Virgin Atlantic Airways response to the CAA's consultation
Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP 1782)

Introduction

1. Virgin Atlantic Airways welcomes the opportunity to respond to the CAA's consultation CAP1782, Economic regulation of capacity expansion at Heathrow airport: policy update and consultation, published in March 2019.

2. Our response primarily sets out our views on the key issue raised in CAP1782, the CAA's approach to financeability for capacity expansion at LHR, after which we address other points arising from the consultation.

In summary

3. While we generally agree with the intention by the CAA to take a holistic view in assessing HAL's financeability we are concerned that the proposed approach as laid out in this consultation is too mechanistic. There is a risk that if the CAA does not consider the nuances in this work HAL may appear less financeable than it actually is.

4. We have noted our support of *ex ante* incentives in our previous consultation responses however as CAP1782 makes clear there are still a number of issues to be resolved. We are not convinced that there is now sufficient time for the CAA to implement an effective *ex ante* framework. We suggest improvements to the existing regulatory framework would achieve a similar result, be less complex and thus quicker to implement.

5. More generally we also raise the following point with regard to the ongoing consultation process. The regulatory framework and the issues surrounding the expansion of Heathrow are complex with multiple interlinking facets. However the CAA's approach to consultation of looking at each issue one at a time may be hampering effective consideration of the framework as a whole.

Approach to Financeability – Chapter 1

Overall financeability

6. In general, we agree with the CAA's intended approach in taking a holistic view in assessing HAL's financeability. The framework does set out many of the key influences and directions of effect, but we also believe that there are key aspects that are missing. We believe this framework is very mechanical, does not allow for important subjective factors to be reflected and focuses overly on improving HAL's revenue generating ability in the event of an adverse scenario. Ultimately, this could result in financeability appearing to be more difficult than it actually is.

7. Specifically, we believe that the CAA does not give sufficient consideration to qualitative factors that affect/influence the credit rating, i.e. the strong fundamentals of HAL, the significant market

power and the traffic mix. It is these qualitative factors combined with financial metrics that provide credit ratings agencies with the evidence from which they make judgements around a business's credibility and quality as an asset in terms of debt financeability (which is ultimately communicated to potential lenders). We discuss these issues further in later parts of this chapter.

Current market evidence on HAL's financeability

8. Before discussing anything about financeability, it is worth looking at HAL's current situation in the debt capital markets.

9. We believe that there is significant market evidence indicating the substantial demand from lenders willing to lend to HAL and that this demand outweighs the amount of lending required by HAL. Table 2.1 outlines a selection of HAL's bonds listing announcements with information on the size of the order book (demand) and the bond amount raised (supply):

Table 2.1: Examples of HAL Bonds with Investor Subscription

Year	Amount (m)	Tenor (years)	Orderbook (m)	Cover Ratio (Orderbook/ Amount)
2019	€ 650	15	€ 2,800	4.3x
2017	€ 500	15	€ 1,000	2.0x
2017	€ 275	10	€ 1,800	6.5x
2015	€ 750	15	€ 2,500	3.3x

Source: London Stock Exchange, Reuters, Investegate and York Aviation Analysis

10. This shows that the order book for these bonds far exceeded the amount required by HAL, with a weighted average cover ratio of nearly four times the required amount. This suggests strong demand for HAL debt financing. With strong demand, also comes strong negotiating power. We believe HAL are not just financeable but are also able to achieve debt at efficient costs. Given the fundamental strength of HAL's business and that ultimately investment in R3 will be added to the Regulatory Asset Base, we believe that in reality HAL should be able to successfully raise the required amount of debt to build R3. This 'common sense' test needs to be borne in mind throughout any assessment of financeability.

11. An excerpt from a recent successful bond placement in November 2018 announcement further demonstrates the advantageous position HAL is currently operating in:

    "The transaction generated a solid order book which enabled the bond to be priced inside initial expectations." – Heathrow News Release

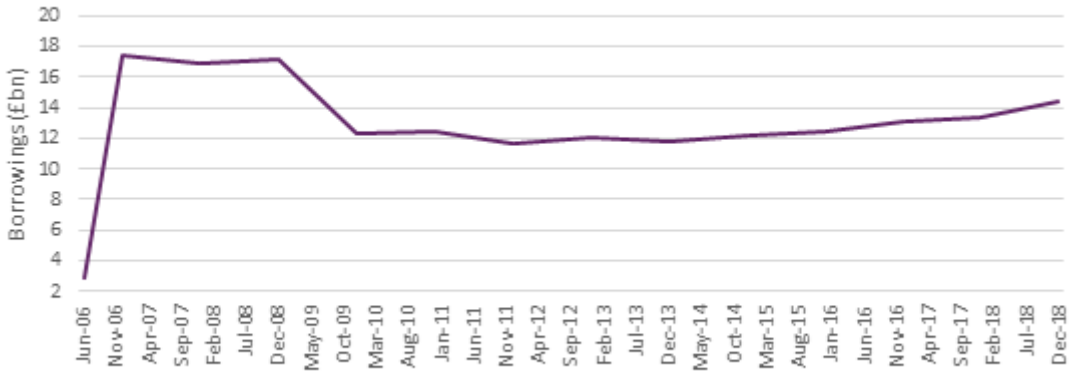
Capital structure and gearing

12. We note that the CAA intends to use a twin track approach to consider the effects of capital structure and gearing, initially using the existing notional gearing structure of 60/40 before moving on to consider a more leveraged structure that is closer to HAL's actual structure. In our view, this is a sensible way forward. We strongly believe that HAL, despite being highly leveraged, produces sufficient cash flow to fund its existing financial commitments and should be able to

raise additional debt to fund the runway 3 (R3). It is clear that HAL is taking advantage of the current favourable debt market conditions and refinancing its existing debt, achieving financial efficiency. The ongoing fall in the cost of debt, combined with growth in passenger revenues, puts HAL in a very comfortable position where they are enjoying the added leverage and improved financial health. There seems limited reason as things stand to suggest that this is likely to change any time soon or even with the capacity expansion. Hence, examining more leveraged capital structures, which could bring affordability advantages is sensible.

13. However, it is also worth noting that the large amount of debt held by HAL is not accidental. In 2006, when HAL was purchased off the stock market for a considerable price tag of over £10bn, the majority of this acquisition was financed using debt. This can be seen in Figure 2.1 and the notes from the December 2006 Annual Report for Heathrow Airport Holdings Limited, which clearly acknowledges the sharp rise in net debt from £2.9bn in June 2006 to £17.7bn in December 2006, explaining the increase as "following the financing of acquisition of BAA plc"

Figure 2.1: Heathrow Airport Holdings Limited Borrowings (June 2006-December 2018)



Source: Heathrow Airport Holdings Limited Accounts June 2006-December 2018.

14. This means that a significant part of HAL's debt today is still potentially due to the original financing of the acquisition. In our view, this debt should be treated with considerable caution when considering HAL's capital structure moving forward and its impact on the financeability of R3. We believe this is an inappropriate amount of debt to add into the capital structure mix while assessing financeability of the highly geared capital structure scenario but that examining the potential financeability of a legitimately more leveraged capital structure is appropriate.

15. If HAL has a financeability issue in relation to R3, the shareholders should need to tackle this acquisition debt first. This would not just improve HAL's borrowing capability, but also potentially improve HAL's existing credit rating on the senior and subordinate debt, on which its current financing risk is deemed as "aggressive". Figure 2.2 clearly demonstrates that HAL's current ratings on its senior and subordinate loans have considered the higher leverage in comparison to its peers, explaining why the credit rating isn't higher due to this debt structure.

16. Ultimately, we do not believe that it is equitable for consumers to pay for higher financing costs that stem from HAL's shareholders acquisition strategy. Adopting a more leveraged position for a notional company to fund expansion is potentially sensible and would result in a lower WACC and costs for consumers. If this is not possible in reality because of HAL's acquisition debt and consequent true gearing would result in higher financing costs, these should not be a cost to passengers. Although HAL is actively refinancing its debt to achieve financial efficiency, we believe that HAL's potential financeability would be stronger without the additional debt added on by the shareholders at acquisition.

Figure 2.2: Fitch Ratings EMEA Airport Peer Group Summary

EMEA Airport Peer Group Summary

	Aéroports de Paris (ADP)	London Heathrow (LHR) Class A	London Heathrow (LHR) Class B	London Heathrow (LHR) HY	Gatwick Funding Limited (GAL)	Manchester Airport Group Funding PLC (MAG)	Aena, S.A. (AENA)	Brussels Airport Company S.A./N.V. (BAC)	Copenhagen Airports A/S (CPH)[a]	Aeroporti di Roma S.p.A. (ADR)	DME Limited (DME)
International scale rating	A+ (IDR/Instrument)	A- (Instrument)	BBB (Instrument)	BB+ (Instrument)	BBB+ (Instrument)	BBB+ (Instrument)	A (IDR)	BBB (Instrument)	BBB/BBB+[a] (IDR)	BBB+ (IDR/Instrument)	BB+ (IDR/Instrument)
Rating Outlook	Stable	Positive	Positive	Stable	Stable	Stable	Stable	Positive	Stable	Stable	Negative
Rating peer positioning snapshot	Highest rating due to strongest Key Rating Drivers (KRDs) together with relatively low leverage. Higher rating than closest peer, LHR's snr debt, due to lower leverage.	Lower than ADP as LHR's similar operating risk profile is offset by higher leverage.	In line with BAC and CPH (consolidated) as LHR's stronger operations is offset by higher leverage.	Low rating due to deep structural subordination and highest leverage among peers.	One notch lower than LHR's senior secured debt due to LHR's stronger revenue risk, backed by its global hub status and constrained capacity.	In line with GAL as MAG's historic severe traffic declines are mitigated by recent long-term take-or-pay contracts and lower leverage.	One notch lower than ADP reflecting mainly AENA's weaker traffic profile and marginally less favourable pricing regime with no downside adjustments	One notch lower than GAL due to reliance on main carrier with some residual financial weakness akin to CPH (consolidated). and ADR due to higher leverage.	CPH (consolidated) in line with BAC due to reliance on financially weak main carrier (SAS) and similar leverage.	In line with GAL as ADR's better traffic resilience and lower leverage is offset by relatively weaker catchment area and covenant-light debt structure. BAC and CPH have higher leverage.	Capped at 'BB+' due to weak corporate governance and regulatory uncertainty, despite relatively low leverage.
Operations											
Country (Rating)	France (AA)		UK (AA)		UK (AA)	UK (AA)	Spain (BBB+)	Belgium (AA-)	Denmark (AAA)	Italy (BBB+)	Russia (BBB-)
Ownership or concession maturity	Ownership		Ownership		Ownership	2123 / Owner.[b]	Ownership	Ownership	Ownership	2044	2047
Asset type	Hub, O&D		Hub		O&D	O&D	Network	O&D	O&D	O&D	O&D
Charge setting flexibility	Price Cap, Adjusted/Dual Till		Price cap, Single Till		Contracts and Commitments	Unregulated	Price Cap, Single to Dual Till	Price Cap, Dual Till	Light Handed, Hybrid Dual Till	Price Cap, Dual Till	Full flexibility from Feb 2016
Traffic overview											
2008 crisis passenger peak-trough variation (%)	**-5.9**		**-4.4**		**-11.6**	**-20.5 /-26.1**[b]	**-11.9**	**-10.5**	**-10.0**	**-5.3**	**-12.9**
Group airport passengers (2016 m)	97.2		75.7		43.1	55.3	230.2	21.8	29.0	47.1	28.5
O&D proportion (%)	76		64		93	99	83	81	77.7	73	73
Capacity utilisation (%)	92		98		81	77 / 52[b]	68	73	100	100	117
Largest airline concentration (%)	48		52		41	48	24.5	35	39	36	39
Key financials (year)	2016		2016		2016	2016	2016	2016	2016	2016	2016
2008 crisis sales peak-trough variation	-5.8		No decline		n.a.	n.a.	n.a.	n.a.	-6.1	-1.3	-14.6
Aero./comm. yield per passenger (EUR)[d]	17.9 / 12.4		27.4 / 17.9		9.9 / 9.1	8.5 / 8.6	10.9 / 4.4	14.3 / 4.0	12 / 8.4	13.5 / 4.6	5.2 / 12.8
EBITDA (EURm)[d] (margin %)	1,195 (41)		2,055 (60)		404 (49)	388 (41)	2,157 (62)	306.9 (59)	337 (57)	529 (62)	193 (38)
Key Rating Driver attributes											
Volume risk	**Stronger**		**Stronger**		**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**
Price risk	**Midrange**		**Midrange**		**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**
Infrastructure renewal	**Stronger**		**Stronger**		**Stronger**	**Stronger**	**Stronger**	**Stronger**	**Stronger**	**Midrange**	**Midrange**
Debt structure	**Midrange**	**Midrange**	**Midrange**	**Weaker**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Midrange**	**Weaker**
Key credit metrics - Fitch rating case											
5-year average net debt to EBITDA	**4.0**	**6.3**	**7.2**	**8.0**	**5.7**	**3.9**	**2.9**	**5.2**	**6.0**	**2.7**	**2.9**
Net debt to EBITDA (x)	2.3	6.0	7.0	7.7	6.2 (max)	3.3	3.7	4.3	6.2	1.7	1.9
3 / 5-year net debt to EBITDA (x)	4.1 / 4.5	6.4 / 6.3	7.2 / 7.1	8.1 / 7.8	5.5 / 5.7	4.1 / 3.8	2.9 / 2.5	5.2 / 5.2	6.1 / 5.7	2.6 / 3.5	2.9 / 3.1
5-year average DSCR (x)		2.0[c]	1.6[c]	1.4[c]	1.5 (syn.[e])		1.6	1.2	2.0 (syn.[e])		1.9 (syn.[e])
Rating sensitivities											
Net debt to EBITDA (x)*	2.0 - 4.0	7.0 - 8.0	8.0 - 9.0	n.a. - 10.0	5.5 - 6.5	3.5 - 4.5	2.0 - 4.0	5.5 - 7.0	6.0 - n.a.	n.a. - 5.0	n.a. - 4
Average PMICR (x)*		1.6 - 1.8	1.3 - 1.5	n.a. - 1.15					n.a.		
Dividend cover (x)[e]				n.a. - 3.0					n.a.		

Stress testing and credit metrics

17. In addition to considering the two alternative capital structures set out above, we also note that the CAA would like to look at financeability under adverse conditions, such as a macroeconomic downturn, to understand HAL's ability to operate under these adverse conditions. In general, we would consider this to be a sensible approach and the use of the Bank of England's inputs framework for stress testing seems a sensible starting point. However, we would highlight a number of issues in relation to this analysis.

18. Perhaps the most significant issues lie in the analysis and potential use of credit metrics, credit ratings and traffic forecasting.

19. Although we are satisfied with the use of the credit metrics dealing with short term liquidity and long-term indebtedness, it is the use of benchmarking credit metrics against "reasonable investment grade" credit ratings that is more difficult. It is worth reminding the CAA that credit rating agencies consider a combination of factors when assigning a credit rating to an organisation and do not just purely focus on credit metrics. This can be seen from the excerpt from Fitch Ratings in Figure 2.2.

20. The agency has used volume risk, price risk, renewal of infrastructure and debt structure as four key ratings drivers when addressing risks. On closer inspection, Figure 2.2 also shows us that HAL, despite having a stronger credit rating than majority of its peer airports, has a weaker set of credit metrics, due to its over indebtedness (Net debt/EBITDA multiples). However, HAL also has one of the best Debt Service Coverage Ratios, due to a strong cash flow (supported by the highest aero and commercial yields in the sample) and a constant focus on refinancing and reducing its cost of debt, enabling a stronger short term liquidity position to withstand more debt.

21. Therefore, looking at standalone credit metrics will not give a complete picture about any organisation's credit rating without looking at the other factors and considering broader subjective issues. Ultimately, understanding the impact of potential changes in capital structure or indeed macroeconomic shocks on credit ratings and ultimately the influence on financeability is not easy and mechanical. CAA will need to consider more subjective issues, not least what appears to be the market's strong appetite for providing finance to HAL.

22. Regarding stress testing scenarios, we notice that the CAA is intending to use UK GDP as the key driver for passenger forecasts at HAL based on the DfT's findings. While we agree that UK GDP is perhaps the key predictor of long run passenger behaviour, it is only one of many factors that could affect HAL's passenger forecast, particularly in the short run. For instance:

    - a key determinant in the short run will be airline behaviour. Different airlines will react differently to changes in macro-economic circumstance and may react differently in relation to the particular market at Heathrow as opposed to elsewhere. This needs to be considered carefully in the context of Heathrow;

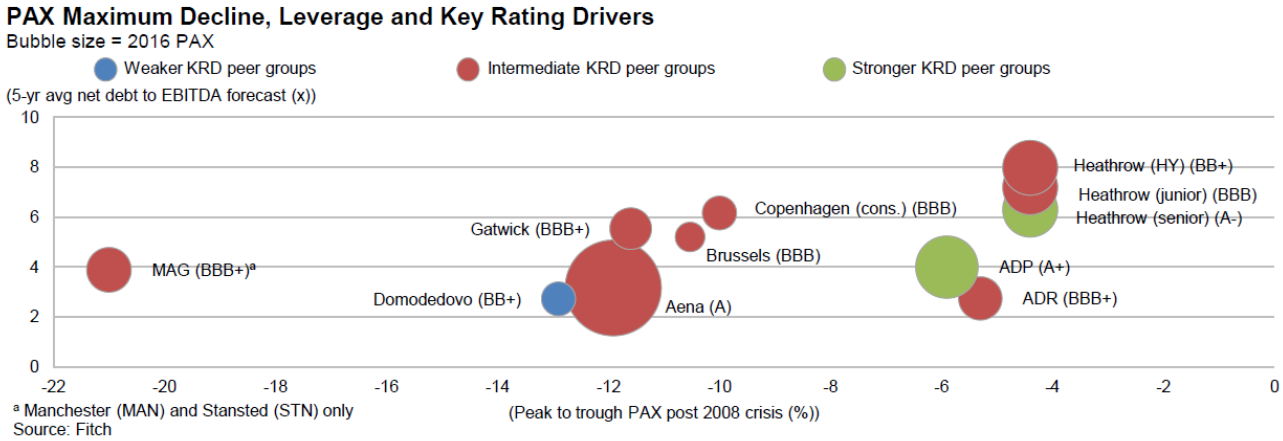
    - the high overseas inbound component of traffic at Heathrow and indeed the level of transfer traffic might also suggest that world GDP or key world region GDP should also be considered

- in terms of stress testing the impact on traffic and consequent knock on effects on non-aeronautical revenues and OPEX, it will be important to recognise Heathrow's resilience (as shown in Figure 2.3). It will not be appropriate to apply standard income elasticity metrics, such as those identified for UK air passenger demand by the Department for Transport, as these will likely overestimate impacts on HAL.

23. Care also needs to be taken when considering the impact of passenger reductions on financeability. Figures 3 and 4 present analysis from a report by Fitch Ratings. It suggests that European hub airports were more resistant to economic downturns since the lower drop in passengers observed at HAL and Aeroports de Paris did not convert into lower Cash Flow Available for Debt Servicing (CFADS) as these airports have a larger catchment areas, larger portfolios of routes, better accessibility and solid transport infrastructure, with active management improving retail offering and operational efficiency. Figure 2.3 shows HAL had the smallest drop in passengers in comparison to its international peers, to the point where Fitch rates the peak-trough variation of 4.4% as "no decline" (see Figure 2.2).

24. Overall, we believe it is important that the CAA takes a reasoned and broad approach to stress testing. CAP1782 does raise some concerns that its assessment may seek to be too mechanistic and will not fully reflect HAL's fundamentally strong underlying financeability position.

Figure 2.3: Peak to Trough Passenger Drop, post 2008 crisis (%)



Adjustments to financeability

25. Clearly a full and appropriate financeability assessment needs to be undertaken and until the results of this assessment are clear, it is not appropriate to comment in detail in relation to potential adjustments to the regulatory framework to support financeability if required. However, broadly, we would be supportive of the principle of adjustments if this were essential to securing delivery and that these adjustments reflect an efficient CAPEX programme and method of financing. However, we believe this should only be a means to secure efficient financing for R3 and should be returned once financing is secured instead of rewarding shareholders. Adjustments to financeability to

ensure efficiency ultimately represent an opportunity cost to airlines. Airlines would essentially be investing to underwrite capacity development by HAL. This investment should be returned over time and with a return on that investment.

26. Regarding the choice of the adjustment, we are open to the use of all of them as they all act as revenue boosters in the short run and without more information on the precise proposals it is difficult to comment on which might be most suitable. Prior to commenting further, the CAA needs to analyse and understand the extent to which the marginal change in these inputs contributes to the additional revenues for HAL and carefully select which variable to adjust to help achieve financeability.

Gearing sharing mechanism

27. We understand that the CAA is considering the use of a Gearing Sharing mechanism for H7. In principle, we believe that the benefits gained as a result of gearing over and above a notional gearing structure should be shared with the consumer. However, it is an issue that does need to be considered and explored further.

28. At this stage, our primary concern is that this mechanism does not consider all aspects of financial outperformance as a result of gearing. EY[1], in its executive summary outlines the following gains made as a result of higher levels of gearing:

    1. Gains made by tax benefits of leverage;
    2. Gains made by achieving actual lower cost of debt than the estimate used in regulatory settlement;
    3. A higher Return on Equity (ROE) as a result of investing the additional debt into revenue generating CAPEX.

29. Also, the mechanism uses a sharing rate which is then multiplied by the product of the difference between the notional cost of equity and actual cost of debt with the difference between the change in gearing level. We do not fully agree with this high-level suggestion as this only considers the notional cost of equity. We believe the CAA should look more closely at HAL's actual return on equity to its shareholders. As HAL is heavily financed with debt, this means that the return on capital investments made from borrowing increases for a static amount of shareholders equity.

30. We also note that the interest coverage ratio has only been reduced by 0.1 to 2.3 on average, from the existing estimate of 2.4. This shows that the short-term liquidity has not materially changed as a result of gearing sharing, and this would not hinder HAL's ability to borrow more.

31. Appendix A in the EY Report shows that option 1B (a true-up with adjustments to regulated charges at the end of the period over the 5-year control period) poses the least drop in revenues, profitability, short term liquidity and shareholder wealth, which makes it more suitable than readjusting the cost of capital each time or both.

32. However, the shareholders would be the biggest bearers of the loss as it is reducing the amount of free cash flow available to issue dividends. We understand that this could be seen as a deterrent to

[1] CAP1782C Report on gearing sharing mechanisms and application at LHR

equity financeability, but the returns on equity would only be fully realised once the R3 is fully built and operational where HAL will benefit from the additional passengers and thus a growing revenue base, which would offset the adverse impacts of gearing sharing.

33. We believe the concept of Gearing Sharing could potentially encourage HAL to reduce its gearing levels, which, in the long run, could be beneficial as HAL would be in a better financial position to raise additional debt for future capacity expansion projects. Figure 4 clearly shows that HAL's current leverage has been a limiting factor to its ratings upgrade. A lower geared HAL would potentially be a more financeable (through an improved and more attractive credit rating) and efficient (thus achieve more efficient financing costs).

34. We believe that the CAA should consider the use of gearing sharing mechanism irrespective of the capacity expansion situation, as we see this as a tool to avoid HAL from over-leveraging and profiting as a result and reduce their financeability constraints.

Incentives for Capital Efficiency – Chapter 2

35. With regard to incentives, we noted in our response to the April 2018 consultation (CAP1658) that the options suggested in that consultation were fairly symmetrical in the sense that the proportion of costs and benefits retained by HAL would be identical in the context of capex over/under spend. We also noted that it should already be in HAL's best interests to manage a 'faster build and lower costs' scenario, as the amount of debt needed would reduce and HAL would be provided with quicker financial returns from the capacity expansion.

36. Nonetheless, if it can be clearly demonstrated that *ex ante* incentives would be likely to protect consumers from the risks of capital cost escalation, we would be open to exploring the idea further. However, at this stage there are a number of potential issues that the CAA (and CEPA) have identified which need to be resolved. These are referred to in paragraph 2.26 of CAP1782 and we are particularly concerned about:

    - the inevitable degree of uncertainty in forecasts that would make assessing the impact of variations on *ex ante* incentives difficult;
    - how to define and agree exactly what the capital expenditure is expected (so as distinguish underspend due to efficiencies from underspend due to lower standards);
    - how agreed changes to specifications or costs during construction would be handled

37. We question whether there is enough time available for the CAA to resolve the issues raised and develop a robust *ex ante* framework that improves the regulatory process. As such we agree with the airline community view that reforming the current regime is likely to be the best option.

38. Irrespective of the eventual framework chosen, it is the CAA's duty to ensure that HAL delivers the capacity expansion in the most efficient way possible and in the interests of consumers. Given the scale of this capacity expansion, this will require much closer regulatory oversight of HAL's capital expenditure than has hitherto been the case.

Promoting economy and efficiency - Chapter 3

39. We have noted above that it is our view that the CAA must exercise closer regulatory oversight of HAL to ensure efficient capital expenditure, but clearly the issue of efficiency should cover all aspects of HAL's business and the CAA noted in its October 2018 consultation (CAP1722) that a licence condition that promotes economy and efficiency in the operation, maintenance and timely development of Heathrow Airport would be appropriate to further consumers' interests and that the lack of such a condition constitutes a significant gap in the current regime.

40. We therefore fully support the proposal to introduce a new licence condition on economy and efficiency and do not believe that such a condition is unnecessary. Given its clearly identified substantial market power and the consequent requirement for regulatory oversight by the CAA, it is incumbent on HAL to be able to demonstrate efficiency in all aspects of its business and to respond for requests for regular and timely information on this topic from its customers.

41. The licence condition proposed would also make it incumbent on the CAA to ensure that HAL is conducting all aspects of its business in an efficient way that meets the needs of its customers. As the CAA notes (in paragraphs 3.20 and 3.22) this would (and should) allow the CAA to intervene in 'real time' where HAL is failing to meet this licence condition, rather than retrospectively at the end of a regulatory period.

42. We are concerned that the proposed condition B3.1 does not make it sufficiently clear that the requirement on HAL to, 'conduct its business and activities that relate to the provision of airport operation services' should not allow the unintended extension of economic regulation to airlines.

43. The most important consideration in relation to this new licence condition is that the CAA are seen to act on it going forward, to ensure that HAL conducts all aspects of its business efficiently and in the interests of consumers.

Alternative delivery arrangements - Chapter 4

25. We have consistently stated that we are open to alternative delivery arrangements or proposals that encourage competition in the design, build and operation of an expanded Heathrow.

26. In our response we our response to CAP 1722 we noted that the CAA still needed to address the introduction of competition and alternative providers.

27. With regard to the Arora proposals and the Arcadis report, we note that the lack of detail at this stage prevents the CAA from concluding whether the proposals are credible and deliverable. We consider the tests set out by the CAA in Appendix E of CAP1782 are reasonable, but it will be essential that Arora are able to obtain adequate information to enable them to progress their proposals. We suggest the CAA should help to facilitate this.