

## **Virgin Atlantic Airways response to the CAA's consultation**

### **Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable (CAP1819)**

#### **Introduction**

1. Virgin Atlantic Airways welcomes the opportunity to respond to the CAA's consultation CAP1819, Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable, published in July 2019.

#### **In summary**

2. We have consistently supported expansion at Heathrow provided it benefits consumers by enabling a significant increase in effective airline competition and that the required scope is delivered efficiently at an affordable price. Our ambition is to provide significantly enhanced competition for passengers on domestic, short and long-haul routes at Heathrow by growing to become the UK's new flag carrier. Therefore we support the delivery of the new runway as early as possible, provided the costs are controlled and spend is efficient. We are increasingly concerned by the significant increases in Category B and early Category C costs for expansion in Heathrow Airport Limited's (HAL) forecasts.
3. Given the near doubling of Category B costs the CAA's existing policy is no longer appropriate and we welcome its review. We agree there is a pressing need for strengthened governance and cost scrutiny procedures as well as sharpened incentives.
4. Consistent with our ambition to provide a significant increase in competition at Heathrow we agree with the CAA that a programme of early Category C costs is in the interests of consumers. That said, any costs incurred prior to planning consent being given must be proven necessary and efficient. This requires strong governance procedures supported by an appropriate regulatory framework. Alongside this consultation response we are working with HAL and the CAA on a pragmatic cost schedule.
5. We welcome the updated business plan guidance from the CAA and agree that HAL's Initial Business Plan (IBP) should still be delivered in December 2019. This is essential to keeping the overall expansion programme on track and we see no value in a delay.

## Policy proposals for Category B costs – Chapter 1

### Current policy for the regulatory treatment of Category B costs

#### 2016/17 Category B decision

6. In our CAP1752<sup>1</sup> response we made it clear that in our view HAL failed to meet all of the efficiency requirements as set out by the IPCR in its assessment of 2016/17 Category B costs. We noted that the IPCR was also unable to assure the efficiency of that spend given the absence of a baseline plan.
7. We also highlighted our concerns with HAL's behaviour in providing poor quality information to the IPCR and then refusing to offer further clarity.
8. We are disappointed by the CAA's decision to award HAL over £80m (around 98%) of costs incurred in 2016/17. Given that the remainder of this response deals with similar issues of governance, transparency and scrutiny we are concerned by the precedent this decision sets in rewarding poor behaviour.

#### Category B cost escalation

9. We welcome the scope of the CAA's proposals in relation to a revised approach to Category B costs over and above the original £265 million. Overall it reflects areas that can be effectively influenced and seeks to address the deficiencies in HAL's previous behaviours by tightening regulatory incentives and removing the reward element to the risk sharing arrangement. That said, we suggest a number of areas where we believe it would be appropriate to go further.
10. We would make three specific comments:
  - Despite the lack of transparency around Category B costs to date and HAL's failure to accurately forecast them in the first instance, we concur with the CAA's view that there should be no change to the treatment of the original £265 million in Category B costs. Retrospectively changing the regulatory framework in relation to these costs would set a dangerous precedent and increase regulatory risk, which would likely impact adversely on future financing costs and ultimately affordability;
  - The failure to identify appropriate regulatory incentives for cost efficiency moving forward is disappointing. We accept that this is a difficult area in relation to planning costs for the reasons stated. However, given the extent of the current estimated cost overrun some arrangement would seem reasonable.
  - There is another scenario as regards Category B costs (and indeed Category C costs) and the success or failure of the DCO application which needs to be recognised. There is the potential for the DCO to fail and for HAL to then re-apply with an amended scheme. We would assume at this point that there would be

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<sup>1</sup> Independent Planning Costs Review on costs relating to the Heathrow Expansion Programme covering the period 2016 and 2017 (CAP 1752)

further consultation and work on the regulatory process around a new application but we would expect the value of acquired knowledge within HAL to be reflected in any future framework.

### **Governance and cost scrutiny**

11. The extent of the cost overrun, the lack of evidence around whether costs have been efficiently incurred and the time it has taken to get this review point, are clear evidence of the need for strengthened governance and cost scrutiny procedures.
12. The CAA has suggested a number of areas for action and we comment on these in turn:
13. **Strengthening reporting requirements** – the existing annual reporting requirements have clearly proved to be inadequate in providing the ability to scrutinise both the level of expenditure but also the quality of information available for scrutiny. We therefore welcome the CAA's intention to move to three monthly reporting. We expect this to include detailed, transparent information on the baseline and of costs incurred with full supporting commentary. The reports must also provide an appropriately detailed forecast up to DCO application, with higher levels of certainty in the short term forecast. We also expect the reports to be timely, with the quarterly information being complete, made available to stakeholders and review meetings taking place within one month of a quarter end i.e. Jan-Mar review before the end of April. We note that this will in itself have resource implications both for HAL and for airlines. Given that these arrangements are largely a result of HAL's failure to report adequately within the original framework established, we would not expect to see HAL's costs for this additional governance remunerated. The additional governance will also result in increased costs for airlines in scrutinising Category B costs. There is no mechanism for these costs to be recovered but we would suggest that an alteration to the risk sharing mechanism in event of failure of the DCO would be appropriate in reflection of this (see further below). We note also the CAA's effort to encourage HAL to be more specific in its reporting. Again, we welcome this development. We would, however, go further and suggest that HAL should develop a reporting template to be agreed with all parties that satisfies these requirements. The template should focus particularly on the extent of risks to the budget and mitigations.
14. **Establishing a recovery cap** – we agree that seeking to establish a recovery cap is clearly desirable. We believe that it would act as a strong incentive on HAL to improve the efficiency of its Category B spend. However, we remain concerned about the practicalities of establishing such a cap. We agree with the CAA's comments that there is very little precedent on which to base a judgement as to an appropriate level of cost; however that should not mean that HAL's new estimates should be presumed to be appropriate for setting the level of any cap. Despite the added scrutiny from the CAA, IFS and IPCR, there remains limited evidence on the efficiency of HAL's Category B costs and £500m is an arbitrary and potentially inappropriate figure. If the CAA is to establish a cap then more information is needed. Although the CAA did not take the opportunity to gather additional information earlier we believe there is still sufficient time to agree a cap based on suitable evidence. When an appropriate cap is set the focus should be on ensuring that HAL is strongly incentivised to stick to its latest cost estimates, and

therefore the cap should be a 'hard' cap. This means that any spend above the cap must be entirely at HAL's own risk.

15. **Increasing cost scrutiny** – we note the CAA's proposals to increase scrutiny on Category B costs and welcome the sentiment. However, the proposal entails little more than the enhanced governance processes described previously. We believe it would be appropriate to seek to enhance the efficiency tests for Category B costs, focussing more strongly on; whether the costs are needed in the first place, were the cost objectives clearly identified and were those proposed benefits of the spend delivered at minimum cost, rather than simply on whether they have been efficiently incurred. There is a need to 'tie' activity more closely to specific outcomes on the path to achieving the DCO so that the rationale for expenditure can be scrutinised more closely.

### **Strengthening existing regulatory incentives**

16. We strongly agree with revisiting the regulatory incentives framework and furthermore we believe that a tightening of these incentives would be appropriate given HAL's failure to date to control costs and to provide sufficient evidence of the efficiency of expenditure. There are a number of issues to be considered;
17. **WACC** – we do not believe that it would be appropriate to make an ex-post change to the WACC in relation to the first £265 million of costs as these are subject of an existing regulatory settlement and to do so would increase regulatory risk. However, we do not believe it is appropriate for the Q6 WACC (5.35%) to continue to be used for costs over and above that level that are to be incurred towards the end of a substantially extended regulatory period, where all existing evidence suggests that HAL's WACC currently should be significantly lower. The CAA should determine an updated WACC that takes into account current market conditions. We expect this to be below or at the bottom of PwC's preliminary range estimated in Feb 2019. This WACC should apply to efficiently incurred costs up to the newly identified recovery cap. Any spend above the new recovery cap should be at HAL's risk. This will act as a significant incentive on HAL to incur costs efficiently and stick to the budgets it has identified. We note the CAA's concerns around the transparency, consistency and predictability of the regulatory framework if multiple WACCs are used. However, given the extent of difference that is now apparent, we would strongly suggest that it would be in the best interest of consumers to be applying a WACC that is more appropriate to current circumstances. We would also point out that if regulatory consistency is a concern, then the application of a new lower WACC to other elements of the framework, notably Category C costs, would be appropriate and address issues around consistency;
18. **Incentive risk sharing mechanism** – again, we do not believe it would be appropriate to alter the existing arrangement for the first £265 million of Category B costs. In relation to costs above £265 million, we are in broad agreement with the CAA. Given the extent of overrun in the original cost estimates, it would seem inappropriate to further reward HAL for achieving the DCO and hence a 100% recovery is appropriate. However, we do believe that HAL's failure so far to provide sufficient transparency in terms of efficiency of spend has had the effect of

transferring risk to airlines, as it has not been possible to adequately scrutinise or comment on the appropriateness of expenditure. The additional governance arrangements will also increase the resources required by airlines, reflecting an increase in risk. As these are reflections of poor behaviour by HAL and potential inefficiency in scoping, it would therefore be appropriate to alter the recovery percentage in the event of failure. We would expect that this is reduced from 85% to 75% for sums above £265 million to the recovery cap. As mentioned previously any expenditure above the new recovery cap would be at HAL's risk;

19. **Unilateral withdrawal** – in the event of HAL's unilateral withdrawal from the DCO application, we would expect the CAA to undertake a stringent best endeavours test to HAL's behaviour. Furthermore, we would expect airlines to be given ample opportunity to provide evidence to input to this judgement.

## **Early category C costs – Chapter 2**

### **A broad programme of early category C costs**

20. We agree with the CAA that a programme of early Category C costs is in the interests of consumers provided that they are strictly:
  - necessary expenditure;
  - efficiently incurred;
  - essential to facilitating the timely delivery of the expansion programme.
21. Clearly, if HAL were not to secure a DCO then some costs would be 'sunk' and unrecoverable and that this would result in higher charges to consumers over the longer term without any benefit from expansion. However, in our view this risk is outweighed by the potential benefits to consumers from enhanced airline competition with early opening. In response to these risks we expect the CAA to ensure that appropriate governance and scrutiny arrangements are in place to guarantee that the criteria for early Category C costs are met and also to consider at the earliest possible stage how to mitigate the risks of a failed DCO by defining which costs might be recovered, to what extent, how and over what timeframe. This will enable the extent of risk to be better understood and sharpen incentives in terms of whether spend is genuinely necessary.
22. Overall, we welcome an option for early Category C costs that provides strong governance and supports the earliest possible delivery of the new runway.

### **Proposal to regulate early Category C costs in a similar way to category B costs**

23. In general we agree with the CAA that the enhanced regulatory arrangements for Category B costs over £265 million (subject to the proposals we make earlier in this response) do provide a useful basis for regulating early Category C costs. We consider some of the key individual issues in more detail below:

## **Allocation of risks**

24. The CAA has proposed that there should be no specific risk sharing arrangements in relation to early Category C costs if HAL's DCO application were not to be successful. This is a departure from the Category B approach.
25. We are persuaded that HAL's ability to manage the risks around early Category C spending is limited and that the primary source of risk to these costs is from a change of government, which is beyond HAL's control. We agree that if the DCO fails as a result of political circumstances HAL should not be penalised.
26. In the event that HAL fails to achieve DCO approval as a result of circumstances within its control we would expect them to receive a return equal to their cost of debt on any Category C costs incurred pre-DCO.
27. That said the escalation of early Category C costs is extremely concerning; we have repeatedly flagged the inadequacies in HAL's approach to these costs and made it clear that we will only support efficient and necessary levels of expenditure. The CAA must ensure that the expenditure is efficient and this can only be achieved through robust governance and scrutiny that protects airlines and ultimately consumers. In our view strong governance is crucial, and we discuss the appropriateness of the proposed arrangements further below.

## **Governance arrangements and regulatory allowances for early Category C costs**

28. We accept that given the nature of some early Category C costs, principally around those relating to the costs of relocating large commercial and other projects and certain other commercial and residential compensation costs, there are significant and legitimate confidentiality issues and may limit the extent to which airlines can realistically require direct scrutiny. However, that does not change the basic principle established in relation to the Category B costs, that HAL's ability to scope these costs and provide evidence of efficiency has been sorely lacking. It would, therefore, seem entirely appropriate that governance and reporting arrangements be strengthened.
29. In common with the approach to Category B governance, we would expect to see:
  - a significant increase in the frequency of budgetary reporting, review and scrutiny. Given the sums involved and the level of complexity, quarterly review via the airlines, CAA, IFS, IPCR and the CAA's appointed expert (as appropriate to the cost item) is necessary. Any additional costs associated with these processes should not be recoverable;
  - we also expect to see a precise template for budgetary reporting and for initial propositions for spend developed and agreed with the CAA, airlines and interested parties. This should ensure that the adequate, high quality information is provided by HAL. In particular, in relation to these Category C costs, the initial budgets for projects and associated case for why the expenditure is required and classified as early Category C should include a detailed consideration of if there is any ability to

recover costs in the event of a failed DCO. This should include an assessment of how much might be recovered, how, by when and if there are any actions that should be taken to enhance this potential mitigation. The intention of this particular element is to ensure that mitigation of the risk of 'sunk' costs is at the forefront on decision making around the need for expenditure. It will also be important in maintaining an up to date view on the extent of the risk facing consumers in the event of a failed DCO;

- alongside the increased frequency of reporting and scrutiny, we would expect stringent deadlines to be set for HAL in terms of the provision of information to support these processes. There is a case for financial penalty clauses to be included to ensure compliance.

30. In order to ensure consistency in the regulatory framework and to avoid HAL seeking to shift costs between Category B and C to take advantage of differences in the regulatory framework, we would support the same recovery arrangements in relation to Category C costs as for Category B costs:

- they should attract a WACC that is reflective of the current situation. The CAA should determine an updated WACC that takes into account current market conditions. We expect this to be below or at the bottom of PwC's preliminary range estimated in Feb 2019. Application of the original Q6 WACC (5.35%) would not be appropriate and would be detrimental to consumers given the changes in the market and the passage of time since this was determined. As with Category B, costs that go above any caps eventually determined for early Category C costs should be at HAL's risk.
- establishing a recovery cap for Category C costs suffers from many of the same issues as Category B, with the added complication that many of the costs are not confirmed as yet. An approach to setting recovery caps in line with the existing Core and Development capex arrangements may be sensible. This would allow a degree of flexibility for legitimate changes in costs for projects still in the early stages of development, while providing a binding limit for more mature projects. Regardless, it is clear that any cap must be set with care.
- given the significant level of costs now forecast the CAA must apply different recovery periods for Category C costs in the event of a failed DCO. These costs will ultimately be added to the RAB and returned over time, raising airport charges for passengers at the airport. In the event that HAL fails to secure DCO approval, the period of time over which these costs are recovered must be significantly extended, thereby reducing the impact on individual passengers and to some extent mitigating the effect of sunk costs. The recovery period could for instance be double that associated with a successful DCO.

### **Recognising early Category C costs through a licence condition**

31. The recognition of early Category C costs via a modification to HAL's licence would provide a greater degree of certainty around the nature, size and regulation of these costs and the additional basis for action for the CAA. However the potential delays to the programme that the consultation process would incur and also delays around any CMA appeal are not appealing given our desire for the earliest possible delivery of the new runway at an affordable cost and scope.
32. In our view, a licence condition provides a useful back stop but needs to be introduced via a fast track process. There should be only one round of consultation and CAA should commit to taking on board responses and developing an appropriate licence condition as rapidly as possible. We note that the escalation of early Category C costs has been known about for some time and that as a consequence the current time pressure around defining the regulatory framework, including the development of a licence condition, is to some degree of the CAA's own making.
33. The potential of an appeal to the CMA in relation to the licence condition and a corresponding six month delay to the implementation of such a condition is a concern. However, by far the best approach to limiting the effects of a CMA review is to avoid one in the first place. This means that it is beholden on all parties to work towards an agreed position on the detailed governance structure and the treatment of Category C costs from which a licence condition can be derived.
34. We expect the CAA to continue to push HAL to engage transparently and effectively with airlines to discuss the latest Category C cost estimates to ensure the airline community is comfortable that they are necessary, appropriate and efficient. We would also expect the CAA to publish its views on the regulation of early Category C costs following this consultation as early as possible, in other words in September rather than October, to ensure maximum time for an agreement to be reached that can then inform any licence modification.

### **Timetable and business plan guidance - Chapter 3**

#### **Regulatory timetable**

35. We support the CAA retaining the requirement for HAL to publish both an Initial Business Plan (IBP) and Final Business Plan (FBP). HAL's IBP should still be delivered in December 2019. This is essential to keeping the overall expansion programme on track and we can see no value in a delay. It is also essential that there is time for a full six months of Constructive Engagement following publication of the IBP in order for airlines to properly scrutinise HAL's plan.
36. With regard to whether it is practicable to retain 2021 as a target date for the next main price control review, we would suggest that it is not just practicable but essential. Q6 has already been extended significantly in an environment where, thanks to market conditions, HAL has significantly outperformed Q6 targets. Further extensions would not be in the best interests of consumers. Although this does mean there will be aspects of the capital costs for the expansion

programme that are less mature than is ideal but the risks around this should be dealt with via uncertainty mechanisms as described earlier in this response. In our view there is sufficient time available for all parties to review a FBP before the CAA publishes its Initial Proposals and thereafter Final Decisions throughout the remainder of 2020 and 2021.

37. The CAA has raised the possibility of implementing a longer price control period for H7 that would fit more closely with the overall construction programme, suggesting a period of up to eight years. There are clearly advantages and disadvantages to doing this, specific to the expansion situation. One significant disadvantage being that there is potentially greater scope for HAL to make gains, as predicting its performance in relation to the regulatory building blocks over a longer period is much harder and consequently setting appropriate regulatory incentives more difficult. That said we would be open to exploring this possibility further.

### **Business plan guidance**

38. We welcome the CAA updated business plan guidance in particular that the business plans should be based on high quality evidence, analysis and assessment. These requirements should enable all stakeholders to engage effectively with HAL on its IBP and FBP.