virgin atlantic

Virgin Atlantic Airways response to the CAA's consultation Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP 1722)

Introduction

1. Virgin Atlantic Airways (VAA) welcomes the opportunity to respond to the CAA's consultation CAP1722, Economic regulation of capacity expansion at Heathrow: policy update and consultation, published in October 2018.

2. Our response follows the structure of the consultation document ending with a brief note on the additional consultation paper CAP1722b.

The overall timetable and the interim price control – Chapter 1

3. In our previous responses to CAP1610 and CAP1658, we acknowledged the difficulties associated with the alignment of the planning timetable with the regulatory timetable, and agreed that a pragmatic approach should prevail. However, we strongly opposed the continuation of the existing price path (RPI-1.5%) on the basis that consumers would be paying more than they should during the interim period, and HAL would be making further windfall gains from higher than forecast traffic and lower than forecast costs of debt. We argued that this cannot be consistent with the CAA's duties to consumers and continue to hold this view.

4. The CAA has now raised the possibility of a further extension to the interim price control should the timetable slip further and planning consent not be granted until 2022. Accepting that there are a number of factors that could lead to further delays, we are deeply concerned about the possibility of a further extension to the interim price control and the basis on which the CAA is considering approaching this.

5. We note that HAL 'hopes' any further changes to their revised timetable will be minor, however they have yet to offer sufficient evidence that would give us confidence that the timetable can withstand further slippage.

6. As a result of the delays that have already occurred to the schedule, the CAA suggests that HAL producing one high quality business plan, updated on a timely basis, would be sufficient to set its price control. In our view, given the importance of the decisions to be made, it would be more appropriate for the CAA to continue with its previous approach, expecting HAL to submit an initial and a final business plan.

7. We believe this approach would provide a more transparent and rigorous review process ensuring the opportunity for proper scrutiny and challenge of the business plans. It would be easier for HAL to have two simple deadlines, one for the initial business plan and one for the final business plan. This would avoid the possibility of disagreement between airlines and HAL as to what constitutes 'timely' and whether information made available in the updates was

appropriate. Overall it would reduce complexity and the risk of diminishing the role of constructive engagement.

8. If a third year of an interim arrangement were to be agreed, this would mean that nine years would have elapsed since the last full regulatory review, as Q6 was previously extended to December 2019. Given the changes that have occurred since that time, particularly in terms of higher forecast traffic and lower than forecast cost of debt, there is now an increasing risk that the interests of consumers are being seriously compromised.

9. The CAA suggests that the terms of a third year of an interim arrangement would reflect the broad approach set out in CAP1658 and could involve a greater range of assumptions that support the price control (i.e. the regulatory building blocks) being reviewed. Furthermore, the CAA suggests that there would be time to conduct a full reset of the WACC. However, the CAA does not say what this would mean for the price path. If the CAA were to seek to maintain the RPI-1.5% price path for a third year of the interim arrangement, we would be strongly opposed to that approach. It is also very difficult to see the benefit of reviewing a greater range of regulatory assumptions and resetting the WACC if the price path is to remain unchanged for yet another year.

10. The CAA has previously proposed that the benefits of any outperformance should be shared with airlines and consumers in the longer term through an adjustment to regulatory depreciation by an amount representing the difference between the price path set and the underlying revenue requirement. The only rationale for this approach was that it was "probably the simplest and most straightforward."[1] Whilst we understand that simplicity is generally to be preferred over complexity, the CAA's overriding duty is to the best interests of consumers, rather than what may be expedient in the regulatory process. We therefore opposed this approach in our response to CAP1658[2] on the basis that today's passengers would be paying more, so that passengers in the undetermined future might pay less. We note that HAL also opposed this approach in its response to CAP1658 arguing (inter alia) that a revenue adjustment would more immediately and effectively protect consumer interests.

11. We therefore urge the CAA to:

   – reconsider what would be in the best interests of consumers if further delays to the timetable were necessary;

   – clarify its thinking, should it consider a third year extension to the interim arrangement to be necessary, about which underlying regulatory assumptions should be reviewed, what process should be put in place for a full re-set of the WACC and, importantly, what this would mean for the price path in the third year of the interim arrangement;

   – reconsider dealing with outperformance through an adjustment to regulatory depreciation over the longer term and examine the benefits to consumers of a more immediate revenue adjustment.

[1] CAP1658, para 5.29
[2] HAL's response to CAP1658, para 101, July 2018

12. The CAA notes that if a commercial deal were to be struck between HAL and the airlines, and if the CAA found such a deal to be in the best interest of consumers, an interim review would not be necessary. We agree however we are disappointed to have had to reach this point. The CAA's proposal for the interim period, making returns via depreciation over a long period, was not acceptable to airlines or HAL, and as a result we have been forced to negotiate with HAL. The CAA has found that HAL holds Substantial Market Power (SMP) and this places airlines at a significant disadvantage in any commercial negotiations. While we believe this negotiation may well result in a deal better than the CAA offered, it will not offer the benefits that a stronger price control review would have done.

13. In our view the emergence of a commercial deal is a direct result of the CAA's failure to carry out its primary duty to consumers effectively for the interim period. We do not believe it is appropriate for any deal to be viewed as a precedent for any reduction in the economic regulation of HAL. An expanded Heathrow will have even more market power and the regulatory requirement is only likely to increase as it expands. As such the approach taken to economic regulation at Gatwick airport is simply not appropriate for HAL, now or in the foreseeable future.

14. The CAA has said that it would need to test whether any commercial deal properly reflects the interests of a range of airlines operating at Heathrow and is ultimately in the interests of consumers. We agree that the CAA should undertake such a test and that it be rigorously applied. We are keen to understand in more detail; the tests the CAA will carry out, how the CAA will assure consumers interests, and how long such a test and associated consultation would take.

Promoting economy and efficiency – Chapter 2

15. We support the CAA's development of further, appropriate licence obligations for HAL which would promote efficiency and further the interests of consumers by not exposing them to inefficient costs. We do not believe that a licence condition need create additional unnecessary regulatory burden.

16. We agree with the CAA that while any commercial pressure that airlines apply to HAL does have some impact on HAL's behaviour, this is not a substitute for a licence condition to protect consumers directly. It is important to acknowledge that airlines have limited resource and whilst we have a role to play in challenging HAL be more efficient, we believe the CAA should have all the powers it needs to monitor HAL's behaviour and address any issues that may arise.

17. We do not consider HAL to be operating as efficiently as it could be and as such view the introduction of licence condition in addition to the full price control incentives as a positive step by the CAA. As with other regulatory tools, they are useful only if they are used effectively and the CAA is prepared to enforce them.

18. We are keen to understand how the CAA will define ‘efficient’ in the context of HAL’s business operations and how they will ensure that efficient spend is also spend that furthers the interests of consumers and effectively satisfies their needs.

19. As well as adding a condition to HAL’s licence we would also urge the CAA to engage more actively in the expansion programme at Heathrow to ensure that HAL delivers an operationally efficient expanded airport at an affordable cost, and ensuring the consumer is adequately protected from inefficient project costs. Given that the CAA has created by its own admission, a period where regulatory incentives on HAL are relatively weak, due to the continued extension to the price control period, we would agree that introducing the condition by the end of 2019 seems sensible.

Alternative delivery arrangements - Chapter 3

20. In our responses to previous consultations we have noted our support for the consideration of alternative delivery arrangements or proposals that encourage competition in the design, build and operation of an expanded Heathrow.

21. On the subject of the BuildCo idea, similar to that of the Thames Tideway approach, we agree with the position stated in the LHR AOC response to CAP1722 that the CAA is best placed to drive further development of this work. We support the invitation from the AOC to the CAA to discuss the idea and work with the airline community to explore the merits of this approach.

22. We do not believe that the Innovation Partner’s scheme set up by HAL meets the CAA’s aim for ‘HAL to exploit competitive forces to a greater extent’. We agree to an extent with the CAA’s view that the scheme is not without merit, however it simply does not meet the original requirements and we would urge the CAA to address this with HAL. We see no reason why the Innovation Partners scheme in its current form cannot continue to run as a means for HAL to improve their procurement processes, but the CAA still needs to address the introduction of competition and alternative providers.

23. We agree it is important to develop a regulatory framework that facilitates and supports alternative delivery arrangements and as such we expect the CAA to resource itself accordingly to complete the work (whether a credible alternative emerges or not). The CAA should ensure that the viability of HAL’s scheme is assessed and where alternative providers do come forward their plans should be benchmarked against HAL’s to ensure the best outcome for consumers.

Surface access - Chapter 4

24. We acknowledge the updates made to the CAA’s surface access policy and continue to support the CAA’s view on the ‘user pays’ principle, namely that consumers’ interests are unlikely to be furthered by airport operators bearing the costs of projects beyond those which are strictly necessary to enhance the efficient operation of the airport and/or necessary to secure planning permission for expansion.

25. We reiterate our position that, in broad terms, the ‘user pays’ principle should apply, although we do not agree that airlines should bear residual costs of surface access schemes that provide wider benefits to the travelling public unconnected with the use of the airport.

CAP1722b - Capacity expansion and scarcity rents

26. We note the debate between the AOC, CAA and HAL on the existence of scarcity rents at Heathrow. As a carrier that operates all of its LHR services on competed routes, we reject the notion that VAA is able to attain scarcity rent. However, we accept carriers who operate on un-competed direct routes may be able to do so.