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Sent via e-mail to: economicregulation@caa.co.uk

Date: 12th September 2016

Dear Stephen,

Virgin Atlantic's response to the CAA consultation on the recovery of costs associated with obtaining planning permission for new runway capacity: initial proposals

Virgin Atlantic (VAA) welcomes this opportunity to respond to the CAA's consultation on the recovery of costs associated with planning permission for new runway capacity.

As we have stated previously, and in agreement with the wider airline community at Heathrow via the LACC, we do not believe that funding for additional capacity should begin until such capacity is in use. However, we note the CAA's enthusiasm to progress with discussions around the treatment of such costs ahead of a decision being taken by the Government. Therefore, we have in-turn provided comments on each of the chapters presented in this consultation document.

There are a number of principles we believe need to be taken into account in the development of a planning cost risk-sharing mechanism to ensure it is the interest of our passengers. These are:

- It is vitally important that the CAA's primary duty to further the interest of present and future users is what guides all interventions and mechanisms in this process.
- Only efficient costs should be passed through. It is not in the best interest of the passenger to reward airport shareholders for inefficient investment.
- There should be no 'gold plating' of proposals – investments need to have sound business cases and show clear passenger benefits. Therefore, we welcome the development of an independent fund surveyor (IFS) at Gatwick and enhancement of the IFS role at Heathrow.

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- Those best placed to bear and manage the risk should be allocated the greatest share in the mechanism. Therefore, we challenge the ratio in the risk mechanism presented in this document.
- HAL/GAL should not be rewarded with any sort of additional return/reward for planning permission being secured to counter additional cost risk.

Finally, it is indicated in this consultation document that some engagement between the airports and airlines has taken place since February 2016 and that some areas of consensus have begun to emerge. We challenge this assertion. We have found no ground for agreement on elements of pre-funding with either airport operator. Greater clarity on this point would be welcome.

Chapter 2. Our duties

The CAA's primary duty is to:

'further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services'

The Civil Aviation Act 2012 also stipulates the consideration of the interests of both present users of the airports in question alongside the interests of future users.

It is not clear how the proposals presented by the CAA furthers the interests of present users who may not accrue any benefit from using future capacity but are presented with a considerable risk to bear in the present.

Interpretation of our duties in relation to planning/Category B costs

Category B costs may only be a relatively small proportion of the total costs of the project, but they remain a significant cost in their own right and therefore it is important that the appropriate level of scrutiny takes place in the best interest of the passenger.

This includes the scrutiny of costs below £10 million along with the scrutiny of costs incurred above this level. While we note that the automatic recovery of costs below £10 million clause is already present in the Gatwick licence, and is seeking to be replicated by the CAA in the Heathrow licence, it is still important that such costs are subject to robust analysis.

Chapter 3. Definition of eligible costs

Definition of Category B costs

VAA is content with the initial proposals for the definition of costs as presented. We welcome that Category B costs must be very clear and precise additional costs to those already included in the Q6 allowance along with being efficiently incurred.

We anticipate with this clear definition in place that expenditure is not remunerated more than once in this process, and request that this is closely monitored.

Category A costs

Whilst we note that the definition of Category A costs remain broadly the same as previously stated in the February 2016 document, we highlight our concern with the term '*most* Category A costs will not be permitted'. In VAA's view, *all* Category A costs should be borne by the promoter in question. It is not clear whether the policy on the treatment of Category A costs has changed, and clarity on whether there is now any ambiguity would be welcome.

Additionally, we are opposed to any re-categorisation of Category A costs as Category B regardless of the case made by any of the scheme promoters.

Category C costs

We welcome there being further clarity on the understanding of the level, type and structure of pre-construction costs prior to the development of a specific policy. We look forward to engaging with the CAA and chosen scheme promoter on this in due course.

Chapter 4. Recovery mechanism for eligible costs

Automatic recovery of up to £10 million each year

As raised in previous consultation responses on this topic we have a particular concern with the automatic recovery of Category B costs of up to £10 million per year. The CAA indicates that this may well be necessary to incentivise the start of



work on gain planning consent as soon as possible after a government decision. However, in our view the chosen airport operator is already highly incentivised to do so, therefore this clause is unnecessary.

With this in mind, we support the CAA's decision not to increase this £10 million threshold and welcome the recognition that this would not be in line with the promotion of efficiency on the part of the airport operator.

However, on the CAA's conclusions to not remove the threshold, we would like further clarity on why this would not be in line with the promotion of efficiency. VAA's view is that this is not applicable and the removal of said threshold would be in line with the CAA's primary duty and would further promote efficiency on the part of the airport operator.

Capitalisation of costs in excess of £10 million per year into a 'planning RAB'

Through a pRAB approach, the planning costs will not be borne entirely by existing users but spread out over both existing and future users. This is significant given all of the benefits will flow directly to future users.

It is for this reason that we do not support the concept of cost recovery via an immediate addition to airport charges. Users should only be charged when use of new capacity comes in use and not beforehand.

Cost recovery when planning permission is secured

We welcome the fact that cost recovery, both the allowed return via the WACC and depreciation, only commences once the asset comes into use.

Cost recovery spread over 10 years

In the case where the Development Consent Order (DCO) is not granted it is important again that the interests of both present and future users are taken into consideration. Whilst we will go on to present our views on the risk-sharing arrangement in the latter part of this response, there is an underlying concern that the recovery of costs over a shorter period will result in even higher charges for a constrained pool of users.

We would also assume given the asset is not coming online in this scenario that an allowed WACC on the remaining pRAB would not be applicable in this scenario.

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Chapter 5. Risk-sharing arrangements

Risk allocation is a significant consideration given the size and duration of the investment compared to smaller incremental projects. Therefore, it is welcome this is addressed explicitly to ensure appropriate incentives are provided to deliver a runway in passenger interests.

When allocating risk, VAA believes the CAA needs to be driven predominantly by its primary duty to further the interests of passengers, while taking account of other relevant secondary duties and promoting competition where appropriate. In light of the primary duty, it is fundamental that risks to passengers are minimised and that any risk allocated to them is balanced by a clear and commensurate benefit.

The principles of a risk sharing arrangement

Whilst it is welcomed that on the airport operator side, the risk-sharing mechanism presented will also encourage HAL/GAL to engage proactively with local communities and other stakeholders we do not think the level of risk apportioned to this goes far enough.

The financial detriment of 15% of the apportioned costs in our view is not a large enough incentive and should be a much greater proportion of the associated costs involved given they are best placed to bear and manage such risk.

On the other hand, while the CAA states in this document that *'airlines stand to benefit from runway capacity expansion'* this is not categorically the case for all airlines. While airlines should be involved in the planning process and be provided with the ability to input views, we are concerned that the risk-sharing ratio between airline stakeholders and the relevant airport operator has not been apportioned appropriately.

As we have previously stated, those that are able to best manage the risk during this process should be the one to bear this, and the relevant airport operator will clearly be in the most appropriate position to bear such risk going forwards. Users should not be expected to bear such a large risk associated with Category B costs if planning approval is not granted.

Design of the risk-sharing mechanism

As mentioned above we think that there is a fundamental issue with the risk-sharing mechanism as presented by the CAA in this consultation for two primary reasons:

- Neither HAL/GAL should be rewarded 5% or any additional return where planning permission is secured. We question whether in a competitive market the delivery of expansion would reap ‘supernormal returns’, and therefore this reward factor should not be applicable.

Users should not be expected to reward the operator while they will also be gaining a return on investment via the WACC apportioned to the pRAB in due course.

Additionally, HAL/GAL will be able to generate additional value as a result of the planning permission being secured and the capacity expansion which follows. Therefore, we are opposed to an additional bonus reward of any amount in addition to these future gains.

- Whilst the CAA notes that HAL/GAL faces the prospect of a proportion of costs having to be written off if planning consent is not achieved or if government policy changes, we do not view a 15% shortfall in cost recovery an appropriate level.

Users should not be expected to bear such a large proportion of the risk, with such a large cost exposure with absolutely no benefits flowing back to them either now or in the future. As we have stated, HAL/GAL would ultimately be in a preferable position in comparison to users to bear a greater level of risk than is currently being proposed.

Different scenarios around the reasons for planning failure

Whilst we note the CAA proposing to use a simple approach to risk-sharing, we do question the rational in the scenario where the airport operator unilaterally withdraws from the planning process.

In this instance either HAL/GAL will be able to recover less than 85% of the Category B costs incurred with no explicit amount presented. In our view users should not have to bear *any* of the costs associated with such a scenario and the operator should bear the full amount of the costs. This would be the only position that would further the interests of users as no benefit at all would be accrued from such a move either for present or future users.



Chapter 6. Promoting efficiency and transparency

Use of an Independent Fund Surveyor

VAA welcomes the section on the promotion of efficiency and transparency and it is important that this is monitored rigorously throughout this process. With this in mind, we support the creation of a new independent fund surveyor (IFS) at Gatwick and an enhancement to the role of the IFS at Heathrow.

This should allow for the close scrutiny of costs associated with the project and drive through better behaviours during the process. It is important that reporting back from the IFS occurs in a timely manner.

We also welcome the encouragement from the CAA on the engagement of the design of the scheme. Robust engagement will be key in ensuring the deliverability of the final scheme design and associated cost for the new runway, and will ultimately be in the best interest for users during this process.

I trust that you find the above comments helpful. Please do not hesitate to contact me if you have any questions in relation to the points made.

Kind regards,

A handwritten signature in black ink that reads "D Joseph".

David Joseph
Regulatory Affairs
Virgin Atlantic Airways