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Virgin Atlantic Airways response to the CAA's consultation
Economic regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion (CAP1871)

Introduction

1. Virgin Atlantic Airways welcomes the opportunity to respond to the CAA's consultation CAP1871, Economic regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion (CAP1871), published in December 2019.

In summary

2. This response was written prior to the announcement of the Court of Appeal judgement related to Heathrow expansion. We are submitting this response in accordance with the deadline set by the CAA. We will be considering how the judgement and its implications may affect our positions.

3. We support the CAA's preference for Scenario 2a. Heathrow has been capacity constrained for more than a decade and consumers are paying the price. Scenario 2a is the best option to deliver additional capacity and benefits to consumers through increased airline competition.

4. We agree with the CAA's proposal to align the polices for Category B and C costs and welcome the removal of risk sharing for Category B costs above £265m. We welcome the requirement for improved governance and scrutiny of both Category B and Category C costs but continue to urge the CAA to take a more proactive approach in ensuring the necessary processes and measures are in place.

5. We disagree with the CAA's proposal to use a 4.83% Interest During Construction (IDC) for Category B and early Category C costs in the period 2020-2021. At this level the IDC is out of line with recent evidence and regulatory precedent and will result in excess returns.

Analysis of scenarios – Chapter 1

6. Following the rapid and significant escalation in early Category C cost estimates from £650m in April 2018 to £2.4bn[1] in July 2019 (in 2014 prices) the CAA charged HAL, in consultation with airlines, with identifying a series of scenarios for these costs to enable consideration of the best option for consumers.

7. The four scenarios identified by HAL, as set out in CAP1871, were:

[1] CAP 1819 Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable

- Scenario 1 - corresponded to HAL's projections at the time that the expansion programme exited the “M4” project gateway, including an estimate of £2.4 billion (in 2014 prices) for early Category C costs and a relatively early target date for runway opening date of the end of 2026;

- Scenario 2 - would involve deferring HAL’s target for runway opening by around a year, enabling lower levels of early Category C costs;

- Scenario 3 - reflected HAL’s estimate of the minimum amount of early Category C spending that would be necessary to deliver a successful application for development consent to permit expansion; and

- Scenario 4 - based on HAL immediately halting all activities (including halting preparation of its DCO application).

8. Following consultation with airlines, two variant scenarios were identified:

   - Scenario 2a – is an "optimised" version of Scenario 2, in which cost forecasts were brought in line with the IFS’ estimates and some changes made to the underlying activities. This retained the timescales set out within Scenario 2;

   - Scenario 3a - in which the forecasts of additional early Category C costs and total scheme costs have been adjusted to be consistent with runway opening by 2030, in line with the NPS deadline.

9. Given that the IFS has identified that Scenario 1 is now unachievable, we see no merit in any further consideration of this scenario. We agree with the CAA’s position that Scenario 2a is likely to give the best outcomes for consumers.

10. In our view, Scenario 2a best balances the benefits of enhanced airline competition and choice to consumers that expansion may enable, against the potential for consumers to be exposed to sunk costs in the event of a failed DCO and delays introducing inefficiency into the construction programme and increased overall costs. The Government via the Airports National Policy Statement (ANPS), the CAA and most interested parties have identified that Heathrow is currently significantly constrained, and that additional capacity has been required for more than a decade to enable the airline market at the airport to function better in the interests of consumers. Consumers are currently paying the price for the failure to deliver the required capacity before now, through a lack of airline competition and an excessive number of monopoly routes leading to higher ticket prices. In this context, a delay beyond the first realistic potential opening date would be harmful to consumers.

11. Scenario 3a results in a substantial further delay to the opening date for Runway 3, during which time consumers will continue to suffer from the lack of competition in the airline market at Heathrow. Assuming that Scenario 3a delays opening by another nine months,

this would result in total lost consumer surplus of between £1.6 and £4.4 billion based on the CAA's estimates of annual losses. It also results in additional Category C costs of around £0.8 billion in total from the introduction of inefficiency into the construction programme. This gives a total potential cost of delay of between £2.4 billion and £5.2 billion. This is clearly substantially worse than Scenario 2a.

12. The ANPS puts a deadline on policy support for the delivery of a new runway in the South East of 2030. It is unclear what the consequences would be of a failure to deliver against that timeframe. While all the variant scenarios push delivery substantially closer to 2030, particularly when the risk adjusted timelines are considered, the schedule risk allowance for Scenario 3a takes the opening date for Runway 3 into 2030. In the context of meeting the deadline set within the ANPS and ensuring continuity of policy support for Runway 3, this makes Scenario 3a higher risk. Any further delay during construction would potentially take the opening date beyond 2030. Given the scale and complexity of the construction project, the prospect of further delays is far from impossible and consequently 'accepting' a delay of the magnitude set out in Scenario 3a at this early stage would be foolish and, in our view, would represent an unacceptable risk to overall delivery.

13. The risk of sunk costs impacting on consumers is ultimately linked to whether the DCO is secured or not. If the DCO is secured the point is moot. Therefore, consideration of the potential risk of sunk costs must be intrinsically linked to an assessment of the risk of a failed DCO. If the risk of failure were significant, then consideration of the additional risks around scenarios with higher levels of early Category C costs would be appropriate. Quantitatively assessing the risk of a failed DCO is not possible, as the CAA has rightly noted. We note the CAA's analysis of breakeven probabilities and particularly its findings in relation to Scenario 3a. The CAA describes that Scenario 3a "would only be consistent with the interests of consumers if the probability of a successful DCO application were very low".

14. Given the available evidence, we do not believe that the risk of failure is very high given the policy support within the ANPS. This policy support essentially means that the 'need' case for the third runway is already proven, which is normally one of the largest hurdles for any planning application, and the basic parameters of the scheme are accepted. A successful application is, therefore primarily a matter of successful mitigation of known environmental issues. Some these are clearly challenging but the task is known and defined.

15. It is within this context that the potential for sunk costs around any of the scenarios should be viewed. All the scenarios involve a significant degree of potential sunk cost. However, the difference between Scenario 2a and Scenario 3a in the context of the overall project is relatively small (£0.6 billion). Given our assessment that DCO failure is not very high, we believe the risk of higher sunk costs is outweighed by the potential consumer benefits.

Regulatory treatment of HAL's early costs – Chapter 2

Category B costs: policy decision

16. As noted in our previous submission[2], we agree that there should be no change to the treatment of the original £265 million in Category B costs. Any retrospective change to the regulatory framework in relation to these costs would increase uncertainty and likely adversely impact future financing costs and ultimately affordability.

Scrutiny and reporting of Category B costs above £265m

17. In various responses to the CAA about Category B costs[3] we have repeatedly highlighted our concerns with HAL's management and reporting of these costs to date. The level of scrutiny and reporting requirements proposed by the CAA's policy is a step forward however HAL needs to do more. For the remaining Category B costs HAL must put appropriate monitoring, management and reporting in place by the end of March 2020. In our view this is straightforward; from M5 entry Category B costs should be treated as a project to be delivered by DCO submission that should have project management principles and governance applied to it. This should include the provision of a detailed execution plan against which activity can be monitored and managed, and the application of performance reporting and cost management principles thereafter. We believe this approach would go a long way to addressing the long-standing and extremely concerning issues surrounding Category B cost reporting and would address the IFS' consistent recommendations over the last several years.

18. We note HAL's comment in relation to the same arrangements for Category B costs that six-monthly reporting should be sufficient. We strongly disagree given HAL's track record in monitoring and controlling these costs. Airlines must have sufficient and timely information to enable them to scrutinise and consider expenditure effectively if the governance process is to be effective. The unchecked growth in costs seen to date must not continue.

19. We also note the CAA's comment in relation to its expectation on HAL to provide high quality information in response to both regulatory reporting requirements and as part of the airport-airline engagement process. High quality information is central to the effectiveness of the proposed governance arrangements. We encourage the CAA to monitor the quality of what is being provided by HAL alongside airlines and not simply rely on airlines to raise issues, not least because of the potential impact on timescales and the consequent cost to consumers from a multistage process.

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[2] Virgin Atlantic Airways response to the CAA's consultation Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable (CAP1819)

[3] Virgin Atlantic Airways response to the CAA's consultations CAP1819 and CAP1752 (Independent Planning Costs Review on costs relating to the Heathrow Expansion Programme covering the period 2016 and 2017)

Recovery Cap for Category B costs

20. In our response to CAP1819 we agreed that establishing a recovery cap is desirable as it would act as a strong incentive on HAL to improve the efficiency of its Category B spend. We recognised the challenge of establishing the level of such a cap and suggested the CAA seek more evidence in order to establish a ‘hard’ cap.

21. The CAA’s policy proposes a cap of £500m that may be adjusted. Given Category B costs have already almost doubled, we think the time has come to insist on rigid cost discipline in relation to Category B cost spend. The CAA’s policy should ensure that HAL manage its costs efficiently within an increased ‘hard’ cap of £500m.

Regulatory treatment of Category B costs

22. We agree with the CAA that HAL should not receive Interest During Construction (IDC) for costs above the recovery cap. We disagree with the CAA’s view that Category B costs and early Category C costs receive a return of 4.83%, for the period 2020 to the start of H7 in 2022, and we address this issue in more detail later in this response.

Early Category C costs: policy proposal

*S*crutiny and reporting of Early Category C costs

23. We agree with the CAA that a programme of early Category C costs is in the interests of consumers provided they are strictly necessary expenditure, efficiently incurred and essential to facilitating the timely delivery of the expansion programme. We are supportive of the regulatory framework for Category C costs proposed by the CAA which is very closely aligned with that for Category B costs. By keeping a broadly consistent, measured approach, the CAA maintains regulatory certainty and reduces perverse incentives on HAL to seek to ‘game’ the regulatory framework to its advantage.

24. Clearly, if HAL were not to secure a DCO then some costs would be ‘sunk’ and unrecoverable and this would result in higher charges to consumers over the longer term without any benefit from expansion. However, in our view this risk is outweighed by the potential benefits to consumers from enhanced airline competition with the earliest feasible runway opening. In response to these risks appropriate governance and scrutiny arrangements must ensure consideration, at the earliest possible stage, of how to mitigate the risks of a failed DCO by defining which costs might be recovered, to what extent, how and over what timeframe. This will enable the extent of risk to be better understood and sharpen incentives in terms of whether spend is genuinely necessary.

25. We note the CAA’s comments in relation to its role in scrutinising early Category C costs. While we fully support the need for ex-post review, action to ensure that HAL’s expenditure is efficient in the first place should remain a priority. We welcome the CAA’s intention to

appoint experts in a range of key areas to assist in ensuring the efficiency of expenditure. Airlines do not have expertise in many of the areas of construction and will be reliant on the experts appointed by the CAA. It is important that the roles and responsibilities of these experts are properly understood by all stakeholders and that there is a strong focus on understanding the necessity of costs as well as their reasonableness. As such, we would encourage the CAA to consult on the intended scope of activity for expert roles. We look forward to the CAA's further proposals in this area.

26. We are pleased that the CAA has set out guidance on quarterly and six-monthly reporting content and standards for early Category C costs, however HAL must put appropriate management and reporting in place urgently in order to demonstrate the timeliness, relevance and efficiency of their planned and actual costs. Again, we believe this can be addressed relatively simply by taking a portfolio and project management approach to early Category C costs and by re-baselining and providing a detailed schedule to create a plan of current stage activity against which progress can be monitored and measured.

Defining a Recovery Cap for Early Category C Costs

27. We welcome the CAA's intention to confirm the level of the recovery cap for early Category C costs following independent assessment and support the principle of a defined cap. The definition of this cap is essential in incentivising HAL to act efficiently.

28. We note the CAA's position in relation to adjusting the cap if required. We accept that precisely defining a cap for early Category C costs is difficult and that ultimately changed circumstances may result in the identification of legitimate additional costs. However, we would expect HAL to be required to demonstrate, to airlines and the CAA, the benefits to consumers and the efficiency of any such additional costs. Airlines should have ex-ante oversight rather than being presented with a fait accompli. This process is essential in ensuring that Category C costs are efficiently incurred and necessary to ensure that airlines can make appropriate judgements about the affordability of the project as a whole.

Risk Sharing

29. In relation to the risk sharing arrangements for early Category C costs, we continue to support the CAA's position. Unlike Category B costs, Category C costs will not influence the outcome of the DCO application. The extent to which the risks around them are within HAL's control is significantly more limited. It is therefore inappropriate to either reward HAL in relation to early Category C costs if the DCO is successful or penalise it for failure. However, we continue to be of the view that in the event of failure to secure the DCO, it would be appropriate for the recovery period for early Category C costs to be significantly extended to minimise the impact on individual users.

30. There is an additional consideration that has come to the fore given HAL's recent comments during the early stages of H7 Constructive Engagement. HAL has repeatedly

said that if key elements of the final regulatory framework and price decision are not acceptable to their investors, then it will not move forward with Runway 3 regardless of whether the DCO is secured or not. In our view, consumers should be protected from the risk associated with what would be a unilateral withdrawal from the process. In these circumstances, HAL should not be able to recover its early Category C costs and liability for these should lie with HAL's shareholders.

Interest During Construction

31. We support the principal of IDC varying dependent on the outcome of the DCO and we believe the policy proposals offer a good alternative to risk sharing, helping to limit consumers' exposure to the sunk costs associated with a failed DCO, without penalising HAL unfairly. HAL will still be able to recover the costs over time and earn some return to reflect the risk they have taken, but, as would be the case for an entity in a competitive market, they will not be able to realise the returns that would have come with a successful DCO.

32. Similarly, only allowing a full rate of return on early Category C costs up to the identified cap provides a strong incentive on HAL to manage Category C costs effectively and efficiently. It also potentially removes any incentive to try to bring forward post-DCO costs that are not genuinely required for timely delivery, thereby limiting consumers' exposure to the risk of sunk costs as far as possible.

33. That said, we disagree with the CAA's view on the level of IDC to be applied to early Category C (and Category B) cost. It is unacceptable to use a cost of capital of 4.83% to reward HAL for both;

    - early Category C costs from 2020 up to the recovery cap, upon successful DCO application
    - Category B costs from 2020 up to the £500m cap, upon successful DCO application

34. We note that the CAA believes the estimate of 4.83% provides more regulatory certainty than the alternative of applying PwC's estimated return for H7 and that the CAA's estimated IDC is a better reflection for HAL's current cost of capital. We disagree with the CAA's position on both issues.

35. Regulatory certainty relies in part on adopting a consistent and reasoned approach to regulatory issues. The CAA's update to the cost of capital in 2018 (CAP1658) was partial and selective, updating the cost of new debt and tax rates. Whereas the PwC report commissioned by the CAA (2019) provides a detailed and robust evidence base on HAL's current cost of capital. It sets out clear evidence that equity returns, and debt interest rates have been dropping over time. Failing to update all elements of the IDC based on the

evidence available would undermine regulatory certainty, as any decision then becomes arbitrary.

36. There are other considerations;

    - The cost of embedded debt has been overlooked. HAL has undertaken a significant amount of refinancing activity during Q6, which has reduced the actual cost of embedded debt over time. We believe this also needs to be updated considering the cost of embedded debt still makes up the majority of the weighted cost of debt;

    - Looking at the cost of equity, the Asset Beta has been fixed at 0.5 and left unchanged since the Q5 decision (see 6.44, CAP1155). The airport is now experiencing capacity constraints on a much greater scale and we believe that this drop in HAL's business risk should be reflected in a lower asset beta.

37. The drop in the cost of equity is due to the reduction in the risk-free rate (a trend observed not just in the UK but also in peer European countries), HAL's business risks (Beta) and equity market returns. As we noted in our response to CAP1610, the demand for UK equities has dropped on a long-term basis (see para. 55 CAP1610). The evidence presented there clearly shows the drop in allocation of UK equities by UK pension schemes and life insurance companies, whilst demand for alternative assets and fixed income securities slowly rising.

38. In our view the evidence that the cost of equity has fallen is overwhelming. This needs to be reflected in a lower IDC. Now is the most appropriate time to implement these adjustments.

39. Although the CAA has tried to clearly distinguish between the H7 Cost of Capital (WACC) estimate and the IDC as two different measures for allowed returns they are in effect fulfilling the same function, providing a return on capital. The level of IDC set for the period 2020/21 is important as it will have an impact on the H7 WACC. Given the level of importance it should be set appropriately reflecting the latest CAA evidence and current market conditions. An IDC of 4.83% will enable HAL to earn excess returns and a lower cost of capital, closer to the PwC's revised recommended range is more appropriate.

40. In addition, we do not believe that an IDC of 4.83% is required in the immediate term to support the financeability of early Category C costs. Early Category C costs account for approximately 4% of HAL's current estimated budget, and therefore are unlikely to put significant financial strain on HAL in the immediate term. There is, therefore, no need to inflate allowed returns to support financeability and overcompensate HAL. As a general principle, allowed rates of return should only be adjusted upwards to support financeability when there is clear evidence of financial stress and when HAL is deemed to be acting efficiently.

41. Outside the UK, predominantly in Europe, there have been several recent regulatory determinations on the appropriate cost of capital for key comparable airports such as Dublin, Zurich and Schiphol airports. We have summarised these decisions below:

Dublin Airport 2019 Determination (2020-2024)

- The Commission for Aviation Regulation (CAR) in Ireland, have set a point estimate business as usual cost of capital of 3.72% with a 0.5% uplift dedicated towards the Airport's Capital Investment Programme (CIP), to yield a final WACC of 4.22%. The drop in both, the cost of equity and the cost of debt have been acknowledged by the CAR in this respect and have been updated accordingly. The negative risk-free rate, combined with a lower and more recent risk perception of the Airport have contributed to a point estimate cost of equity of 6%, which is considerably lower than HAL's Q6 cost of equity of 8.58% (CAP1155). Given HAL's inherently lower risk, we would expect its WACC to be lower.

Zurich Airport

- We note from an S&P Report (July 2019) that the Swiss Regulator, Federal Office of Civil Aviation (FOCA), has assessed a cost of capital ranging between 3.5%-4% for Zurich Airport. This is a significant drop from the previous 5.8%. Again, we would expect HAL's cost of capital to be significantly lower given the relative risk of the two airports.

Amsterdam Schiphol (2019-2021)

- The 2017 Aviation Act governing Schiphol's Airport Charges set the regulatory period for 3 years starting from 2019 instead of 1-year, with the first 3-year period of 2019-2021 to sustain a WACC of 2.71% (post tax).

Implementation - Chapter 3

Licence condition

42. We see merit in holding HAL more specifically to account through the introduction of a licence condition. We note that the draft potential licence condition, as set out in Appendix F of CAP1871, makes specific reference to opening the runway no later than 2029 and incurring no more than £1.6 billion (in 2018 prices) of construction costs prior to obtaining the DCO. We would welcome these requirements being made specific through a licence condition.

43. However, we are also conscious that the introduction of a licence condition could potentially introduce a delay to the process, given that consultation is required, and representations can be made by interested parties, all of which could be time-consuming. We would therefore like to see the introduction of any new licence condition expedited as far as is

possible. We would also urge the CAA to clarify what penalties it might be able to impose if the licence condition was not adhered to, how the amount of penalty would be determined, and how the money would be returned to users.

44. It is also important to note that the 2012 Act requires the CAA to be sure that the potential benefits of regulation by licence condition are likely to outweigh the potential associated costs and/or delays. The value of imposing this licence condition could be outweighed in its effectiveness if the time it might take to consult on and implement, with a potential appeal by HAL, becomes excessive or leads to the licence condition being 'watered down'. We therefore urge the CAA to take a 'fast track' approach to the introduction of any new licence condition and to ensure that it is robust and will be effective.