



Rob Toal
Economic Regulation – H7
CAA House
Kingsway
Sent to: economicregulation@caa.co.uk

Re: Strategic themes for the review of Heathrow Airport Limited's charges ("H7")

Dear Rob,

Virgin Atlantic (VS) would like to thank the CAA for this opportunity to respond to the 'Strategic themes for the review of Heathrow Airport Limited's charges (H7)'. Virgin's aim since its inception has always been to provide high quality, innovative services and value for money for all our passengers. Given the CAA's primary duty to further the interests of users of air transport services, we therefore welcome the move by the CAA to focus on the impact to the passenger through this review.

As indicated in the consultation document, our passengers pay the highest charges in the world at Heathrow Airport and the Q6 settlement did not go far enough to address this; for our passengers there is still further work that needs to take place. Value for money and affordability continue to be vital for our operations and our passengers, particularly while airlines are continually striving to gain further efficiencies in what is a highly competitive market.

This response supports and compliments those of the LACC/IATA at Heathrow.

Interaction with potential new runway capacity and regulatory approach

We understand the complexity of the H7 review taking place against a background of political uncertainty associated with an additional runway at Heathrow. Although the Government has indicated that the package of work that is currently taking place on additional capacity is anticipated to conclude over this summer, there is the potential for such timeframes to change or be amended due to political risk and increased uncertainty in the current climate.

Our view, therefore, is that with this level of uncertainty in place all options for the process following the formal end of Q6 need to be considered and evaluated and we see these captured under three broad themes.

- H7 process to continue as is currently laid out in the CAA's high-level

Virgin Atlantic Airways Limited

The Office
Manor Royal
Crawley RH10 9NU
United Kingdom

T +44 (0)844 811 0000
F +44 (0)844 811 0747
www.virginatlantic.com

Registered Office Company Secretariat,
The Office, Manor Royal, Crawley RH10 9NU
United Kingdom
Registered in England 1600117
VAT Number GB425 2161 84

timetable with implementation in the fourth quarter of 2018.

- Extension of Q6 for an additional year to partly cover the political uncertainty associated with an additional runway.
- Extension of Q6 for two additional years to fully cover the political uncertainty associated with an additional runway.

Given the level of uncertainty currently associated with H7 and whether the review would take place from a two-runway or three runway viewpoint, we must also take into serious consideration the potential for and extension of the current regulatory regime.

We would welcome further discussions with the CAA on the potential and appetite to take forward of each of these options.

Category B Costs and Pre-Funding

The Heathrow airline community has always recognised the challenging environment associated with the provision of additional capacity in SE England. Our response to the Airport Commission noted these factors as well as drawing attention to the commercial viability of the proposals and stated that the correct risk allocation processes must be in place to mitigate political, regulatory, demand, financial and construction risk.

The CAA in its economic regulation of new runway capacity paper (CAP 1279) acknowledged that risk should be allocated to those parties who can best manage it. The airline community is not persuaded that the political risk factors have been resolved and, whilst the Government is reviewing the location options, it seems premature, currently, to enter into commercial discussions with HAL on many aspects associated with Cat B costs. Furthermore, the conditions which may be proposed by the Government regarding the longer term nature of capacity expansion, surface access, capacity release and compensation regarding noise and blight remain unknown. These factors alone will have a huge impact on the commercial viability of the project and consequently will influence the response of the airline community.

Consequently, a robust baseline to enable sustainable discussion does not yet exist and can only have real meaning when the final nature of the package is determined by the Government. Some of these factors are already acknowledged in CAP 1372. Indeed, the previous CAA paper CAP 1332, entitled Economic regulation of new runway capacity – Update, acknowledged in September 2015 that this process, the treatment of planning (or Cat B) costs, could only “start in earnest” once the Government had taken a location decision which was then expected in December

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United Kingdom

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2015. As the Government has delayed a decision, the rationale to determine Cat B costs remains unchanged.

Market Power Assessment

VS has consistently held the position that Heathrow holds Significant Market Power (SMP) and will continue to do so for the foreseeable future. Therefore, we welcome the initial conclusion reached by the CAA that there has not been a material change in circumstances since the previous determination in 2014 and that Heathrow will require ongoing economic regulation over the next regulatory period.

Our view, even if there were to be a decision to deliver a third runway at Heathrow in the near future, is that this would not constitute a requirement for a new MPD to take place for a number of years beyond 2019 and the airport will continue to require economic regulation.

We also agree that at Heathrow only a RAB based approach can provide the right framework for regulation and adequately protect passengers.

Regulatory best practice

We believe that it is good practice to take the lessons learned from other regulatory regimes. Where there is sufficient evidence that practices have worked well and could be applied to the economic regulation of airports, these should clearly be considered.

However, given the diversity in regulatory approaches across sectors and the entities being regulated, it is important that this is only considered where appropriate and after a thorough review.

In the remainder of this response we have provided some high-level commentary on some of the areas of best practice that have been presented in this consultation.

Empowering consumers and furthering their interests

VS welcomes CAA recognition that airline interests are aligned with their consumers, the passengers. Airlines continue to be best placed to represent the needs of passengers, who are the primary consumers of airport services. We are committed to offering the highest levels of service for all of our passengers and will be doing our utmost to represent their views during the forthcoming review.

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Consumer Challenge Forum (CCF)

The concept of a CCF is interesting and one that could bring the consumer closer to the economic regulatory process than ever before. We continue to believe that airlines represent the interests of our passengers; however, we remain open to reviewing how such a forum can play an appropriate role in this process.

Our main concern is that it will be vitally important to ensure that the CCF is comprised of the appropriate members. If taken forwards airlines need to be able to have a considered voice on who is able to sit as a member, in an equal manner as the airport operator. Additionally, before we are able to provide a robust assessment of such a Forum we would need to have sight of the precise scope, format and detailed roles and responsibilities of the CCF and exactly how it will interact with the H7 process and outcomes.

✂. We would be happy to share our views on such operations if this would assist going forwards over this review and would welcome further discussions with the CAA as to what evidence would be useful.

Incentivising the right consumer outcomes

Innovation, quality, value for money and great service are key to VS for all customers. We pioneered a range of innovations that set new industry standards of service. It is therefore vital for us that the passenger experience on the ground delivers for our customers.

VS, along with other airlines, holds the principal contractual agreement and relationship with passengers. However, the airport operator is obliged to provide airport services through its contract with airlines.

At Heathrow, the service quality rebate and bonus scheme (SQRB), does go some way to evaluate whether a certain level of service is being provided for the passenger. However, there is a need to ensure that there isn't the on-going ability for the airport to game the system.

It is important to ensure that service propositions fully and 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 operators' business to manage how airlines deliver their service; they are a supplier. Moreover,

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airlines operate in an extremely competitive environment and one which enables consumers to base their purchases on the level of service they expect.

We would welcome a more robust approach to service-quality that builds on the system. However, in the interest of achieving an outcome-based environment, we would be apprehensive if the SQRB regime was to be overhauled or disbanded completely.

We would welcome more precise details on what the CAA's thinking is in this area.

Increasing airport operational resilience

We note the importance of operational resilience for our passengers. Ensuring resilience is critical to the airport and the success of our operations.

Airlines are already highly incentivised to provide the best services for passengers, and would be interested in viewing what "ambitious options for better management" the CAA is currently considering. There is a need to ensure that any review of resilience is balanced against the potential for over-investing through placing too much emphasis on this area.

We would like to discuss further what innovative ways to manage and reduce disruption are being considered, and ensure that this is not being looked at through a lens of over-investment, further licence conditions on airlines or caps on movements being implemented.

It is also worth noting that resilience is also applied to airspace utilisation, and would welcome further consideration of this in conjunction with NATS. Furthermore, we also support the Future Airspace Strategy (FAS) and its implementation in a timely manner.

Promoting cost efficiency and financeability

Business Plans

Given HAL's dominance as outlined above and the lack of competition to pressure a distinct improvement in the quality of the business plan presented, it is difficult to see how or why HAL would be incentivised to provide a stark improvement in the business plan it initially provides.

Our secondary concern is that if HAL is allowed an increased amount of time to achieve such an 'improved' business plan, in what is an already constrained time period for engagement, this would result in a vastly reduced timeframe for airlines to scrutinise the business plan and provide a robust assessment.

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Totex

Our initial thoughts are that this could make data sharing less transparent and difficult given the CAPEX bias and airports natural inclination to build. We would welcome exploring the issues around such a move with the CAA.

RPI vs CPI

The switch from RPI to CPI is one that VS raised during the Q6 review due to the practice being established in other regulated sectors. This is a view that we continue to hold over the H7 period due to reasons around the legitimacy of the RPI indexation process and real-term impact on the prices our customers at Heathrow will face. We would welcome the CAA carrying out a robust assessment into the costs and benefits of this potential switch and whether such a switch would further the interests of passengers.

WACC

We continue to support the use of the WACC as the measure of return set for HAL for the next regulatory period. However, the level at which the WACC is set should be calculated as an investment in a regulated infrastructure investment company with substantial market power.

We would welcome further transparency from HAL on the analysis it is currently undertaking on this issue, however, would be cautious about the CAA or HAL providing an estimated range at this stage. Our view is that the current WACC set at 5.35% should be used, and HAL should then be required to provide a fully evidenced assessment if it wants to deviate from this figure.

Constructive Engagement

VS has been broadly supportive of the Constructive Engagement (CE) process set out to date and has been an active participant in community work and discussions to drive forward a common understanding of requirements and transparency of costs for Q6.

In our view, CE worked well over Q6 and is a process that is vital going forwards. We welcomed the level of discussion that took place over what we viewed was an appropriate length of time given the nature of the topics in question. Continued transparency and the timely ability to scrutinise costs is highly important in this process.

We would be extremely concerned if the period of constructive engagement was to be significantly shortened. A period suggested by HAL in its presentation at the industry workshop held on the 17th March raised a period of three months; this was incredibly concerning in our view and not at all workable. A period of three months

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would not allow sufficient time to hold robust and detailed discussions around important topics.

Conclusion

As we have laid out in this response we are currently requesting all potential options for the next regulatory period to remain on the table for consideration, this includes extending the Q6 period. Given the backdrop of the Government decision around new runway capacity and the uncertainty this brings, it is therefore essential that we are considering all possible options at this stage.

Given the level of competition between airlines, our views are wholly aligned with our passengers and are always at the heart of any decisions taken. As previously mentioned our passengers pay the highest charges in the world at Heathrow and the Q6 settlement did not go far enough to address this. For our passengers focusing on value for money and affordability continue to be vital whichever option is taken forward for the next regulatory period.

We welcome any further discussion of the points made in this response.

Kind regards,
David Joseph
Specialist, Regulatory Affairs

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Manor Royal
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