

Virgin Atlantic Airways response to CAA H8 Initial Proposals

Executive Summary

1. Virgin Atlantic ("VAA"), as part of the Heathrow Reimagined campaign, has set out the perverse incentives that the current economic regulatory model at Heathrow Airport creates and the outcomes that it drives for consumers. The use of a Regulated Asset Base ("RAB") model, coupled with insufficient regulatory constraints on the exercise of Heathrow Airport Limited's ("HAL") market power, results in consumer harm (as recognised by the CAA in establishing its case for change set out in CAP3251¹). It is clear that the current model incentivises HAL to maximise its capital investment envelope for each economic regulatory period because (all else being equal) it earns a guaranteed return at the prevailing weighted average cost of capital ("WACC") and such returns are, as a result, underwritten by the regulatory model regardless of the efficiency of capital spend. As a result of the current model, we see the following harmful consumer outcomes:
 - high charges – that reflect the absolute level of inefficient capital spending (both historic and current) i.e. users of London Heathrow Airport ("Heathrow") pay the highest average charge of all global airports; and
 - poor service quality – seen in both the varied quality of infrastructure across campus (i.e. many users do not get a quality of service that is in line with the price they pay) and in absolute terms, [REDACTED].
2. In our view, the dislocation of capital spend and quality of infrastructure / service is best articulated as a two-part problem set: there is undoubtedly a 'charges problem' given the absolute price paid by users but there is also a 'mix problem' in the allocation of capital by HAL, which airlines are not able to sufficiently control. Put simply – HAL's market power combined with the regulatory model today severs the link between consumer need and supplier investment. In a competitively functioning market, any business strives to profit from efficiently meeting the optimal mix of consumer needs. HAL's investment incentive to meet consumer needs is limited to administratively showing that individual business cases are directionally aligned with a consumer need, which is a significantly lower hurdle from calibrating the overall mix of investments to win consumers' business.
3. Within H8 we see both the above dynamics playing out – a high capital envelope being sought by HAL and an indicative mix of capital deployment that continues to ignore or deprioritise the areas of the campus that are in most need of investment [REDACTED] despite several rounds of 'constructive engagement'. Furthering the interests of users in general, as is the CAA's primary duty under s1 of the Civil Aviation Act 2012 ("CAA12"), and ensuring that HAL's licence contains conditions that address the risks identified above, requires the CAA to remedy not only the quantum of capital investment but also the mix. [REDACTED].
4. It is also worth noting, in this context and under the current regulatory regime, that there can be good outcomes for HAL in prioritising investment away from assets that need it most. If HAL can successfully achieve a capital envelope based on over investing in some areas of the campus and under investing in others, it becomes a matter of time and necessity that the airline community requests, or safety critical justifications require, further (and incremental) capital to be agreed within an economic regulatory period. In circumstances where neither users (airlines) or consumers (passengers) can actively switch away from Heathrow: (i) users have to bear the increased cost on charges to achieve critical investment while (ii) consumers face a choice between airlines based on those that benefit from better services on campus (and are therefore able to operate out of high

¹ <https://www.caa.co.uk/data-and-publications/publications/documents/content/cap3251/>

quality, more resilient and newer / better maintained facilities. The latter is a distortion of competition in the downstream market and one the CAA, as a regulator, should be increasingly concerned about.

5. Whilst the H8 price control period is, in many respects, similar to preceding price control periods in facing this two-sided capital challenge, it is also unique: it is being considered by the CAA at the same time as the Government is reviewing the policy framework for expansion (particularly the Airport National Policy Statement ("ANPS")); the CAA is reviewing the underlying regulatory model (CAP 3251); and HAL is pursuing a combined capital envelope of at [REDACTED] across the next decade to deliver capacity expansion in various forms.²
6. In line with its primary duties to users of air transport services under CAA12 (s1), it is incumbent on the CAA to ensure that in setting the capital envelope for H8, it ensures:
 - the lowest possible capital envelope – permitting only efficient and necessary spend tied to BAU activities;
 - all expansion related capacity is properly scrutinised, governed and subject to a fundamentally revised regulatory model pursuant to CAP 1395 outcomes – capturing as much capital within a regulatory framework that addresses the poor consumer outcomes of the existing model;
 - through the exercise of its powers under CAA12 (including sections 18 and 21(c) and (d)), that HAL is required and/or incentivised, to direct investment to the areas on campus that require it most – i.e. to assets that are at/near end of life and/or safety critical investments. Only once such investment has been delivered should further capital allocation within the envelope be released.
7. [REDACTED]
8. [REDACTED]
9. For completeness, VAA notes that, other than as set out in this response, and on the non capital building blocks of CAA's Initial Proposals, we have contributed to and fully support the Airline Community Response.

The H8 capital envelope

10. VAA strongly supports the CAA's material reduction from HAL's c.£10bn proposal to a midpoint of c.£5.8bn. While we recognise there is significant tactical investment required across the Heathrow campus – especially in the CTA – HAL's proposal was predicated on immature proposals, took very limited account of airline priorities, and at cost estimates that were not credible given HAL's track record of inefficiency, delays, and overspends. Therefore, the adjusted envelope reflects a more realistic and deliverable range and is a necessary correction to HAL's excessive H8 plan and is essential to further the interests of users under section 1, CAA12.
11. The CAA should maintain this approach in the Final Proposals. The capex allowance should not be increased unless HAL can demonstrate improved maturity, deliverability, efficiency and consumer need across the portfolio. The Final Proposals should not allow HAL to use the existence of an envelope to preserve optionality for projects that are insufficiently mature, weakly evidenced or not clearly required for an efficient two-runway Heathrow. To permit otherwise would be contrary to the CAA's statutory duties and would risk unwarranted higher charges for consumers/other users of HAL. Instead, airlines should be granted greater influence and control over project prioritisation, ensuring that those that

² [REDACTED]

most improve the consumer experience across the campus, represent value for money for all users, and target areas of the campus most in need, proceed.

12. [REDACTED]. Moreover, it is essential that CAA take stronger action to address the chronic lack of risk-sharing on cost overruns, where HAL are largely insulated from material risk of capital spending beyond both project allocation and overall capital envelope. The consequence of this in previous control periods is that airlines are forced to either (i) allow increase in capital spending to complete investment programme or (ii) cancel/roll forward essential projects. Front-loading delivery of critical projects in the poorest facilities will go some way to mitigating these risks.

The persistent quality gap between Heathrow's terminals

13. [REDACTED]
14. [REDACTED]
15. Tactical investments of the kind governed by the H8 process may prevent Terminal 3 (and Terminal 4) degrading further, but cannot replace the transformational, multi-billion pound investments that are proportional to the current problem that has emerged through more than a decade of under investment.

The harmful plan pursued by HAL

16. What HAL presented to the Airports Commission in 2013, amended in various minor ways since, continues to guide the make-up of its strategic investment programme: a move to fewer, larger terminals surrounded by a 'toastrack' of satellite piers, with Terminal 3 being demolished to make way for an expanded Terminal 2. [REDACTED].
17. [REDACTED]
18. [REDACTED]
19. [REDACTED]
20. [REDACTED]
21. [REDACTED]
22. This extraordinarily long period (and for reference, we note JFK will have had every one of its terminals modernised or rebuilt within the 2000-2028 period) is a consequence of (i) the complex and costly development programme HAL is pursuing and (ii) the prioritisation of capacity-related investment at the western end of the campus. To prevent the continued worsening of harm between users of the campus the CAA must: (i) fully scrutinise HAL's masterplan; and (ii) take a more interventionist approach on the sequencing of capital investment across campus (in both H8 and during expansion) to ensure the worst consumer outcomes (and harm) [REDACTED], are remedied as quickly and efficiently as possible. The levers to do so must include ex ante direction and ex post review. This is best placed within a reformed regulatory model that creates the right incentives, oversight and penalties; necessitating an approach to H8 capital that is limited only to fully justified BAU investment.

Appendix A: notes on specific H8 business cases

23. VAA requests that the CAA treat the following business cases and projects as pre-G3 airline-supported for the purpose of the H8 capital investment needs assessment process:
- a. T3 strategic infrastructure and airline-focused enhancements [REDACTED]
 - b. T3 Hold Baggage Screening replacement (BC03.03)
 - c. T3 Pier 7 external and internal rehabilitation (A258, BC03.01 Asset Management & Compliance)
 - d. T3 renewal of Pier 5 and Pier 7 gate rooms and stairwells (B111, BC04.00 H8 new asset renewal scope)
 - e. T3 interior (BC04.00 H8 new asset renewal scope)
 - f. T3 departure lounge retail enhancements (BC13.00 H8 new commercial scope)
 - g. T3 arrivals baggage reclaim buggy route (L10, BC17.00 H8 new passenger experience)
 - h. Additional lift access for EMA handling (L17, BC17.00 – H8 new Passenger Experience)
 - i. Airport look and feel, T3 targeted (L22, L23 & L24, BC17.00 H8 new passenger experience)
24. VAA support the CAA's classification of Terminal 5 Capacity Optimisation as within the Expansion workstream