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## **Setting of future prices controls – review of approach CAP2618**

### **1 Introduction**

- 1.1.1 Thank you for the opportunity to provide comments on the " Setting of future prices controls – review of approach CAP2618" (the "Response").
- 1.1.2 The consultation conducted by the Civil Aviation Authority (the "CAA") is predominantly a review of its approach to the H7 and NR23 processes and the associated building blocks. The Response is made by Virgin Atlantic Airways ("VAA") and its joint venture partner, Delta Air Lines ("Delta").
- 1.1.3 To assist the CAA in its efficient review of the consultation responses, this submission constitutes the joint response of VAA and Delta to the consultation. While reference is made to 'VAA' throughout, Delta fully endorses the views expressed in the submission (save to the extent that this submission contains material which is confidential to VAA).
- 1.1.4 In order to assist the CAA as far as possible, VAA has provided in this response some information which is confidential, particularly in relation to section 6 of this response (Broader Strategic Issues – CAP2618 Chapter 3). VAA therefore considers that an unredacted version of this response should not be disclosed publicly on the CAA website or in the event of any request made under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004, or otherwise. In the event that the CAA does receive such a disclosure request, VAA would expect to be informed in good time before any decision is made on disclosure and to be provided with an opportunity to make representations.
- 1.1.5 In the following sections, VAA provides an executive summary of the matters set out in the remainder of this response, followed by a more detailed consideration of the individual questions in the CAA's consultation.
- 1.1.6 We agree with the CAA's assessments of the current market power of both HAL and NERL and that economic regulation and associated licenses are

required to protect wider stakeholders from potential abuse of their respective dominant positions.

## **2 Executive Summary**

2.1.1 Despite the lowering of charges during H7, Heathrow Airport (HAL) remains the most expensive airport in the world. As the organisation responsible for the economic regulation of HAL, we expect the CAA to do more to protect consumers in the shorter-term, for H8 and more materially in the longer-term.

### **2.2 Timetable and Resource**

2.2.1 The CAA must ensure that it is scaled appropriately to run concurrent H8 and NR28 price control processes. It must establish sufficient expertise such that is capable of achieving the best outcome for consumers in a timely fashion.

2.2.2 The CAA must learn from the H7 process in that it is obliged to create a timetable that is achievable, detailed, and definitive. Milestones need to be embedded within the timetable citing specific target dates to ensure both H8 and NR28 processes stay on schedule.

### **2.3 Constructive engagement**

2.3.1 'Constructive engagement' typically means both parties are actively involved, and are able to jointly input tangibly towards an outcome. During both H7 and NR23 this wasn't the case; it was an opportunity for HAL and NERL to present their business plans in a very one directional sense. Neither process encouraged airlines to provide feedback or to constructively enhance the proposals.

2.3.2 The CAA must address the issue for H8 and NR28 by ensuring it deals with the asymmetry of information and compels HAL and NERL to provide detailed information about their business plans in a timely fashion. The CAA also needs to facilitate a process via which airline input can be incorporated into the plans.

### **2.4 Forecast models & consumer research**

2.4.1 We encourage the CAA to take a different path in the formulation of forecast models for H8. We would expect the CAA to already be in dialogue with independent organisations that are capable of building robust forecasting models to be quantifying the scale of the task, the time and cost required in advance of the draft method statement publication later in the year so that we can review the options accordingly. The independent forecasts should include expected passenger volumes, operational expenditure, and commercial revenues.

2.4.2 In our opinion, as the consumer advocate in the regulation of HAL and NERL, it should be the CAA that has ultimate control of understanding the wants and needs of consumers ahead of future price controls. As a fundamental part of ensuring the airport and ANSP meet the needs of consumers, it is essential that the research carried out to understand their views is independently sought and assessed.

## **2.5 Governance around price controls & indexation**

2.5.1 Heathrow is independently recognised as the most expensive airport in the world by a significant margin and it is HAL's RAB that is spiralling out of control at its heart. While benefitting HAL and its shareholders, it is penalising consumers. At the very least, the CAA must amend the indexation of the RAB in line with modern process, such as CPI over RPI.

2.5.2 Fundamentally, we encourage the CAA to look long term, outside of the 5-year cycle, specifically as to how HAL is regulated; whether it can amend, change, or even break-up the RAB to allow for an alternative model to prevail at London's main hub airport. This is a material piece of work demanding serious consideration of alternative models seen at other airports around the world, or potentially something more groundbreaking.

## **2.6 Charges and conditions of use**

2.6.1 It is our view that HAL repeatedly takes advantage of its dominant market position each year when it sets the future airport charges and reviews the conditions of use. HAL continue to disregard the ICAO policies on cost-relatedness with impunity and seem to be able to continually layer on increasingly stringent one-sided terms on airlines whilst protecting itself from any liability without challenge from the regulator.

2.6.2 We urge the CAA to take a more pro-active approach to both the real airport charges that consumers and airlines are expected to pay within the MAY and the highly unbalanced CoU that wouldn't be acceptable in an ordinary commercial relationship. We propose that the CAA brings both of these aspects of HAL's tactical manipulation of their license under greater scrutiny of the CAA and that they essentially become a further building block within the regulatory framework of H8 and beyond.

## **3 The process of setting price controls**

### **3.1 Are there particular outcomes or objectives the CAA should focus on as part of the upcoming HAL and NERL price controls?**

3.1.1 With regards to the process itself, it is our view that the CAA should focus on ensuring that its own practices are efficient, that it sets out a clear timetable and that it commits to delivering to it.

- 3.1.2 More broadly, the natural outcome for the CAA must be to create regulatory framework that most accurately represents a competitive landscape. HAL and NERL must be compelled to operate in a manner that ignores their market dominance, encourages them to focus on the outcomes for their customers at an affordable price for the quality of the service received.
- 3.1.3 We expect the CAA to address the overall level of charges of the most expensive airport in the world by conducting a root and branch review of the most significant driver of cost, the RAB, and how it can be brought under control.
- 3.1.4 We'd like to see the CAA ensure there is genuine 'optioneering' in both HAL's and NERL's plans that demonstrate the pros and cons of key aspects of their business plan.
- 3.1.5 Finally, we expect the CAA to demand a comprehensive, joined up approach to capacity development, maintenance and resilience, operational performance & sustainability initiatives relative to overall costs, both in terms of capital and operating costs.
- 3.1.6 In respect of NR28, the CAA need to embrace a more proactive approach to monitoring of the evolution of costs versus NERL's business plan. We would emphasise that this not only applies to capex, but also opex elements such as staffing plans, training, and service quality.
- 3.1.7 In simple terms, NERL should be regulated in a much more dynamic way and, as such, more in-line with how commercial businesses are required to operate.

**3.2 Are there areas of the H8 and NR28 frameworks that should be simplified or where the current approach is not transparent or proportionate?**

- 3.2.1 A regular theme throughout this consultation response from VAA is the issue of asymmetry of information, particularly between HAL and airlines and to a certain extent, between HAL and the CAA. This lack of transparency of information leads to a high degree of inefficiency in the process such as duplication of resources, inaccurate assumptions being made and reworked responses.
- 3.2.2 The CAA must ensure critical information is provided by HAL to the CAA and airlines in a timely fashion and to the requisite level of detail to enable transparent scrutiny. Without this, the H8 process will repeat failings recognised throughout the H7 price review.
- 3.2.3 Although for NR28 VAA advocate simplification of the regulatory framework as a general concept, it considers that fair and proportionate re-calibration of all mechanisms, is of equal priority for NR28. The issue of asymmetry must be addressed as a priority, as well as the 'stripping out' of compounding Covid-19

specific mechanisms designed to protect NERL from post-pandemic uncertainty.

**3.3 Do you have suggestions on how to improve constructive engagement for H8 and NR28? Do you have suggestions for how the regulated entities and airline customers could best work together and engage effectively in future reviews?**

- 3.3.1 The 'rules of engagement' for H8 and NR28 need to be better understood by all parties ahead the activity. 'Engagement' typically means both parties are actively involved, however, during the H7 constructive engagement process, this wasn't really the case, it was an opportunity for HAL to present aspects of their business plan in a very one directional sense.
- 3.3.2 It didn't feel like a process where airlines were being encouraged to provide feedback, constructively enhance the proposals, or have views taken into account in any way. A primary example of this was the request by airlines for HAL to share their passenger forecasting model. This was also the case for N23, the presentation of the business case effectively being a 'show and tell' exercise.
- 3.3.3 The CAA must provide greater clarity as to how both HAL and NERL enable the process to be more discursive in nature to allow airlines to feed into the business planning processes constructively.
- 3.3.4 With a greater level of information sharing by HAL in advance of constructive engagement and throughout the H8 process, the airline community can be equipped with the tools to be able to be more effective. With information asymmetry to the extent experienced in H7, airlines will continue to be more of a passenger in a passive sense rather than an active, and ideally, pro-active stakeholder.
- 3.3.5 In terms of the content of the constructive engagement sessions, we expect the business plans to synchronise with a clear narrative aligned to the needs of consumers and airlines in the medium to longer-term – the objectives. HAL should be able to present and offer alternative options for consideration that meet the objectives so that when choices are made, preferably collaboratively with airlines, we understand the pros and cons of the varying options available.

**3.4 Do you have views on the timetables for H8 and NR28, including the advantages and disadvantages of completing the NR28 review between 2027 and 2028?**

- 3.4.1 At Virgin Atlantic we are comfortable with the current timetables being outlined by the CAA. We would advocate an earlier start to the H8 process to minimise to potential for delays that may occur throughout the process.

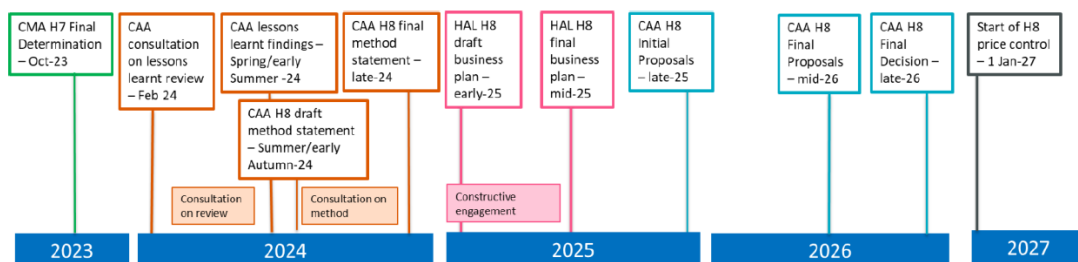
3.4.2 We understand the issue that the CAA have outlined with the parallel running of the H8 and NR28 price reviews simultaneously for a period. The root cause of this issue is the size and scale of the economic regulation function at the CAA and its ability to flex while maintaining an element of consistency in output. On behalf of consumers, it is our expectation that the CAA must be capable of running concurrent processes for both entities that it regulates in order to ensure the consumer achieves the best outcome in a timely fashion.

#### 4 Governance around price controls

##### 4.1 **Do you have any views on governance and whether there are examples that the CAA should consider in terms of best practice in making decisions on price controls or similar issues?**

4.1.1 From this consultation, CAP 2618, it is clear to us that the CAA is continuing to be purposefully vague about its timetable for H8 as it was for H7. One lesson we believe the CAA must learn from the H7 process is that it must create a timetable that is achievable, publish it and stick to it. Figure 2, shown below, taken from the CAP 2618 documentation is clearly indicative but we believe that even at this early stage of the H8 planning process, there should be a definitive timetable published by the CAA of which all parties are aware. Statements such as 'spring/early summer' and 'summer/early autumn' are blocks of time covering 4 months or more and are simply too vague allowing complacency to be established and for the later period of the windows outlined quickly to become the reality because we haven't set the timetable up with specific target dates to aim at.

4.1.2 Figure 2 – Indicative timetable for H8 price control review



Source: CAA

4.1.3 The definitive timetable must set at the earliest opportunity factoring in key decision milestones, such as CAA Board meeting dates, to ensure the process is as efficient and effective as possible.

4.1.4 We don't anticipate a backdrop of a global pandemic or similar destabilising event to impact H8 or NR28 in the same manner H7 and NR23 were impacted, therefore, we see little excuse for the programmes to run later than they

should. We expect the CAA to have already begun resourcing the Economic Regulation teams to the standard expected to run concurrent price reviews. It was certainly apparent, particularly in the H7 price review, that the CAA failed to have adequate technical resources trained to the standard required to be able to discharge its duties comprehensively. We hope and expect the CAA is working to ensure the same issues aren't repeated for the forthcoming processes.

- 4.1.5 We're encouraged by the CAA's own assessment that the current governance and approvals processes are no longer fit for purpose and that changes are required. We can see how the proposal of some kind of Board sub-committee could help 'robust decision making and senior level interactions with stakeholders'<sup>1</sup> and we would actively support that approach. However, for this to be a success, the Board members or external advisers that form the sub-committee must be well briefed and knowledgeable of the subjects for which they are being expected to advise upon. At various points in the H7 process and the associated RAB Adjustment assessment, we weren't convinced that the CAA Board members were sufficiently informed of the complexities and nuance of how Heathrow is economically regulated.
- 4.1.6 A further enhancement we feel would vastly improve the efficiency of the process is the unified use of consultants which seem to be used extensively by HAL, CAA and airlines to help to justify their specific positions. In H7, particularly on the side of the CAA and airlines, consultants were used to bridge the gap between the inherent knowledge HAL have on certain building blocks, such as capex, opex and commercial revenues. If HAL were more transparent with their information in advance of the key stages of the process, there would be less requirement for airlines and the CAA to use consultants to make assumptions due to lack of knowledge. The information asymmetry is vastly inefficient and if addressed through legal constructs like confidentiality rings, it could help decisions to be made much faster with less conjecture and a more harmonised outcome.
- 4.1.7 These processes are expensive to administer for all parties and if we're able to make them more efficient, through innovative information sharing techniques, they should be considered for use in future price reviews.
- 4.1.8 Finally, we think that the CAA should consider its approach to regulation in the longer-term. The NR and H processes are clearly cyclical in nature, following a similar format and timetable that is overly restrictive with a relatively short horizon. There is little in way on real longer-term consideration about how the respective regulated entities should be regulated. In H7, we saw very small incremental changes in the construct of the regulatory framework such as Traffic Risk Sharing, even less change in NR23. Fundamentally, as the CAA presides over the regulation of the world's most expensive airport by a significant margin, it demonstrates that something is wrong and that by repeatedly adopting broadly the same regulatory framework won't change

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<sup>1</sup> CAA CAP2618 document 2.28 P14



this dynamic. Therefore, we expect the CAA to actively consider an alternative approach to regulation that breaks the existing cycle that is clearly failing consumers.

4.1.9 Virgin Atlantic encourages the CAA to continue to conclude the H8 process but, concurrently, consider how it regulates the UK's main hub airport in the longer-term which may involve breaking the current model. Without the CAA setting aside time and resources to conduct a material in-depth review of economic regulation, the cycle of small incremental change will only continue. That won't address the significant issue that faces users of Heathrow airport ergo the significant imbalance between cost and quality relative to other major hubs around the world.

**4.2 How should we ensure that consumer views are understood and reflected in our approach to setting price controls? How effective was the consumer research for H7 and NR23 and what improvements could be made for the next price reviews? How could the CAA improve its engagement with stakeholders for H8 and NR28?**

4.2.1 In our opinion, as the consumer advocate in the regulation of HAL and NERL, it should be the CAA that has ultimate control of understanding the wants and needs of consumers ahead of future price controls. As a fundamental part of ensuring the airport and ANSP meet the needs of consumers, it is essential that the research carried out to understand their views is independently sought and assessed.

4.2.2 We advocate that the CAA conduct all market research studies independently themselves so that it can be sure that the information it collects is based on a set of criteria that is unbiased. Although we are not suggesting that HAL manipulated the consumer research for H7 to its advantage, we know that depending on what questions and how they are asked can influence the outcome of any response. The only way that either the CAA or airlines could disprove the outcome of any of HAL's H7 research was to have carried out its own set of research to a similar extent too. That exercise is simply expensive and inefficient.

4.2.3 An independently administered process would be able to reflect far better the true wants and needs of consumers if the research was conducted free of bias. We expect the CAA to begin resourcing itself to adequately research consumer needs for H8 and beyond immediately if it hasn't already begun to do so, so that it can effectively advise HAL of its findings ahead of the business planning process for H8 later this year.

**4.3 How should the CAA secure the provision of timely and high-quality information to support the H8 and NR28 reviews?**

4.3.1 We believe that for the process to be as effective as possible for both H8 and NR28, it is important for the CAA to set strong and clear expectations of what is required to be delivered by the regulated entities in their business plans.



Furthermore, there must be real and credible consequences for failure to meet those expectations.

- 4.3.2 We felt that HAL were allowed to frustrate the process at points throughout the H7 price control review, essentially dictating the pace of the CAA's own timetable. For example, HAL failed to provide detailed capital plans for key investment areas, requiring the CAA to make repeated requests for more information. Neither the CAA nor airlines had the requisite information to be able to understand whether HAL's plans were achievable or realistic.
- 4.3.3 We expect the CAA to provide details to the regulated entities on the areas of detail the CAA expects the business plans to cover and level of fidelity expected at a minimum. The CAA's demands don't to be exhaustive but provides HAL and NERL greater scope to go into greater details as required.
- 4.3.4 It is our understanding that the CAA has powers to demand that key information is provided to a certain quality and within a reasonable timeframe so it was frustrating when the CAA failed to implement those powers when HAL continued to provide weak business plans. We advise the CAA to ensure that it is clear to all parties what powers the CAA possess to hold HAL and NERL to account for comprehensive on-time delivery of business plans and provide clarity on what any consequences could be for failure to deliver.

**4.4 Do you have any views on the quality of the reports that we published by our external consultants during H7 and/or NR28 and do you have any suggestions for how we should best use external consultants and advisors in the future?**

- 4.4.1 Generally, VAA found that the quality of the external reports produced by the CAA's consultants in the areas of Capex, Opex and Commercial Revenues was comprehensive. The main issue we have with the use of the consultants was that on several occasions, the CAA failed to take the advice of the consultants it had employed.
- 4.4.2 One example of where the CAA failed to fully follow their expert's advice is in the use of a shock factor in the development of the traffic forecast. The CAA employed Skylark as consultants to provide a level of quality assurance on its own forecasting methodology and in Skylark's report on the Initial Proposals it stated that *"Shock Factors are not, in Skylark's experience, a conventional part of a 'mid' forecast... but if an additional factor is included, drivers should exclude the impact of shocks to avoid double counting"*<sup>2</sup>.
- 4.4.3 Despite Skylark's advice that the use of a shock factor was unconventional in its expert opinion, the CAA chose to ignore this advice and maintain the use of a shock-factor, essentially leading to the double counting of historical shocks in its passenger forecast which for 2023 has proven to be woefully inadequate.

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<sup>2</sup> 2021 Skylark Report, page 27.

4.4.4 For H8 and NR28, if the CAA is expected to continue to use expert advice in certain areas where it has little experience within its own team, then we expect the CAA to adopt their experts' advice.

4.4.5 As mentioned elsewhere in this response, we advocate the use of external advisors and would be open to consider how all parties can settle on the use of shared advisors that create a single version of the truth using information shared by HAL to the fullest extent possible creating efficiency in the process.

## **5 Approach to key price control issues and building blocks.**

### **5.1 How should we develop passenger forecasts for H8 and what are your views on using external forecasts?**

5.1.1 Despite the CMA's overall assessment that the CAA's approach to H7 passenger forecasting (with the exception of the calculation of the Risk Factor) was satisfactory in the circumstances, it remains VAA's strong belief that the forecast that was arrived at by the CAA was fundamentally wrong. Not only did we repeatedly explain that to the CAA and their Board at the time, we gave the CMA multiple pieces of evidence to support our claim. VAA and our joint appeal partners in British Airways and Delta Air Lines have effectively proven to be right, particularly as far as 2023 passenger forecasts are concerned.

5.1.2 The CAA forecast a total of 73m passengers would travel through LHR in 2023. The actuals were 79.2m, a significant variance of 6.2m. At multiple stages throughout the CAA's process, the CAA layered on pessimism on top of pessimism. The end result for 2023 has been an over collection by HAL of £194.2m at a maximum allowable yield of £31.57, this is not a small error.

5.1.3 Ultimately, it is consumers for whom the CAA has a primary duty to protect that have suffered from overly inflated airport charges and in our view, will continue to suffer for the remainder of the price control. To base such a fundamental building block of the price control on a model produced by the regulated entity without being able to share it comprehensively with the airline community, was a significant error that the CAA only rectified in the final stages of the H7 process. The CAA must ensure that it doesn't make the same mistake again in assessment of passenger volumes for the H8 period.

5.1.4 There are a number of reasons why, in our view, the CAA failed to accurately forecast passenger numbers. They include the continued use of HAL's inherently biased base forecast which the airlines had no ability to scrutinise to a credible extent and a misguided approach to moving away from the use of HAL's forecast with an untested 4-step approach. Both HAL's and the CAA's forecasts have so far proven to be overly pessimistic, only the airlines' forecast that was constructed by colleagues at VAA, has proven to be accurate.

5.1.5 We encourage the CAA to take a different path in the formulation of a passenger forecast for H8. We would expect the CAA to already be in dialogue with independent organisations that are capable of building robust forecasting models to be quantifying the scale of the task, the time and cost required in advance of the draft method statement publication later in the year so that we can review the options accordingly.

5.1.6 We would expect to be able to work closely with any independent forecast specialist in the formulation of the H8 forecast throughout the process. Virgin Atlantic and other airlines have a vested interest in ensuring the passenger forecast is accurate but most importantly, airlines have a significant role to play in delivering the real passenger numbers from deciding which aircraft it operates at LHR and the prices that it charges passengers. To a certain threshold, airlines have a greater degree of influence on the passenger numbers than the airport actually does.

**5.2 Are there changes to our overall approach to service quality issues that we should consider for H8 and NR28?**

5.2.1 With regards to OBR in H7, at VAA we were extremely frustrated with the extent to which the CAA moved from its existing SQRB model to OBR. The CAA had consulted on OBR since December 2016 with CAP1476 yet when it came to finally implementing OBR, it was essentially just a rebadged SQRB regime with a large majority of the same measures as the historical approach. It was clear that the CAA had de-prioritised OBR through the H7 process evidenced by the later publication of CAP2274 which was published as a separate document 1 month after the date of Initial Proposals, CAP2265.

5.2.2 Despite being actual recipients of HAL's services, we felt that the CAA continually ignored our advice and ideas with a pre-determined approach that was to replicate SQRB. 2 key areas where the CAA ignored our and other airline responses on OBR enhancements was around moving the measurement of security queuing times from monthly to daily measures and to make HAL more responsible for baggage system availability. In both scenarios where consumers and airlines are directly impacted, the CAA failed to review the potential of these areas that would clearly benefit consumer outcomes.

5.2.3 HAL continue to be measured for security queue performance at an aggregated monthly level and HAL still have no commercial incentive to ensure that the part they play in ensuring a consumer's bag successfully arrives at its destination at the same time as the consumer is delivered. We believe that in both measures, the CAA is needlessly failing individual consumers.

5.2.4 We expect the CAA to deal with both baggage system performance and security daily measures as part of its OBR mid-term review later this year.

5.2.5 As we have outlined elsewhere in this response, the major shift we expect to see for OBR in H8 is how consumer feedback is gathered and interpreted. Because this information is so critical to the future roadmap of the airport, we believe this should only be conducted by an independent body.

**5.3 Are there any changes in our overall approach, or specific factors that we should take into account, when considering whether and how to implement traffic risk-sharing for H8 and NR28?**

5.3.1 At Virgin Atlantic, we understand why a TRS mechanism has been installed in both the H7 and NR23 frameworks *'designed to protect the regulated business from undue risk and prevent unnecessary increases in its cost of capital that would lead to higher charges for customers.'*<sup>3</sup> To a certain extent, the fact that the WACC reflects the increased risk burden on consumers helps to lower charges, we wouldn't like to see TRS removed in future price controls. However, particularly for H8, when the airport is at capacity, there is little opportunity for airlines or consumers to benefit from beating the forecast and the 'sharing' element becomes disproportionate.

5.3.2 We expect the CAA to revisit the construct and proportionality of the TRS mechanism to reflect the asymmetry involved in how each party is rewarded in the event of over or under delivery. As designed, HAL are hugely protected in a downside scenario, whereas consumers and airlines have little ability to be rewarded in an upside scenario. This imbalance must be rectified.

**5.4 What are your views on our approach to cost and commercial revenue assessment for H7 and NR23? How should we change our approach for H8 and NR28?**

5.4.1 Fundamentally, we expect the regulated parties to be required to demonstrate both a top-down but also bottom-up approach to budgeting. These approaches must be able to be shared either directly with airlines or through confidentiality rings as required to ensure transparency.

**5.5 What are your views on our existing approach to opex and capex incentives? Are there options we should consider for H8 and NR28 to strengthen incentives for efficiency and service delivery?**

5.5.1 We have welcomed the introduction of ex ante capital incentives in the H7 price control and firmly believe that a similar approach could be adopted in NR28 and beyond if implemented correctly.

5.5.2 It is too early to assess whether aspects of the ex-ante approach such as delivery obligations, DOs, have been successful or not but there are a number of key questions which we expect the CAA to answer as part of a review of H7. The most significant of these is the degree to which the CAA expects

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<sup>3</sup> CAA CAP2618 document 2.39 P. 17

consumers to carry the cost of the increased risk of HAL failing to meet its delivery obligations.

5.5.3 In recent DO setting sessions with HAL, we have seen the potential for an increase in the project delivery cost to be inflated as HAL seek to pass on the cost of risk onto its supply chain. It is our expectation that when the CAA derived the DO incentive approach, it expected HAL, and HAL alone, to bear the full cost of failure to meet the DOs, not for those to be passed on throughout its supply chain and impacting the total cost of delivery.

5.5.4 Sadly, it is very difficult for airlines and the Independent Fund Surveyor (IFS) to analyse the extent to which the cost of risk is picked up by the supply chain contractors in the current arrangement, but we would expect it to be taking place. Simply, why would HAL accept the risk liability when it can be absolved as part of the total project costs?

5.5.5 We expect the CAA to review how DOs are designed to incentivise HAL in the way it originally intended as part of the capital incentive approach to H8 and don't increase costs for consumers un-necessarily. These should then be reflected in NR28 price control too.

**5.6 Are there more steps that HAL or NERL could reasonably take during H8 and NR28 to contribute towards net zero? Are there any changes the CAA should make to enable this?**

5.6.1 Virgin Atlantic supports HAL's transition to net zero and NERL's continued work to make the UK airspace more efficient for airlines. In both scenarios, environmental initiatives can't just be delivered at any cost and must be weighed up against the overall cost challenges. For example, during H7 initial proposals stage, HAL produced very little information detailing what projects it was expecting to need to deliver towards its net zero targets, yet the CAA ring-fenced a large proportion of the capital expenditure budget for sustainability initiatives despite their being no credible plan.

5.6.2 As important as sustainability and environmental considerations should be for the CAA, both the airport and NERL, must be capable of reflecting this in their detailed business plans. Furthermore, the capital projects they put forward for delivery in future price control periods must be in the control of the regulated entities to reduce their own carbon footprint or to enable infrastructure that enables airlines themselves to reduce their carbon emissions, such as hydrogen fuel provision.

**5.7 Do you have any views on our plan to consider the approach to indexation for H8 and NR28 and our initial view that we should adopt CPI or CPIH indexation?**

5.7.1 We support the CAA's plan to review the current indexation to HAL and NERL's regulatory asset bases (RAB). The existing methodology is outdated, the use of CPI, rather than RPI, is a more realistic index.

5.7.2 When reviewing the RAB methodology, we would also suggest that the CAA consider the make-up of the RAB and the extent to which indexation is applied. For example, HAL apply a standard management fee to capital projects to cover costs for leadership and logistics (L&L) charges, regardless of whether those costs were actually incurred. Not only do we think that this methodology is not fit for purpose, but we also don't believe that these costs should be treated in the same way as other elements of the capital expenditure. Regardless of which indexation is ultimately applied, we don't think sunken L&L costs should be liable for inflation.

**5.8 Do you have a views on the areas that it will be particularly important to focus on in estimating the cost of capital at H8 and NR28?**

5.8.1 We refer the CAA to British Airways' report on the approach to estimating the cost of capital for future price controls in their equivalent submission to the CAP2618.

**5.9 Do you have any views on the factors we should consider in establishing an approach to regulatory depreciation for H8 and NR28? Are there any changes we should consider to the existing regulatory mechanisms that lead to RAB adjustments?**

5.9.1 Fundamentally, the RAB is spiralling out of control benefitting HAL and its shareholders and penalising consumers. Heathrow is independently recognised as the most expensive airport in the world by a significant margin when compared to other similar airports across Europe but this is not reflected in the quality of services offered. At its heart, HAL's excessive charges are driven by the substantial size of RAB.

5.9.2 Although we recognise that the CAA are unlikely to review the RAB regulatory model as part of the H8 price review, we encourage the CAA to look more longer term, outside of the 5-year cycle, specifically at how HAL is regulated, whether it can amend, change, or even break-up the RAB to allow for an alternative model to prevail at London's main hub airport. This is a material piece of work demanding serious consideration of alternative models potentially seen at other airports around the world or potentially something more groundbreaking. Regardless, the current cycle needs to be broken and the CAA must resource an appropriate review of how Heathrow is regulated. Options include allowing alternative airport operators to finance, build and operate new or existing terminals within the current estate or creating alternative commercial models that aren't predominantly geared to growing the RAB.

**5.10 Do you have any views on how we should assess the package of incentives and risk sharing arrangements for H8 and NR28?**

5.10.1 There are a number of areas where the CAA could quite quickly and relatively easily rebalance the risk sharing arrangements for H8. Some of these are discussed elsewhere in this document too.

- Delivery Obligations – these ex-ante incentives are encouraged, however, in practice they have the potential to only drive up the cost of capital projects due to HAL being able to pass on the cost of risk on to their supply chain. The CAA must find a mechanism where the incentive truly works to influence HAL's behaviour positively for consumers, not to simply drive costs into the capital programme.
  - TRS – there is a clear asymmetry between how much potential there is to beat the passenger forecast and be in a position where money is returned, relative to the opposite on the downside. Airport capacity is the ceiling, which is very close to where the airport operates day to day. Conversely, zero passengers is the downside risk, which from an annual c. 80m passengers gives Heathrow a very large scope to be rewarded. This imbalance in the reward mechanism should be recognised for future price controls.
  - OBR – Under no circumstances should HAL be rewarded a bonus for meeting or exceeding its OBR targets. Either the target should be higher or the incentive must be stronger for failure to meet target, or both. To reward over-achievement is an un-necessary cost burden on consumers that receive limited benefit.
- 5.10.2 In terms of NR28, NR23 incentivisation is lacking in the event of a complete service interruption. This must be addressed.
- 5.10.3 We have formally responded to the CAA independent review panel (the panel) in respect of the August 2023 NATS system failure. We are encouraged by the panel's interim view such that it is inappropriate that NERL is likely to achieve almost all of its performance targets in 2023. It is therefore likely to suffer very little financial consequence, after having caused disruption to passengers, cost to airlines, airports, and tour operators. This suggests that the performance incentive framework is currently not fit for purpose.
- 5.10.4 VAA also shares the panel's concern (as per its scope statement) that the level of economic penalty that the CAA can currently impose on NERL, for breach of its licence, appears relatively modest in relation to the overall cost of the August 2023 incident, and also in relation to NERL's financial position.
- 5.10.5 Irrespective of the commercial effect on NERL, there is no mechanism within the NR23 regulatory framework via which airlines can mitigate the financial impact of a NERL service failure; airlines are unsatisfactorily the insurer of last resort. Although we recommend a review of the incentives within NERL's licence to consider this, we believe, as the panel eludes in its interim report, that the primary route to reform are changes in UK261 legislation as to ultimately hold NERL liable for passenger compensation when its failure(s) are the root cause.
- 5.10.6 As we expect to be case with the implementation of HAL's H7 Delivery Obligations, reforms in NERL's incentivisation must not drive an increase in up-



front capital investment purely for the cynical purposes of 'counteracting' the potential consequences of the incentive mechanism itself. This will inevitably shift the burden of risk back to consumers.

- 5.10.7 In development of the NR28 price control, VAA would emphasise however that any incentive scheme must avoid unintended consequences i.e. take into account NATS' responsibilities to provide safe and efficient air traffic services.

**5.11 Do you have any views on our approach to assessing equity financeability and any changes we might consider?**

- 5.11.1 A significant concern we witnessed through the H7 process and the parallel process that resulted in a £300m RAB adjustment was the relative importance the CAA gave to HAL's financeability relative to its primary objective to protect consumers. In our opinion, the CAA got that balance wrong. Despite the CMA's decision on our appeal point of a wrongful award of a £300m RAB adjustment, we are still of the opinion that the CAA erred.

- 5.11.2 HAL continue to raise finance against its ever-increasing RAB in full view of the CAA, despite the dangers of over-leveraging as we witnessed through the pandemic years leading to the un-necessary £300m RAB adjustment. In 2023, HAL had borrowing costs of over £1.6bn yet during COVID-19, HAL had zero permanent equity injected into the business.

- 5.11.3 In our opinion, the balance between the CAA's primary and secondary objectives are skewed disproportionately towards HAL's financeability.

**5.12 Is the approach of waiting to see the impact of changes to governance arrangements and the results of the independent review a reasonable and proportionate way forward?**

- 5.12.1 We agree that waiting to see the outcome of the independent review is reasonable and proportionate in the circumstances. However, we must also recognise that the situation that has transpired with airlines paying a disproportionate amount of ORC fixed costs in 2024 and beyond is as a result of the CAA's H7 decision.

- 5.12.2 This is a completely un-acceptable situation that the airlines are now facing. The argument that commercial organisations that operate from the airport are there to support airport consumers and, therefore, shouldn't necessarily pay the full extent of the fixed costs is mis-guided.

- 5.12.3 Those commercial organisations are absolutely there because of the consumers but only to serve their own commercial interests and should pay to use those ORC services to the full extent they are liable. To have airlines

subsidising non-airlines' fixed costs fails to address the 'user pays' principle that HAL is expected to administer.

- 5.12.4 Regardless of the outcome of the independent review, the CAA must ensure that airlines are paying no more than they should.

## **6 Broader strategic issues**

### **6.1 Form of controls:**

- 6.1.1 As discussed elsewhere in this document, we welcome the CAA considering alternative form of controls, particularly on HAL where the existing model has spiralled out of control.

- 6.1.2 A RAB was "*initially developed for UK infrastructure industries by Ofwat*" in the early 1990s as a tool "*to remunerate investors for delivering substantial investment programmes for long-life assets*" that had been privatised.<sup>4</sup> "*RABs are regularly put in place for infrastructure industry monopoly networks,*" whether water pipes or electricity grids or railway tracks.<sup>5</sup> Even within the utility industries subject to RAB regulation, in other words, it is the transmission or distribution of homogenous commodities or commoditised services that is subject to that method of economic intervention, while upstream or downstream activities typically are not.

- 6.1.3 The known disadvantages of a RAB model (encouraging inefficient investment or other efforts to inflate the size of the RAB by the operator, for instance)<sup>6</sup> are significantly easier to manage when the activity is homogenous and commoditised. Investment requirements relate to simple, quantifiable outcomes and service quality is almost binary; transmission is on or off. Consumers as end users have minimal or no involvement in the delivery of the regulated service, and on each occasion the needs that are being met are entirely functional and one-dimensional.

- 6.1.4 Seen in that context, the CAA's allocated task – to apply the same tool to effectively regulate investment and outcomes at Heathrow's passenger terminals – is an outlier. The many activities being regulated are far more complex, as are the consumer needs being served. From this root cause spring many of the problems outlined elsewhere in this submission.

### **6.2 Environmental sustainability:**

- 6.2.1 As we have highlighted elsewhere in this response, Virgin Atlantic is supportive of the industry moving towards net zero carbon emissions by 2050. We need to see detailed plans of how both HAL and NERL plan to deliver on

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<sup>4</sup> Stern, City University London Centre for Competition and Regulatory Policy (CCRP), 'The Role of the Regulatory Asset Base as an Instrument of Regulatory Commitment' (2013)

<sup>5</sup> Oxera, Stern, 'The Regulatory Asset Base and Regulatory Commitment' (Feb 2014)

<sup>6</sup> Competition Commission's report, paragraph 6.18.



[REDACTED]

[REDACTED]

**6.5 Scarcity Rents:**

6.5.1 We await further details from the CAA on its approach to scarcity rents.

**6.6 Airspace modernisation and new users:**

6.6.1 We are ready to support the CAA as required with input into airspace modernisation more generally but the principle of existing airspace users funding the CAA's activity for new modes of air-travel is not justified and must be funded through public funds.

**6.7 Charges and Airport Charges Regulations (ACRs):**

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### Conditions of Use

- 6.7.8 Virgin Atlantic has long-standing concerns that the approach HAL takes to interacting with and considering the view of airlines (and by extension, the views of consumers) is reflective of an organisation with significant market power that considers itself free to act with impunity and without the usual commercial constraints of a competitive market. For example, VAA is particularly concerned at HAL's approach to its Conditions of Use, which is the commercial contract framework between HAL and its airline customers that airlines must adhere to as a condition of operating from the airport. These Conditions of Use are, in practice, a one-sided set of obligations on airlines that have not been commercially negotiated or agreed, but are effectively imposed unilaterally on airlines by HAL in order to access services at LHR. In addition to legitimate objectives to facilitate with the operation of LHR, they seek to almost entirely exclude HAL's liabilities to airlines, place almost no obligations on HAL itself and conversely grant HAL very significant and comprehensive rights and remedies against airlines users.
- 6.7.9 By doing so, HAL is purporting to absolve itself of any liability to airlines, even when it does not perform services to an acceptable standard or even at all, or when its conduct leads to airlines incurring significant liability to passengers (e.g. under EC261 for delays and cancellations, or under the Montreal Convention for baggage losses and delays).
- 6.7.10 Despite significant concerns raised by the airline community over several years, at no time has the CAA taken any action to consider or amend the Conditions of Use or enforce Service Level Agreements. HAL has been able largely to ignore the complaints of almost every airline using LHR, including complaints raised via the annual consultation process on the Conditions of Use. This demonstrates that consultation is not an effective mechanism to curb HAL's market power nor is it a replacement for proper CAA regulatory oversight of HAL (either through the licensing regime or the CAA's other powers, e.g. competition law powers.) The commercial outcomes that result cannot be in the best interests of consumers nor discharge the CAA's primary statutory duty.
- 6.7.11 We urge the CAA to take a keener interest in both the real airport charges that consumers and airlines are expected to pay within the MAY and the highly one-sided CoU that wouldn't be acceptable in an ordinary commercial relationship. We propose that the CAA brings both of these aspects of HAL's tactical manipulation of their license under greater scrutiny of the CAA and that they essentially become a further building block within the regulatory framework of H8 and beyond.

## **7 Conclusion & recommendations**

- 7.1.1 In order for the CAA to fully meet its primary objective of protecting consumers and within the scope of its other responsibilities, there are 5 key areas we'd like the CAA to concentrate on delivering for the forthcoming price reviews and beyond:



- Timetable & resources – put in place robust timetables at the earliest opportunity and hold regulated entities to account to ensure they're met. Ensure the CAA is effectively resourced to be able to deliver concurrent high quality price control processes.
- Constructive engagement – create a process that compels HAL and NERL to provide detailed information about their business plans in a timely fashion to enable airlines to critically review the content and feedback accordingly. This will be more efficient use of resources creating an effective and collaborative process.
- Forecast models & consumer research – The CAA must take control of the forecasting and customer research elements of the price control process to enable an unbiased approach.
- Governance around price controls & indexation – The fact that Heathrow is the world most expensive airport demonstrates that the existing model is no longer fit for purpose. The CAA must recognise that fundamental change outside of the standard 5 years cycle is required.
- Charges & conditions of use – We compel the CAA to take a keener interest in how HAL set airport charges on an annual basis and to review the one-sided set of terms that are forced on airlines that fly from London's only Hub airport.