virgin atlantic

Mr. Paul Smith
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6th November 2020

Re: CAP1966 Economic Regulation of Heathrow Airport Ltd: Response to its request for a Covid 19 related RAB adjustment.

Dear Paul,

Thank you for the opportunity to respond to the CAP1966 document. Heathrow Airport Limited's request to adjust the RAB remains an issue we strongly oppose. Whilst we are responding independently, we are also highly supportive of the joint AOC / LACC submission dated 5th November 2020 on this subject.

It is clear that the Covid-19 crisis will leave a lasting mark on the nation, the global economy and specifically, on travel and aviation. Even once the situation stabilises, we will be dealing with an economic recession slowing recovery even further. Recovery to pre-crisis levels is expected to take three years or more. Virgin Atlantic has been required to make huge sacrifices to be able to protect the future of its business and we have witnessed other carriers, OEMs and the aviation supply chain around the world take similar action in order to survive.

Understandably, HAL also needs to take steps to safeguard its future but, as we have highlighted previously to Ross Baker at HAL and yourself, seeking a retrospective adjustment to the RAB, in circumstances where it has revenue risk mitigated in the WACC, would undermine the ex-ante regulatory framework and be to the detriment of consumers, airlines and other stakeholder groups that rely on passenger air travel through Heathrow airport.

Summary of our position

- We support the CAA view that HAL has not demonstrated the need for urgent intervention
- It is not in the consumer interest to approve the proposal
- There is no justifiable reason in regulation or in the principles of reasonableness and fairness to agree Heathrow's ask
- Heathrow's business remains financeable, raising £1.4bn only last month; CAA's license obligation is fulfilled
- Like the airlines, Heathrow must use all available commercial levers to support its business
- There is no middle ground that is fair to the consumer. Granting Heathrow's request, in whole or in part, simply means the consumer pays twice. The WACC already accounts for risk and depreciation in the settlement.
- Heathrow's investors have enjoyed years of dividend returns, over £3.8bn in this regulatory period alone. It is now time to support Heathrow with additional investment

A RAB adjustment is incompatible with the Q6 regulatory settlement

Firstly, it is important to re-emphasise that there is no regulatory justification for reopening the Q6 settlement. Although HAL insisted in its application that it was not intending to reopen the Q6 decision, this is exactly what the proposal seeks to do. In support of the CAA's stated position, there is no obligation for the CAA to grant HAL's request. Its primary duty is towards furthering the interests of consumers.

The Q6 settlement represents a regulatory framework that balances HAL's risks and rewards. Taking account of the different building blocks that underpin a charges decision. Through the WACC, HAL benefited from traffic risk protection throughout the Q6 regulatory period. It cannot selectively seek to re-open part of the regulatory framework i.e. traffic risk in 2020 and 2021, without full consideration of the full Q6 settlement.

As clearly detailed in its appendix, the CAA has calculated that HAL has outperformed its Q6 regulatory settlement by £1.11bn (in 2018 prices) between 2014 and 2019. Although the airport bares all the traffic risk, it is wholly unreasonable for HAL to seek a RAB adjustment when it has significantly outperformed for most of the period. To be allowed to cherry-pick what elements of the regulatory settlement it prefers, mid-period, would set a precedent we would be very uncomfortable with.

In addition, if HAL is able to seek retrospective "compensation" through a RAB adjustment, its incentive to achieve efficiencies will be significantly reduced and it is against the incentive-based nature of UK Regulation. HAL's focus should be that of achieving further efficiencies. During the CE process, a consultancy report commissioned by the airline community, and shared with both HAL and the CAA, indicated substantial opportunities for operating cost savings. Virgin Atlantic, as well as airlines globally, have undergone substantial restructuring processes to adapt to the unprecedented impact of Covid-19, and we expect our business partners in the value chain to behave in a similar manner, aiming to stimulate demand rather than stifling it by adding costs for customers and consumers of the UK's largest airport.

We are concerned at the ex-post nature of the adjustment proposed. Clawing back depreciation that was already allowed in the calculation of charges for Q6 would lead to a double counting of costs, with consumers essentially paying twice for the same service. HAL's framing of the problem, that it is not able to "earn on its RAB" is incorrect. This is about a single risk factor, affecting two years of the regulatory period, for which HAL has already been compensation for within the WACC. In this regard, we are also concerned that while the CAA has rightfully concluded that no immediate action is necessary, it is still keeping the possibility open to apply this same mechanism during the H7 process (para D.26 of CAA consultation's appendix). We recognise that the CAA will need to review the regulatory framework through price control consultations, but this should be defined as regulatory evolution at each price control period, and not via ex-post adjustments.

<u>Exhaust all private funding opportunities</u>

HAL's shareholders have benefited from circa £3.9bn in dividends since the beginning of this quinquennium in 2014. Only this year, at the hight of the pandemic in April 2020, HAL elected to make a dividend payment of £100m to its shareholders against the advice of the airline community. Any perceived issues relating to HAL's current balance sheet could have been mitigated with a different financial strategy.

We're pleased that the CAA have identified that HAL have provided little evidence to suggest that they have exhausted all their options to seek private funding unlike Virgin Atlantic has been publicly required to do by HM Government. The most logical solution, as highlighted by the CAA, is that HAL should look for an equity injection from its shareholders. If shareholders have so readily received such significant amounts of dividends during the "good times" in the regulatory period, then they should be prepared to inject funds back when needed.

<u>Long-term price increases untenable</u>

A further £1.7bn on the RAB would lead to an extra £1 / £2 per passenger charge, dependent on passenger numbers, for the next +20yrs equating to over £100m per year. In a sector where margins are so tight, £1 to £2 per ticket could be the difference between a profitable or loss-making flight. It might seem insignificant, but the reality is that there is such a fine balance in fare structures and profitability for airlines like Virgin Atlantic, who heavily compete on the vast majority of routes out of Heathrow. This has never been more important than now when passenger numbers are so low, less than 30% of 2019 levels. To see HAL artificially protected from the effects of Covid-19 when Virgin Atlantic is completely exposed to the consequences of the pandemic and the natural laws of competition cannot be justified. Not least when consumers will be attempting to recover from the worst global recession they have ever experienced.

HAL's comments that "Pressure to cut costs could jeopardise quality of service and future investment" appear to be unfounded

a) Service quality in 2020

To date in 2020, service levels have largely been maintained by HAL, particularly following the outbreak of the pandemic. Investigation by HAL has concluded this has not been due to lack of resources. HAL have stated that service breaches have been due to lack of staff training, impact of Covid on passenger demographics and service delivery and un-forecast peaks in the schedule. Management focus by HAL since early October has resulted in significant service improvements. HAL security management have stated that they have not been constrained by costs in delivering the required service levels and that they expect performance to continue to improve.

Punctuality performance with the reduced levels of movements seen in 2020 has been very good and significantly better on average than that experienced over the whole of Q6.

b) Service quality in 2021

HAL's statement that punctuality may drop to 60% and security queue times may increase by 5 minutes due to the need to cut costs further in 2021 appear unfounded and have not been substantiated by HAL. In its own business case for 2021 ("BBU Low no RAB adjustment (CAA PCM).xls"), HAL forecasts that 2021 costs [redacted] vs 2019 levels, even though traffic is forecast to be [redacted] vs 2019. With a [redacted] in traffic levels forecast it seems very unlikely that service levels will fall significantly as a result of [redacted] in costs as is claimed.

	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	[redacted]
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[redacted]	[redacted]	[redacted]	

(Source: HAL doc BBU Low no RAB adjustment (CAA PCM).xls)

Service quality is important for all our customers; however, it must be appropriate given the economic environment. Virgin Atlantic will not be unreasonable in demanding excessive service levels as the industry recovers from Covid-19. In our opinion, HAL has the opportunity to reduce operational costs further, without negatively affecting service quality.

Notwithstanding the points above, fundamentally, we question to what extent opex and spending to meet current consumer standards has to do with the long-term capital investment charged to future consumers via the RAB.

c) Investment to maintain service quality in 2021

HAL have stated that without intervention on the RAB, they will not be able to continue essential investment to maintain ongoing and efficient operations. It seems irrational to suggest that a lack of investment for 1 year in the existing infrastructure which has been designed for 42% greater volumes than that forecast for that year will result in reduced service quality levels in 2021. HAL's argument just does not make sense and we would request specific detail of which pieces of infrastructure require investment to maintain service levels in 2021 before being persuaded further on this argument.

Investment in capital expenditure should only be in the consumers interest and the RAB is increased naturally as a result of the capital investment delivered, but only in return for real, physical, efficient investments. Virgin Atlantic supports efficient capital expenditure that delivers demonstratable consumer outcomes (always subject to the agreed governance processes).

HAL's proposal to increase the RAB for no discernible consumer benefit is an abuse of the norms of the RAB. If HAL has excessive debt and insufficient equity to fund future capital investments, the correct solution is an injection of real cash equity to replace the equity that has been stripped out of the business through excessive dividends.

<u>Higher financing costs are self-inflicted rather than a consequence of COVID or the regulatory settlement</u>

Firstly, it is unclear to what extent HAL is having the financing problems it claims. For instance, HAL was able to raise £1.4bn in early October 2020. Its bonds are still rated investment-grade and its yields on bonds barely moved when the CAA's consultation document came out (which means that markets are not expecting any adjustments from the CAA). Moreover, HAL has £4.5bn of liquidity that will cover all forecast Opex, Capex, debt interest and debt repayment according to their CFO's statements at the recent Q3 results presentation. The forecast levels of capex for 2020 and 2021 have been appropriately reduced, via airline engagement through the governance process, to essential maintenance of assets and existing service quality and are the lowest in the Q. Virgin Atlantic, therefore, concludes there is little pressure from an investment perspective that would require any immediate retrospective action. We would strongly argue that there is no need for the CAA to intervene and accept HAL's request.

In any case, if HAL is experiencing the financing barriers its claims, this is due to HAL's high gearing practices rather than solely the impact of Covid-19 and to address this through a regulatory settlement adjustment would be wholly unreasonable. HAL's high gearing strategy (with gearing levels of c.90% vs. the 60% assumed by the CAA) has been designed to allow it to earn substantially higher returns on equity than that assumed by the CAA, allowing HAL to pay c. £3.9bn in dividends over the Q6 period.

<u>Closing</u>

We maintain that any adjustment to the RAB is unwarranted and that HAL has provided little evidence to justify a retrospective RAB adjustment. It’s completely unreasonable for the consumer to pay twice, given the WACC HAL has been able to leverage during Q6 and the extent to which it has outperformed the regulatory settlement. However, should the CAA take a differing view, concluding that regulatory intervention is required to support HAL, we counsel this would be better dealt with in the context of the H7 settlement process.

Yours sincerely,

Corneel Koster
Chief Customer and Operating Officer