Virgin Atlantic response to CAA's final proposals for Q6

4th November 2013

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Executive Summary

Since it was founded in 1984, VAA has become Britain's second largest long-haul carrier serving the world's major cities. From its inception, VAA's aim has been to provide high quality, innovative services offering exceptional levels of customer service and value for money for all classes of traveller.

Virgin Atlantic has played an active role in the CAA's Q6 process. We welcomed the detailed assessment published in the CAA's initial position, and worked with the airline communities at Heathrow and Gatwick to provide a detailed, evidence based assessment of these proposals. However, whilst there are a number of areas where airlines were aligned with the CAA's thinking, VAA believed the initial proposals from the CAA did not go far enough to address the significant operating cost inefficiencies identified both by airlines and the CAA's own consultants. The CAA also proposed an over-inflated price. Given the wealth of credible evidence available to the CAA, we looked forward to these issues being dealt with in the CAA's final proposals.

We were therefore extremely disappointed with the final proposals from the CAA for Q6, which increased both the price and return to airport shareholders from the initial proposals. Other than speculating that the CAA have bowed to pressure from GAL and HAL and their shareholders, it is difficult for airlines to understand why there has been such movement from a position that was already considered more generous to the airports' shareholders than to consumers. VAA is concerned that the CAA is failing to meet its primary duty to consumers by providing over-generous and insufficiently challenging settlements which over-reward airport shareholders at the expense of passengers.

We are concerned that the CAA may have made errors of both fact and judgement in reaching these proposals. VAA and the airline communities at Gatwick and Heathrow provided substantial evidence to the CAA's initial proposals. Much of this evidence appears to have been overlooked in the CAA's assessment. This is particularly in relation to:

- The acceptance of Price Commitments and the 'fair price' comparison;
- The appropriate WACC at both airports;
- Efficiency savings; and,
- Traffic forecasts.

The proposals also inconsistently apply macroeconomic impacts to the building blocks that make up the allowed regulated revenue, this has the effect of further distorting the fair price. Furthermore, announcements by both airports, and their shareholders, since the decision appears to have proved the validity of the airline assessments and point to a lower price being appropriate.

This response from VAA complements the responses from the ACC and LACC, which we support. In the limited time available the assessment has focused on the key areas where we believe the interests of our passengers are being overlooked.

We urge the CAA to use this final consultation period to urgently review its recommendations and fulfil its obligation to regulate in the best interest of present and future passengers.

Heathrow

This section sets out VAA's views on the CAA's final proposals for Q6 at Heathrow.

Prioritising shareholders over passengers

VAA was shocked by the reaction of HAL to the CAA's initial proposals. Our view, as previously set out, was that not only did the CAA's proposal offer a generous return but that there was significant room for HAL to outperform the inflated settlement in order to deliver a much higher return to its shareholders.

We therefore believed the price should have been significantly reduced and provided substantial further evidence to the CAA on additional opex savings. We also provided evidence for:

- A higher traffic forecast than that used by the CAA, taking out the shock methodology which we see as a double counting of risk;
- A capital plan of up to £3bn, covering improved resilience and key passenger priorities across all terminals;
- A correction of the over generous WACC to one that is more balanced in terms of the risks faced by the airport; and,
- A commercial revenue forecast that drives commercial behaviour by HAL.

VAA is therefore extremely disappointed with the revised price from the CAA and the process by which it was derived.

We believe the proposals also inconsistently apply macroeconomic impacts to the building blocks that make up the allowed regulated revenue, this has the effect of further distorting the fair price.

Furthermore, announcements by both HAL, and Ferrovial[1], since the decision appear to have proved the validity of the airline assessments[2]. ✂ VAA believes this is clear empirical evidence that equity investors do see value in HAL at the return set in the initial price

[1] http://www.telegraph.co.uk/finance/newsbysector/transport/10397806/Ferrovial-sells-Heathrow-stake-to-UK-pension-fund-for-392m.html

http://www.telegraph.co.uk/finance/newsbysector/transport/10410323/Heathrow-boosts-profits-at-Ferrovial.html

2 http://mediacentre.heathrowairport.com/Press-releases/Heathrow-SP-Limited-Results-for-the-nine-months-ended-30-September-2013-6ce.aspx

proposal, let alone the more benign final proposal, and will continue to invest through Q6. We therefore believe the CAA needs to urgently revisit its final proposal on the cost of capital for HAL.

This response compliments the LACC response and focuses on some of the key areas where VAA believes there is compelling evidence that the CAA needs to urgently reconsider its position ahead of its final decision.

Operating costs

VAA is extremely disappointed with the lack of progress on operating cost savings. The CAA's final proposal on opex efficiency is neither challenging for HAL nor fair for passengers.

The CAA has a statutory obligation to ensure that regulated airports operate efficiently and effectively. ✂

The airlines have continually outlined, in this and previous evidence, the extent of the efficiency savings that exist and how these could be achieved in a sustainable manner by HAL over the Q6 period; substantial areas of these savings have been overlooked with no justification. This submission therefore makes the case for further savings than those outlined by the CAA in their proposals.

Finally we have three major concerns about the way in which the CAA's revised operating cost projections have been derived:

1. VAA and the Airline Community were unaware that the CAA had asked their consultants SDG to carry out detailed work to revise their previous efficiency savings. For the initial proposals SDG had engaged in a transparent process engaging both HAL and the airlines in the collection and assessment of relevant data. If we had known a detailed study was taking place, given the weight of data on operating costs VAA had previously provided we would have liked the same opportunity to feed further data to these studies as it seems HAL did. Finally we are concerned this puts the airline community at a disadvantage as we only had access to the new SDG reports when the CAA published its Final Proposals. By comparison it seems HAL has had the whole period between the Initial and Final Proposals to work with SDG and to shape their advice. If this is not the case then we would welcome the CAA's explanation of the process followed.

2. We note that the CAA has drawn many conclusions on efficiencies from HAL's workforce strategy and ABP. The workforce strategy is not a document that VAA has been able to see and provide any comment on. Unlike most inputs to the Q6 process we are unable to comment on its robustness and whether it is sufficiently challenging.

3. The CAA states it will be more difficult for HAL to deliver wage savings now the economy has picked up, but the supporting evidence is unclear. While growth forecasts have picked up, there is no evidence to suggest wage growth will have kept pace, in fact independent forecasts for 2014 show a drop in forecasts since April[3] 2013 despite an improvement in the GDP outlook. If the CAA believes wages have picked up in the medium-term this should also be fed through to an improvement in the commercial revenue forecast.

[33] HM Treasury Independent forecast comparison

4. Finally, VAA and the airline community do not accept that we have double counted savings in getting to our proposed efficiency savings. We remain happy to take the CAA through our assumptions to demonstrate this.

The section below outlines the further efficiency savings we believe need to be addressed by the CAA in its final decision. We stand by the analysis we presented in our response to the CAA's initial proposals which is attached in Annex B.

Operating costs

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Macroeconomic impacts

VAA is concerned that macroeconomic impacts have been inconsistently applied through the CAA's final proposals. This has a distortive effect on arriving at the appropriate fair price for Q6. VAA believes the CAA needs to consider these impacts further ahead of coming to its final decision in January 2014. In particular:

- Traffic growth has been revised up very modestly over the medium term to account for higher GDP growth. However, the stronger than expected economic recovery in the base year and the significant impact on traffic that has been delivered has been ignored.

- It is not clear what assumptions have been applied to operating cost efficiencies. The CAA states that an increase in average earnings growth means HAL will not be able to deliver wage efficiencies but there is no data to support this. Even if this is true, it ignores other positive effects that a stronger macroeconomic environment could have on HAL's ability to deliver savings. For example a stronger economy could mean a higher turnover of staff which would allow HAL to re-employ at market rates or be able to deliver structural savings faster.

- Finally, the assumption highlighted on traffic and opex of higher GDP and average earnings growth has not been fed through to retail projections which have, in fact, decreased since the initial proposals.

Traffic

VAA welcomed the analysis the CAA has presented on the traffic forecasts for Q6 and the extent to which some of the analysis presented by VAA and the Airline Community were taken on board in reaching its assessment of expected traffic levels at Heathrow over the next five years.

However, we believe the balance of risk is wrong in the final proposals as the forecasts understate the likely passenger growth at the airport and therefore inflate the fair price proposal. We therefore believe that this does not meet the CAA's duty to the passenger as HAL's shareholders will be over-rewarded at their expense.

We believe there are two areas which point to a significant increase from the proposals put forward by the CAA:

- Significant outperformance of estimates in the base year. HAL's traffic growth has continued to outperform previous assumptions. The base year has a significant impact on the overall forecast so this needs to be taken into account. Particularly as the capacity forecast is only used for 2 years rather than the three preferred by airlines;
- We continue to dispute both the inclusion of adverse demand shocks and their nature and scale.

These impacts combined with the more favourable economic outlook mean we believe HAL has the opportunity to significantly outperform the traffic estimates in the final proposals.

1. Base year growth

The base year of the forecast (2013/14) has a significant impact on the overall level of traffic over the quinquennium. Since the LACC provided its last assessment, traffic at Heathrow[4] has shown much stronger growth than forecast. Moreover, it is also already significantly outperforming the growth assumed in the CAA's final proposals.

We are surprised the CAA has not already tried to capture this growth in its projections and is currently projecting the same growth for 2014/15 as it was in April 2013. Especially as this was an area raised by the Airline Community in our response to the initial proposals:

[4] http://mediacentre.heathrowairport.com/imagelibrary/downloadmedia.ashx?MediaDetailsID=1838&SizeId=-1

'Finally, Heathrow appears to have been achieving strong traffic growth in recent months[5] *so the CAA should ensure that its base year forecast remains appropriate ahead of its October proposals.'*

If just an increase in the base year is built into the projections (with no change in the CAA's projected growth rates) this increases the projections for Q6 by 10m, as shown in the table below.

	CAA	**VAA**
2012/13	70.3	70.3
2013/14	70.2	72.4
2014/15	70.8	73.0
2015/16	71.0	73.2
2016/17	71.7	73.8
2017/18	72.5	74.6
2018/19	73.2	75.2
Q6 total	359.2	369.7

This is obviously a cautious estimate as there is clearly a case for raising the medium term traffic growth rates from higher GDP forecasts.

<u>VAA believes that in order to reach a fair settlement this growth needs to be captured in the base of the CAA's assessment.</u>

2. Adverse demand shocks and the use of asymmetric variables

VAA supports the work previously done by the Heathrow Airline community that the CAA has not made the case for changing the way in which it accounts for demand risk. We also believe that there is a strong risk of double counting this risk, together with the risk arising from truncation, and so do not support the CAA's proposals in this regard. VAA does not accept that an adverse shock generator should be included in the passenger forecast.

[5] http://mediacentre.heathrowairport.com/Press-releases/Heathrow-traffic-and-business-commentary-May-2013-58a.aspx

Capital Programme and Governance

VAA generally supports the airline community's position that up to £3bn of capital could be invested in Q6, subject to a robust and transparent Business Case based Gateway review process. This is essential in order to enable airlines and the Independent Fund Surveyor (IFS) function to effectively scrutinise investment proposals, before committing to a project transferring from "Development" to "Core", where the bulk of the capital spend is incurred.

VAA would like highlight a few important additional points, rather than repeat detail from previous submissions at this stage in the consultative process, as follows.

Whilst we support improvements in passenger experience in T3 in Q6, and are generally pleased that better alignment is emerging between the airline community and Heathrow regarding investment plans in Q6, capital investments will only be supported by VAA in T3 on the basis we incur no, or very minimal, operational disruption to our existing T3 passenger operations. ✂

We are especially disappointed, despite VAA's best efforts over a number of years, that Heathrow has not made more progress to develop plans to introduce PCA into T3 which would not only reduce fuel burn through minimising the need to run aircraft APUs, with the associated environmental benefits, but also deliver competitive equivalence between VAA in T3 and BA, who currently enjoy the benefits of PCA in T5. We would urge the CAA to help support VAA with this issue, and to encourage HAL to identify a solution that delivers PCA in T3 in the early years of Q6, with minimal disruption to operations. Related to this is the need to consider T3's High Voltage power requirements and HAL's broader supply strategy, that is an additional constraint to overcome.

We object to the CAA's position supporting £70m of Crossrail investment in Q6, do not believe that such a contribution would be in our passengers' interests, and maintain that a robust and positive business case for such a contribution has yet to be produced. It is our view that the CAA has a duty to robustly analyse the case for the inclusion of any project into the capital plan and that this should be the case regardless of who the capital payment is made to. We do not believe that the CAA has reflected the evidence placed before it and therefore its judgment is open to challenge in this instance.

Regarding Governance, VAA would encourage the CAA to support an efficient, streamlined structure of meetings to the greatest extent possible to effectively govern the Q6 settlement, recognising the limited resources VAA and some other airlines will have relative to Heathrow. This is in the passenger's interests and vital to the successful implementation of the Q6 settlement, to ensure as many airlines as possible are able to consistently resource key meetings and decision-making forums.

VAA has previously stated that we are pleased with progress made in the capex efficiency area, however cannot fathom why the CAA is willing to allow HAL an RPI level of increase, when VAA have clearly demonstrated to the CAA that we are able to consistently achieve a real 0% inflation in our supply chain. VAA believe that there is no reason why HAL cannot achieve the same, and we would therefore urge the CAA to revisit its position on this basis.

Commercial Revenue

It is clear that there is significant potential for commercial revenue forecasts to be revised up. VAA believe there is a strong case for the CAA revisiting:

- Retail spend per passenger: If the CAA believes real earnings are going to grow over Q6 then this should be fed through to spend per passenger;
- The total forecast will also need to be uprated to reflect the much higher traffic forecast.

Cost of Capital

VAA supports the work carried out by Jonathan Mirlees-Black from RARE Infrastructure for the LACC. This work finds fundamental fault with the revisions the CAA has made to the proposed WACC for HAL since the initial proposals. An extract is shown below which argues that both the cost of debt and equity have been overstated.

There are three ways in which the cost of debt appears to be overstated by the CAA:

- *In making its estimate of the cost of embedded debt for Heathrow at the notional gearing level, the CAA uses Heathrow's actual debt costs.*
- *The CAA makes an alternative estimate of the real cost of embedded debt using historic yields on a bond index. It does this by calculating historic real yields using historic inflation expectations. The real cost of embedded debt as faced by a company, though, is the nominal cost of embedded debt less forward looking inflation expectations. Inflation expectations have risen, and this means that the CAA method overstates the real cost of embedded debt today that it is appropriate to reflect in a price control.*
- *For new debt, the CAA relies on PwC's estimated real cost of debt. This has been estimated by PwC by deducting an RPI inflation expectation of 2.8% from nominal bond yields, compared to the 3-3.4% that the CAA identifies as an appropriate RPI inflation expectation.*

In addition, the cost of equity appears to be overstated:

- *The CAA has increased its estimate of the asset beta since the interim determination.*
- *The CAA uses en equity risk premium of 5.75%, which is higher than other UK regulators and above a level typically used in financial markets.*

These factors are material.

Moreover, the CAA has estimated ranges for each of the major parameters determining the cost of capital. In its point estimate it has chosen parameters at the upper end in almost every case. This suggests an unbalanced assessment of the evidence.

Airport infrastructure and regulated assets with index-linked revenues and regulatory asset values are attractive assets to a broad range of investors. These arguments were highlighted previously, as well as providing supporting evidence for a lower cost of capital to that selected by the CAA in both its interim and final determinations. The CAA has not taken time to examine what the developments in capital markets mean for what an appropriate return is for an asset like Heathrow. The impact of lower bond yields and other capital *market developments is having a far larger impact on decisions by Ofgem and Ofwat without any detrimental impact on the supply of capital.*

Furthermore, announcements by both HAL, and Ferrovial[6], since the decision appear to have proved the validity of the airline assessments[7]. ✂ VAA believes this is clear empirical evidence that equity investors do see value in HAL at the return set in the initial price proposal, let alone the more benign final proposal, and will continue to invest through Q6. We therefore believe the CAA needs to urgently revisit its final proposal on the cost of capital for HAL.

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[6] http://www.telegraph.co.uk/finance/newsbysector/transport/10397806/Ferrovial-sells-Heathrow-stake-to-UK-pension-fund-for-392m.html

http://www.telegraph.co.uk/finance/newsbysector/transport/10410323/Heathrow-boosts-profits-at-Ferrovial.html

7 http://mediacentre.heathrowairport.com/Press-releases/Heathrow-SP-Limited-Results-for-the-nine-months-ended-30-September-2013-6ce.aspx

Gatwick

This section sets out VAA's views on the CAA's final proposals for Q6 at Gatwick.

A flawed comparison

VAA is disappointed by both the price and assessment set out by the CAA in its final proposals. Moreover, we believe that the CAA's assessment is flawed. This submission supports the ACC submission and provides further evidence on our two main disagreements with the CAA:

1) The significant increase in price from their initial proposals in April

VAA is extremely disappointed with the sizable shift on price from the CAA's own initial proposals. We felt that there was already significant evidence which showed that the price proposed in April was entirely too high. This response highlights the key areas where we believe the CAA needs to urgently re-consider the evidence ahead of its final decision:

- Traffic: the CAA's proposals don't take sufficient account of recent strong performance or GAL's recent slot reconfiguration which has released an additional 21 slots from summer 2014.

- WACC: we disagree with changes made from initial proposals, particularly on the cost of debt where we believe there are errors in the assessment.

- OPEX: significant areas of savings have not been addressed including on the unit cost of a security officer. We also believe the CAA's approach is flawed and is likely to result in an inflated price as it is based on *'the need to ensure that GAL has a realistic chance of outperformance as a regulatory incentive'* rather than the efficient cost of running the airport.

- Commercial revenues: projected retail revenues have been revised down despite a more positive economic outlook. Combined with new higher traffic there is significant headroom in the commercial revenue forecast.

- CAPEX: we disagree with the inclusion of pier 6 south and the pension commutation payment in the price cap.

The effect of this inflated price is magnified in the CAA's assessment as it is the basis for the CAA's assessment of whether the price offered under Commitments is a 'fair price'.

2) The CAA's adoption of GAL's price commitments as a whole

VAA have remained open to the concept of alternative forms of regulation at Gatwick, but have continually stated that the right checks and balances need to be in place along with a robust regulatory backstop. As such we have provided feedback and voiced concerns to the

CAA and GAL over the course of the year however much of this has failed to be addressed in these proposals.

Our overarching view is therefore that the Commitments have not been thoroughly thought through either by the CAA or GAL, with a number of outstanding issues with the detail that have yet to be addressed. This means there are significant risks to passengers which have failed to be mitigated.

We are therefore concerned that the latest proposals fail to meet the CAA's primary duty and are not in the best interest of passengers at the airport and have supported the detailed work carried out by the ACC to respond to the CAA's consultation.

As expressed in our response to GAL's revised Commitments (email dated 3rd September 2013), we do not believe that the modifications GAL has made to the terms of the proposed Commitments remedy the risk of the airport exercising its significant market power to the detriment of the passenger.

Given the feedback we have provided, and the provisional market power assessments, we are surprised with the CAA's acceptance of these Commitments as a whole.

Price Commitments

VAA have remained open to the concepts of alternative forms of regulation at Gatwick, but have been clear that the right checks and balances need to be in place along with a robust regulatory backstop. As such, we have provided feedback and concerns to the CAA and GAL over the course of the year however much of this has failed to be addressed in these proposals. Overall the Commitments appear to offer GAL much of the same protection they would have under a RAB regime whilst removing most of the protections for airlines and passengers.

We are therefore concerned that the latest proposals fail to meet the CAA's primary duty and are not in the best interest of passengers at the airport and that the approach set out in the final Q6 proposals, based on GAL's current Commitments[8], will not realise the benefits claimed.

We also consider that the CAA has wrongly concluded that the Commitments price is comparable to the 'fair' or RAB price based price and has relied on this when proposing Commitments over alternative approaches.

As expressed in our response to GAL's revised Commitments (email dated 3rd September 2013) we do not believe that the modifications GAL has made to the terms of the proposed Commitments remedy the risk of the airport exercising its significant market power to the detriment of the passenger.

A major disadvantage of the proposed approach is that the CAA appears to be unable to change any of the terms of the Commitments before adopting them and unwilling to make adoption conditional on GAL making any changes. We see no advantage to the regulator in fettering itself in this way. This approach also undermines the current consultation process, if the CAA cannot make changes to key terms, including the price.

VAA supports the work and response of the ACC on Price Commitments. Particular areas of concern are:

- The proposed price remains too high. Our view is that the CAA should have challenged GAL's Commitments price further, rather than simply adopting the proposals. This submission sets out clear evidence for a lower RAB price than that adopted by the CAA;

- The CAA was wrong to accept GAL's Commitments price on the basis of an unequal comparison with the CAA "fair price" and an exaggeration of the benefits of Commitments. (For example the CAA 7 year fair price of RPI+0.3% would include more guarantees on capex delivery and outputs and a much lower risk of price increases

[8] We understand that the Heads of Terms version issued in September is the current version and that an earlier (August) version has been incorporated in the Conditions of Use agreement.

during the period. It therefore offers significantly better value than even the blended Commitments price of RPI+0.5%);

- Comparisons between the Commitments price and a RAB price are also unequal because the Commitments price excludes costs that are in a RAB price, e.g. premium services. If adding these additional costs to the Commitments price, it is highly likely the Commitments capped price could be equal to or higher than under RAB pricing;

- The proposals are also unclear on the formal definition of premium services. GAL has still not presented to VAA or the wider airline community the definition of premium services, despite repeated requests. It is highly important that robust definitions are developed to prevent gaming of the system and the redefinition of what are currently core services. We agree with the ACC that reference to 'Premium Charges' should be removed from the Commitments;

- One of the most significant differences is that the Commitments only commit to a minimum spend of £100m on capex per year compared to around £160m per year used to calculate the RAB-based framework. The CAA acknowledges this lower capex commitment as a drawback of the Commitments[9] but it does not adjust the prices it uses in its comparison to reflect it. It is clear that GAL's price is based on only a minimum commitment of £100m per year. The CAA should at least have adjusted its RAB-based 'fair price' comparator so that it was calculated on the basis of the same capex commitment. Over a 5 year period, the difference between the Commitments capex and the RAB based capex of £791m would be 2 percentage points on the value of "X" in the formula RPI+/-X.

- The comparison the CAA makes is between the RAB-based price and the 'average' or 'blended' price commitment under the Commitments. As such it includes any lower prices offered to airlines under bilateral agreements. The price commitment for published prices is 1% per year higher. We do not consider this to be an appropriate comparison as the lower prices under bilateral agreements will not be automatically available to airlines and will only be made available in return for conditions different from those assumed in the RAB-based approach. Thus, for example, the price may be lower in return for accepting lower service standards.

- We also challenge the ability to change the mechanism. The ability for airlines representing 67% of passengers and 51% of airlines responding to a consultation is, in our view, unworkable. It is essential that consensus is reached with all airlines, not just a subset. Under the mechanism as it currently stands it would be possible for one type of airline (e.g. low cost carriers) to impose changes on all carrier at the airport,

[9] Paragraph 10.98

adversely impacting competition and consumer choice between different business models;

- The proposals create significant risks for passengers over the costs of a potential second runway, which the CAA has recognised could be £9 billion. This has been left as an open ended item in the proposals, and any future figure could be considerably in excess of this. Therefore there is no guarantee that passengers will be receiving value for money, and resulting passenger charges could increase exponentially;
- The detail on other variations to the price cap to pass through including security costs and hold baggage screening also remains unclear from the proposals. There is no onus on GAL to run either efficiently, which could therefore have significant implications for the passenger charge;
- Although the Commitments will be supported with a licence, our ability to challenge GAL's actions on issues such as investment plans or behaviours is reduced under commitments with less onus on GAL to consult/be transparent with airlines; and
- The airlines still remain in the Commitments proposal "the insurer of last resort". In a standard commercial relationship, the supplier would have a contractual liability for direct costs incurred by the customer through supplier under performance or negligent actions
- We would also welcome further clarity as to what the repercussions will be if an airline does not sign up to Commitments, i.e. what is the resulting price that will be applicable – the maximum allowed price under Commitments?

As a regulator for the passengers' best interests at Gatwick there is a need for the CAA to address the significant concerns outlined above if price commitments are to prevail and be workable in practice. It is highly likely implementation of the commitments as currently drafted will cause significant detriment to the passenger along with allowing GAL to exercise its significant market power.

VAA welcomes the letter the CAA sent to GAL on 28th October which recognises some of the issues we have raised. We are keen to work with GAL and the CAA to try to achieve a solution on these. However, the CAA letter does not deal with all the other changes highlighted by the ACC, including for example the significant flaw in the proposed treatment of the security cost pass through (the S term) nor the change mechanism.

Unless the concerns outlined by VAA and the ACC can be remedied we believe that RAB regulation is more appropriate and will offer better outcomes and value for passengers in Q6.

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Operating costs

VAA are disappointed by the level of operating cost efficiencies proposed by the CAA in their assessment. Operating costs have a significant impact on Gatwick's price cap, and therefore the fares paid by passengers. Consequently, it is critical that these costs are properly assessed as part of the regulatory process and that they are as efficient as possible. It is not in the passenger interest to subsidise inefficiency. VAA stand behind our previously submitted evidence to the CAA which we believe has not been fully taken into account. This is re-attached in Annex B.

We also believe the CAA's approach is flawed and is likely to result in an inflated price as it is based on *'the need to ensure that GAL has a realistic chance of outperformance as a regulatory incentive'* rather than based on the efficient cost of running the airport.

The CAA has a statutory obligation to ensure that regulated airports operate efficiently and effectively. The CAA's initial proposal had an efficiency of 1.1% per year. ✂ It has therefore failed to find and tackle any new efficiencies between the initial and final proposals.

VAA supports the assessment set out in the ACC document. In particular we would highlight:

- The fact that the CAA has failed to take into account many of the arguments / pieces of data that the ACC provided in the response to GAL's Q6 Business Plan, for example in relation to security costs including benchmarking and the inclusion of process efficiencies at AMD's (Archway metal detectors) to reduce headcount.

- The CAA's scale of potential efficiencies and the choice of point in range.

- The CAA's acceptance of only around 25% of the possible total savings developed in the work produced by its consultants. At a minimum the ACC believes this should move to the 50% point to reflect the concern that GAL needs to work towards greater levels of efficiency.

- The ACC considers that it is not appropriate to use GAL's projection of costs in 2013/14 as the start point for applying efficiency. Regulatory precedent (for both airports and other sectors) is generally to use the most recent full year for which actual data is available as the base year, which in this is case is 2012/13. Otherwise, the outperformance that GAL enjoyed during Q5 will not be shared with users. This would be inconsistent with the fundamental principle of RPI-X regulation.

Traffic

VAA supports the traffic estimate presented by the ACC. We believe there are 2 areas which point to a significant increase from the proposals put forward by the CAA:

- Significant outperformance of estimates in the base year. GAL's traffic growth has continued to outperform previous assumptions. The base year has a significant impact on the overall forecast so this needs to be taken into account;

- The announcement by GAL of an additional 21 daily slots including 8 peak slots from summer 2013. The ACC does not believe this type of slot growth was accounted for in the CAA's forecast in the final proposals. We have provided evidence below on the increase in traffic this could provide;

These impacts combined with the more favourable economic outlook, and recent announcements on long-haul growth from the airport (from BA and Norwegian) mean we believe GAL has the opportunity to significantly outperform the traffic estimates in the final proposals.

We support the updated forecast set out by the ACC.

Macroeconomic impacts

VAA is concerned that macroeconomic impacts have been inconsistently applied through the CAA's final proposals. This has a distortive effect on coming to the appropriate fair price for Q6. VAA believes the CAA needs to consider these impacts further ahead of coming to its final decision in January 2014. In particular:

- Traffic growth has been revised up very modestly over the medium term to account for higher GDP growth. However, the stronger than expected economic recovery in the base year and the significant impact on traffic that has been delivered as a result has been ignored.

- It is not clear what assumptions have been applied to operating cost efficiencies. CAA state that an increase in average earnings growth means GAL will not be able to deliver wage efficiencies but there is no data to support this. Even if this is true, it ignores other positive effects that a stronger macroeconomic environment could have on GAL's ability to deliver savings. For example a stronger economy could mean a higher turnover of staff which would allow GAL to re-employ at market rates or be able to deliver structural savings faster.

- Finally, the assumption highlighted on traffic and opex of higher GDP and average earnings growth has not been fed through to retail projections which have, in fact, decreased since the initial proposals.

Capital development

VAA supports the appropriate capital plan set out in the ACC's assessment. The main points are summarised below:

P6 South: VAA continue to believe the proposed Pier 6 South project is both unnecessary and poor value for money and should therefore be excluded from the Q6 price. There are three key pieces of supporting data on why Pier 6 south should not be included in the Q capital plan (or fair price comparison).

- The CAA has stated that Pier 6 South provides cost in excess of the passenger benefits.
- All parties agree that 95% PSL is achievable in Q6 without building P6S.
- No expert evidence has been provided to support the £28m renewals spend.

Taking all of these points together the most appropriate way to protect passengers, airlines and the airport operator is to remove Pier 6 South from the core pricing and treat it in the same way as the HBS project. Therefore if traffic materialises significantly ahead of the passenger forecast then Pier 6 South could be moved from "flexible" to "core" within the period.

Incorrect use of COPI: VAA believe it is inconsistent and incorrect for the CAA to ignore the effects of real COPI when calculating the cost of the capital plan in the forthcoming regulatory period. We are surprised to see that COPI is largely ignored within the final proposals issued by the CAA, particularly as it featured prevalently in the Q5 decision. Davis Langdon the CAA's own consultants have provided advice that real COPI moving forward will be negative until at least the end of the period.

The commutation payment: VAA does not agree that the full pension commutation payment should be added to the RAB. We have three objections:

- the payment was part of the transaction to buy the airport and therefore was reflected in the sale price;
- the payment was 165% of the amount needed to repair the deficit; and
- recovering the payment through the RAB will result in GAL earning a high rate of return on the amount in addition to inflation.

Capital Plan in Q7: VAA supports the assessment by the ACC. It appears inconsistent that the CAA would allow GAL a capital plan of £151.4m & £201.6 for the first two years of Q7 given that the CAA also supports GAL's commitment to only spending an average of £100m per annum within the commitments framework. The capital plan put forward appears completely arbitrary and has not undergone any scrutiny by the ACC or, as far as we are aware, the CAA or their consultants. Asset stewardship in Q6 averages £64m per annum, yet for the additional two years this figure is allowed to rise to £90m per annum. All of this information leads to a position where the ACC is unable to reconcile the values proposed by the CAA for use in the capital plan or within the "fair price" calculation. It would appear more practical to either use the RAB based value of £1.1bn within the fair price calculation or reduce the capital plan in the RAB calculation to £700m.

WACC

VAA supports the ACC and BA's conclusions on the proposed WACC. We believe that the CAA's estimate of WACC of 5.95% (compared with an effective rate of 6.3% in Q5) is inaccurate in three key respects and fails to reflect the WACC of a notionally efficient airport. In particular:

- The cost of debt is excessive and errors have been made in its calculation;
- The reduction of gearing to 55% and increasing beta is not based on evidence;
- The CAA is wrong to take a point at the top of the range, implying illogically that all uncertainty is in one direction. The decision on the range also fails to account for the CAA change of policy on reinvestment of returns.

Annex A: Gatwick Licence

VAA continues to welcome the CAA's ability to grant economic licences under the Civil Aviation Act 2012. Such powers will bring the CAA in-line with other economic regulators and update the way in which regulation is applied at each airport.

However, we have a number of significant concerns with the licence as is currently drafted in the CAA's final proposals and have deemed it necessary to set out our concerns based on the advice received from our Legal Counsel in this annex.

The views presented in this annex both support and supplement that presented by the ACC in its response to the CAA's final proposals.

Comments

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Annex B: Previously submitted evidence on operating costs

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Annex C: The appropriate inflation index

VAA provided comments previously about the appropriate inflation index for use in the regulatory determination:

VAA notes the work being carried out by the UK Statistics Authority and the ONS on RPI, in particular the decision to be made this summer on whether RPI merits continued designation as a National Statistic. If the RPI is no longer deemed fit for purpose because it overestimates inflation then there are obviously questions about value for passengers from its on-going use. We therefore believe this should be something that is under consideration.

Since or previous response in June the ONS has removed RPI's designation as a national statistic[10]. Further work is being undertaken on new measures and we feel that this warrants re-consideration by the CAA.

This is particularly the case because the ONS had found that RPI overstates actual inflation so when used to in the calculation for a price cap it will inflate the amount passengers should pay. Therefore the assessment by the CAA that HAL (and GAL) would bear any risk of changes to inflation are an incomplete assessment because they assume that there is a symmetrical risk however the risk is one sided. If another inflation index is used it will reduce the prices that consumers pay in Q6.

We are happy to discuss this further with the CAA.

[10] http://www.ons.gov.uk/ons/guide-method/user-guidance/prices/cpi-and-rpi/index.html