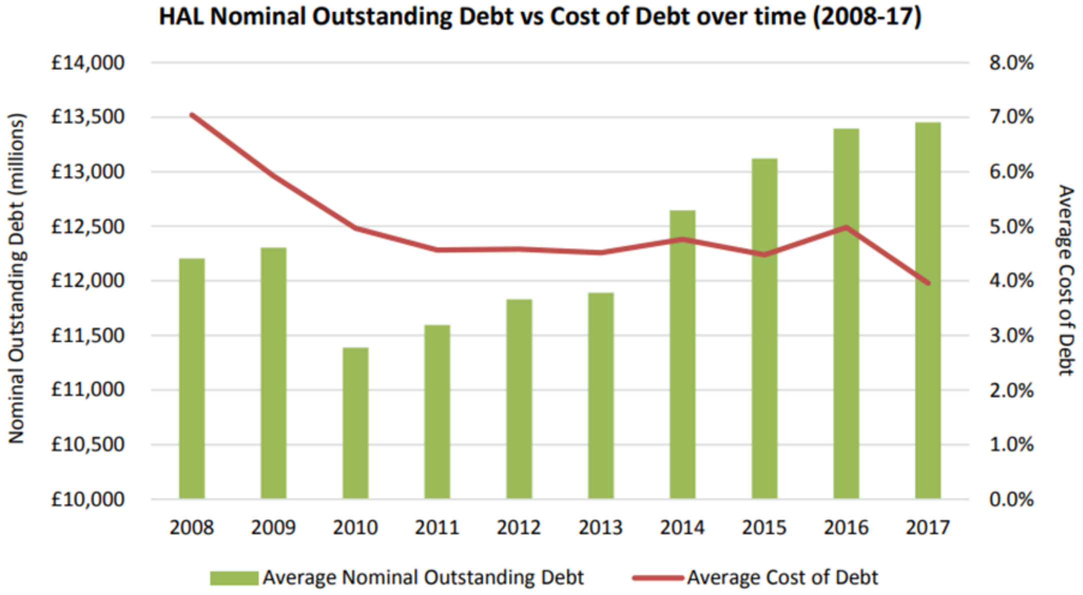
19. We understand that the key reason for the two year price extension is to allow more time for HAL to prepare its business plan and to engage with stakeholders. As such we expect HAL to deliver a high quality initial business plan. We remain of the view that this two year extension favours HAL's interests without giving sufficient weight to consumer's interests. Specifically, HAL's windfall gains from higher than forecast traffic (provided by airlines) and lower than forecast costs of debt (driven by the markets) would be allowed to continue for a longer period at the expense of consumers. This cannot be consistent with CAA duties.

20. The CAA is now proposing a continuation of the RPI-1.5% price path for the further two-year extension. This approach compounds the dis-benefit to consumers and over-rewards HAL for windfalls that were not wholly of its own making. We are therefore clear that lower prices at Heathrow now, rather than in the future and resulting from uncertain adjustment mechanisms, would be in the best interests of consumers.

21. The CAA sets out its approach to determining charging levels (para.5.33) for 2021 (iH+2 in CAP 1658 Figure 5.2) and includes a review of the revenue building blocks for that year. However, we believe that RPI-1.5% should not be a 'given' for iH7+1 and that the building blocks review should be brought forward so as to test whether such a price path is appropriate in terms of financeability.

22. The CAA also states that the WACC for the interim price control would be adjusted to the updated cost of new debt and the tax rate. It would be helpful to understand why the CAA has chosen to update only the two variables and not the rest, as most of the variables have changed since the last determination. This is especially the case with the cost of debt, as the cost of new debt only makes up a relatively small proportion of the weighted cost of debt and the overall debt holds a 60% weight in the WACC.

23. In our response to CAP 1541, we noted that HAL's embedded cost of debt has generally been declining since 2008. The trend can be observed in the chart below:



(Source: VAA's response to CAP 1541)

24. Despite the increasing amount of debt, the nominal average cost of debt has been dropping, with an updated 2017 year-end rate of 3.92%[7] and 3.76%[8] as of March 2018. This is due to HAL's constant debt financing and refinancing activity, replacing the more expensive debt with lower cost debt and thus reducing the average nominal cost of debt. We therefore suggest that the CAA should consider the cost of embedded debt and also update this variable to HAL's most recent real cost of embedded debt in setting the cost of capital for the interim price control.

Early Category C Costs (Chapter 6)

25. In our response to CAP 1610 we said that the provision of additional capacity at Heathrow is in the interests of consumers only if the expenditure incurred in providing it is affordable and efficiently incurred and demonstrably in the interests of passengers. Without clarity on those matters agreed by all parties, which has not yet been established, any early construction costs incurred prior to DCO consent must be entirely at HAL's own risk. It is possible that the planning inspectorate may not approve HAL's DCO application, or that the Secretary of State for Transport does not grant approval to the planning inspectorates' recommendation.

26. We also said that even with appropriate provision of information and consultation, the question remains as to when and whether consumers should be expected to pay for early construction costs when the affordability and deliverability of additional capacity is not yet clear.

27. The CAA also notes that: "HAL has much more work to do in providing robust information on the need for the individual components that will make up its early Category C spending and providing evidence and assurance on cost efficiency."[9] Until such information is provided it is

[7] https://www.heathrow.com/file_source/Company/Static/PDF/Investorcentre/Heathrow-(SP)-debt-31Dec17.pdf

[8] https://www.heathrow.com/file_source/Company/Static/PDF/Investorcentre/Heathrow-SP-Debt-31-Mar-18.pdf

[9] CAP 1658, para 6.20

difficult to make further comment on the Category C costs other than to agree that HAL should seek agreement from the airlines on the overall need for and timing of expenditure.

Surface Access (Chapter 7)

28. We fully support the CAA's statement that "*we do not consider it in consumers interests for them to pay for surface access schemes, or enhancements and upgrades to schemes that are not required for capacity expansion. We also agree with respondents strong support for the user pays principle"*[10], namely that consumers' interests are unlikely to be furthered by airport operators bearing the costs of projects beyond those which are strictly necessary to enhance the efficient operation of the airport and/or necessary to secure planning permission for expansion. We also agree, in broad terms, that the 'user pays' principle should apply, although we do not agree that airlines should bear residual costs of surface access schemes that provide wider benefits to the travelling public unconnected with the use of the Airport.

29. We agree that there needs to be greater coordination of work between all stakeholders involved in surface access schemes to understand how these might affect airport charges.

[10] CAP 1658, para 7.12