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Dear Paul,

CAP2098 Economic regulation of Heathrow Airport Limited: Response to its request for a covid-19 related RAB adjustment - Updated consultation

I hope you are well. Thank you for the opportunity to respond to the CAP2098 document. Heathrow Airport Limited's request to adjust the RAB remains an issue we strongly oppose. Whilst I respond on behalf of Virgin Atlantic and our close joint venture partner, Delta Air Lines, we are also highly supportive of the AOC / LACC submission dated 5th March 2021 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 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.

The options that the CAA have outlined in the CAP2098 document and associated appendices are fully understood by Virgin Atlantic and Delta and we appreciate that the CAA needs to make a decision on the way forward in a reasonable time frame to allow the H7 settlement process to remain largely uncompromised. Somewhat frustratingly, a RAB adjustment is still not completely dismissed at this stage and the CAA have effectively stated that a 'do nothing' approach is not in line with its statutory duties. Nevertheless, we appreciate to see that the CAA have listened to the reasoned arguments we made in our last letter dated 6th November 2020 and that any intervention is best dealt with 'in-the-round' as part of the H7 settlement process. We maintain that intervention is not required and will outline our reasons further below, however, as this is no longer an option, it is on that basis that Virgin Atlantic and Delta preference Package 1: No intervention before H7, but consider interventions at H7, to delay any immediate intervention and consider any support HAL may require as part of H7 as we progress through 2021.

Summary of our position

- **A RAB adjustment is incompatible with the Q6 Regulatory settlement**
- **HAL's proposal to inflate the RAB is harmful to consumers**
- **HAL's comments that "Pressure to cut costs could jeopardise quality of service and future investment" appear to be unfounded**

Reasoning behind our views:

1. A RAB adjustment is incompatible with the Q6 Regulatory settlement

Firstly, it is important to re-emphasise the point we have made several times before, there is no regulatory justification for reopening the Q6 settlement. There is nothing explicit within the CAA Licence that obliges the CAA to re-open the regulatory settlement for Q6. We also fully support the CAA's statement that there is no obligation for the CAA to grant HAL's request and that its main duty is towards furthering the interests of consumers.

It is our opinion that the Q6 settlement package, in which risks, and rewards were assigned to HAL, were carefully balanced among the different building blocks that underpin a price control. HAL was assigned the passenger volume risk throughout the period and this included a downward adjustment to the passenger forecast (a 'shock factor') at HAL's insistence. In addition, the CAA has previously calculated that HAL has outperformed its Q6 regulatory settlement by £1.11bn (in 2018 prices) between 2014 and 2019.

Statements by HAL as recently as November 2019 Debt Prospectus, just prior to the Covid-19 outbreak, outline that passenger numbers at LHR are subject to risk from *"Health scares, epidemics or pandemics across the globe"* (Nov_19_Heathrow_Finance_plc_Final_Prospectus.pdf). Clearly, this illustrates that HAL's cost of capital already includes assessments by investors and debt holders as to the impact of a pandemic on passenger volumes.

It is possible that investors failed to under-estimate the effects a 'pandemic across the globe' could have on aviation but HAL's assertion that their cost of finance will increase significantly without a RAB re-opener as investors did not take a pandemic such as Covid-19 into account is simply untrue.

2. HAL's proposal to inflate the RAB is harmful to consumers

During the Q6 and iH7 periods, HAL have been rewarded on the basis of holding all passenger volume risk in the form of an increased % in the WACC for the whole of the Q6 and subsequent iH7 price control. If the RAB is inflated by any increment, then this will result in the consumer paying twice for a risk that was already incorporated in determining the underlying Q6 WACC since 2014. Historically, it is evident that HAL have used debt leverage to remove equity from the business and fund dividends. HAL have stated that in their Jan 2021 Investor Presentation that they have £2.4bn in cash and that a "*Strong liquidity position covers all forecast obligations beyond 12 months even in an extreme no revenue scenario*" and more recently HAL openly admit in their recent 2020 results that *"we have £3.9 billion of cash, which would be sufficient to take us well into 2023 under our current traffic forecast or through 15 months even without any revenue. This is as strong a position as we could have hoped for"*. Both statements would suggest there isn't a pressing need for intervention.

We maintain that HAL's shareholders should continue to provide suitable levels of equity before consumers are asked to pay further. In the meantime, we are interested to understand the CAA's assessment of what amounts to be a reasonable equity injection from shareholders of a notional Heathrow company, particularly considering historical and future dividend payments. Simply, the RAB adjustment figure is not relevant to liquidity and will not improve HAL's financeability.

Perversely, it runs the risk of rewarding shareholders well in advance of others across the industry which can not be furthering the interests of consumers by potentially distorting competition.

It must also be highlighted that HAL is stating it no longer wants the volume risk it agreed to (hence, its request for the RAB adjustment), but HAL is happy to continue applying the current framework on the items that are in its favour, for example, HAL were insistent that they recovered the entirety of the 2020 and 2021 ORC under-recovery of c. £160m in 2021. We, together with the rest of the airline community, have agreed to honour the risks we faced as our part of the regulatory decision (ORC increases), effectively resulting in a significant increase in charges to the consumer of £8.90 per departing passenger for the full year of 2021, HAL should be expected to do the same.

3. The CAA's proposal to consider other actions

The CAA Notice granting the 2014 HAL licence (CAP 1151 Economic Regulation of Heathrow from April 2014: Notice Granting the licence) notes in Appendix I para A12 that the CAA would consider a request from HAL to reopen its price control "*in the light of its statutory duties under the circumstances prevailing at the time*". The Notice does not state that the CAA is obliged to reopen the price control in "exceptional circumstances". The CAA has considered HAL's request for a RAB adjustment and found in CAP 1966 and CAP 2098 that it is not justified in that it does not improve HAL's financing metrics (under the CAA's secondary duties).

In CAP 2098 para 15. the CAA states that the Q6 price control appears to give little weight to the circumstances created by the pandemic. However, in the Q6 price control HAL was paid a premium on the WACC for taking passenger volume risk and additionally benefitted from the downward 'shock factor' to passenger forecasts. We therefore do not agree with the CAA's statement that it is necessary or appropriate to reopen the price control on the basis of changes in volumes related to Covid-19.

4. The CAA's proposal for an assessment Framework

We note from the Civil Aviation Act of 2012 that the CAA's primary duties are: to protect the consumer (passengers and cargo users) and specifically the availability, continuity, cost and quality of the airport's operation. We also note that the CAA must carry out these functions in a manner that promotes competition in the provision of airport services. We also note that the CAA's secondary duties are only in support of these primary duties and include ensuring that HAL, or in this case, the notional company, is able to finance its provision of airport services and to promote economy and efficiency in HAL's provision of airport services.

It is also clear to us that in conducting its secondary duties of financability of the notional entitiy, that the CAA should pay equal attention to ensuring that the notional entity is operating in an economical and efficient manner. Through work we have fed into as part of the airline community response to the RBP, we feel HAL still have work to do to truly be at the 'efficient frontier' and this should be considered. This should be as equally important as ensuring that the notional company is financeable. We will review the CAA's assessment framework in the light of these duties.

Framework a) – Compensating HAL for the reduction in revenues via a RAB increase:
We agree with the CAA that framework a) presents too narrow an approach as it does not address the key issues of the notional entity's financeability, the impact on the consumer and ensuring HAL operates in an economical and efficient manner. We also note that HAL's approach as outlined below:

- Requesting a depreciation holiday in 2020 and 2021
- In combination with a RAB adjustment at the start of 2022 and a final adjustment at the end of 2022
- With no depreciation allowed on the RAB adjustment itself during H7

- With allowed returns to be made on the RAB adjustment to be included in the H7 maximum yield calculations
- Is complex, not transparent, is in breach of any regulatory precedent and certainly not proportionate. It also, does not take any account of the substantial cost savings HAL have made in 2020 and 2021

Framework b) – Assess a broad range of issues due to the pandemic and an appropriate package:
If the CAA is to intervene (and note, primarily we do not agree that it should) then this framework b) is better than Framework a) and would be our preference. It allows consideration of all issues that are or might be presented by Covid-19, to be assessed as part of an integrated review. However, we still maintain that the Q6 allocation of risk and reward, set ex-ante, captures all passenger volume risk to which Heathrow is exposed, and where Heathrow itself declares that it does not have any issues relating to liquidity or covenants – issues that themselves are inappropriate to consider as part of the economic regulation if the notional company is not affected.

Framework c) – No intervention, the Q6 allocation of risks covered the impact of Covid-19:
Our overall view is that there should be no intervention, as HAL have repeatedly demonstrated that they do not have any issues relating to liquidity or covenants, re-iterated several times in their most recent published accounts on the 24th February 2021. To intervene would increase costs to the consumer and reduce the incentive for HAL to ensure that it is operating in an efficient and economical manner – both in 2021 and forward into the H7 period. If the CAA do go ahead and intervene, and can demonstrate that it is both more efficient to do so, and therefore results in a better outcomes for consumers, then we would support Framework b) over Framework a) for the reasons stated above.

We note the summary of assessment framework and objectives (CAP 2098 - para 1.23, Fig2) and agree with the Primary and Secondary duties and objectives listed by the CAA. We do not agree that the CAA should discount the need to promote competition in the provision of airport services (as stated by the CAA in CAP 2098 para 1.19 and appendix J). This should be included in the assessment framework. If the CAA chose any of the 4 options stated, then there could be an impact on competition in that other airports simply do not have any similar facility to recover Covid-19 losses and a competitive market would be less likely to emerge if any intervention disrupted emerging competition.

5. The CAA's options for assessment

5.1 <u>Package 1 – No intervention before H7, but consider interventions at H7</u>

Of the 4 options proposed by the CAA this is the only option we could support. It is clearly appropriate to consider the impact of the pandemic on risk and also on the ability to reliably forecast passenger numbers over the H7 period. If volume risk is removed in H7, then we strongly feel that the agreed WACC must fall substantially to reflect that. It would be appropriate for the CAA to detail what the WACC would be with and without HAL bearing traffic risk.

5.2 <u>Package 2 – Targeted intervention now and consider further intervention at H7</u>

We do not support this option given both our earlier comments on adjusting the existing settlement, but that it is also clear from the assessments that there is no immediate issue to address that would require the CAA to act within 2021. HAL has shown it has strong liquidity and has repeatedly stated publicly that it is not at risk of breaching covenants. There is a 2021 Capital Plan in place, and it does not constrain HAL from reopening T4 if required. The SQRB measures performance demonstrated by HAL during 2020 and early 2021 have been good and largely to agreed standards. This illustrates that HAL can maintain service levels without the need for intervention by the CAA.

In addition to the above, even if we felt that a RAB adjustment in any form was a suitable intervention, which clearly we don't, from a timeline point of view, we see little value in making an adjustment now when the CAA's H7 Initial proposals (which would already consider this item "in-the-round") would be published only a few month after the CAA's decision on CAP 2098.

5.3 <u>Package 3 – Application of H7 traffic risk-sharing approach to 2020 - 2021</u>

We agree with the CAA that this is unworkable, complex and not transparent. In addition, we do not support this option for the same reasons we do not support Package 2 (see above). There is no need for the CAA to intervene retrospectively in 2020 and 2021, and this would be contrary to ex-ante incentives of the price cap.

5.4 <u>Package 4 – HAL's proposed risk-sharing arrangements for 2020 - 2021</u>

Again, we agree with the CAA that this is not a feasible option. We have been clear on our views throughout previous responses on this subject, these remain unchanged. We read with concern that HAL's recently published 2020 Financial Results would suggest they still maintain that their request is fully justified *"We have proposed a reasonable adjustment that allows the CAA to act now",* we wait with interest to learn if Heathrow continue to support Package 4 even though CAA's own analysis shows that this won't assist HAL's credit rating nor support any financing metrics.

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

Understandably, HAL proudly reference their positive performance to deliver service quality throughout the Covid-19 pandemic in their recent annual reports and accounts. We agree that they have performed very well in the circumstances in meeting the targets originally set for a world of more predictable operations.

To suggest that failure to grant their RAB application could jeopardise quality and future investment has so far not been demonstrated by the actions and financial presentations we have seen through the pandemic as part of our standard approach to governance of the airport. The SQRB model and any future OBR mechanism we introduce in H7 should help to ensure that any deterioration is arrested swiftly otherwise HAL risk 7% of charges being paid as a penalty which would be counter intuitive to their statement.

HAL have stated that without intervention on the RAB they will not be able to continue essential investment to maintain ongoing and efficient operations. HAL's own forecast for 2021 is for 37m passengers, a 54% reduction in traffic in 2021 versus 2019 levels. We fail to agree with HAL that a lack of investment for 1 year in the existing infrastructure which has been designed for 54% greater volumes than that forecast for that year will result in reduced service quality levels in 2021. In fact, we have requested specific detail of which pieces of key infrastructure require investment to maintain service levels in 2021 and have been assured that the current capital plan caters for essential maintenance investment.

Investment in Capital Expenditure should only be in the consumers interest and the RAB is increased for efficient investment only. We continue to support efficient capital expenditure that delivers demonstratable consumer outcomes (subject to the agreed governance processes).

Closing

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 / iH7 and the extent to which it has outperformed the regulatory settlement.

We would have preferred the CAA to agree that no intervention would be the most appropriate solution to this issue and in the best interests of consumer for the reasons outlined above. However, we recognise that the CAA feel compelled to make an element of intervention, the extent to which we await to see through the development of the H7 pricing settlement process. It is on that basis that Virgin Atlantic and Delta jointly agree to support Package 1 with the expectation that any formal intervention is proportionate based on a notional entity that is on the efficient frontier, sufficiently well financed through the tail of the pandemic effects and has interests of consumers, not investors, as a principal objective.

Yours sincerely,

Corneel Koster
Chief Customer and Operating Officer