Virgin Atlantic Response to CAP 3044: Draft H8 method statement and business planning guidance

16 December 2024

1. About Virgin Atlantic

1.1. Headquartered in London, Virgin Atlantic Airways ("Virgin Atlantic") is a UK flag carrier and the second largest long-haul airline, employing 8,500 people. We operate a global passenger network including 33 direct destinations worldwide, 12 of which are in our US heartland, all flying out of our London hub at Heathrow. 90% of our capacity is operated from London Heathrow and 92% of our London Heathrow capacity brings consumer choice and direct competition to British Airways. We also operate to five destinations from Manchester airport and seasonal flights from Edinburgh. Through our transatlantic joint venture with Delta Air Lines and Air France-KLM, we offer more than 150 daily flights to 220 destinations in North America and over 120 destinations in the UK and Europe.

2. Executive Summary

2.1. The economic regulatory framework at London Heathrow airport ("Heathrow"), based on a Regulated Asset Base (or "RAB"), has delivered the highest passenger charges in the world[1] and declining service standards, while delivering shareholder returns exceeding £4.5bn since 2013[2]. During this period, HAL has invested c.£7bn of capex without material improvement for users; Terminal 3 has moved to end of life asset management, Terminal 1 stands derelict, and Terminal 4 remains a poor user experience. Despite a lack of improvement in the user experience of terminals, the RAB is almost flat in real terms, with the depreciating asset base of existing terminals offset through capital investment that has failed to deliver for consumers.

2.2. In 2009 the Competition Commission ("CC") highlighted that price caps set on the basis of allowing a given return on a RAB provide no strong incentive for efficient and effective investment to reflect and respond to customer requirement[3]. This is because, in the longer term, the airport operator earns the cost of capital on all its investments allowed in the RAB, regardless of whether these investments address passenger and airlines' needs.

2.3. A RAB based model, designed for regulating homogenous infrastructure or commoditised services, is overextended in application at Heathrow given the complexity and customer experience-based nature of operations, particularly for terminals. This is further compounded by the unique position of Heathrow as the UK's only hub airport and the significant market power of its owner and operator, HAL.[4]

[1] Jacobs, Review of Airport Charges, 2023,
[2] Based on Refinitiv data for Heathrow Airport Holdings Limited, 2013 – 2022
[3] 22 CC's Report, paragraph 6.18.
[4] https://www.caa.co.uk/our-work/publications/documents/content/cap1133/

[redacted]

2.4. [redacted]

2.5. Virgin Atlantic recognises that both the CAA in its draft Method Statement ("Method Statement"), and HAL through its Constructive Engagement, are proposing alternative approaches to the RAB, such as changes to indexation or removing some assets. Although these different approaches will have implications for the future profile of RAB growth and passenger charges, they do not represent a fundamental change that addresses the core problem at Heathrow. Furthermore, the impact of changes to the RAB – such as moving to a nominal rather than real-terms value – are largely compensated by commensurate increases in the WACC. Consequently, passenger charges will likely remain the highest globally, with material growth in charges the only possible outcome once HAL's future capex plans are taken into consideration.

2.6. [redacted]

2.7. The primary objective for economic regulation of Heathrow should be clear: to drive competitive like dynamics that serve users and consumers, meeting the duties as set out in the Civil Aviation Act 2012. This should deliver a reduction in passenger charges to bring them into line with the service and infrastructure quality provided, or an increase in the quality of the service and infrastructure commensurate with the existing level of charges.

2.8. [redacted]

2.9. [redacted] We have also contributed to the

Heathrow AOC's response to this consultation, which considers specific proposals set out in draft the method statement in detail.

3. **The RAB based regulatory model**

3.1. A RAB based model, designed for regulating homogenous infrastructure or commoditised services is overextended in its application at London Heathrow given the complexity and customer experience-based nature of operations, particularly for terminals. This is further compounded by the unique position of Heathrow as the UK's only hub airport and the significant market power of its owner and operator. [redacted]

3.2. The CC 2009 Report highlighted that price caps set on the basis of allowing a given return on a RAB provide no strong incentive for efficient and effective investment to reflect and respond to customer requirement[5]. This is because, in the longer term, the airport operator earns the cost of capital on all its investments allowed in the RAB, regardless of whether these investments address passengers and airlines' needs. The CC found that this led to decisions on investment projects being made on administrative grounds, rather than market-generated grounds which would consider the quality, quantity, location and timing of the investment. As a result, price controls may dull the incentive for the airport to innovate and rapidly take up new technology.

3.3. [redacted]

3.4. [redacted] During this period, HAL has invested c.£7bn of capex without material improvement for users; Terminal 3 has moved to end of life asset management, Terminal 1 stands derelict, and Terminal 4 remains a poor user experience. This inefficient capex spend has maintained a very high RAB value in real terms while the user experience has degraded. This should be viewed against the tide of 20 years of regulatory depreciation profiles that should be expected to create headroom for future investment i.e. the RAB contribution of T2, the newest terminal, indicatively depreciated by half over the period. The cost of modernising Heathrow's outdated passenger experience will therefore be incremental to what is already the highest cost of use for comparable airports (see section 4.3 for consideration of Heathrow's masterplan).

[5] 22 CC's Report, paragraph 6.18.
[6] Jacobs, Review of Airport Charges, 2023,
[7] Based on Refinitiv data for Heathrow Airport Holdings Limited, 2013 – 2022

3.5. A RAB or regulatory capital value 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.[8] "*RABs are regularly put in place for infrastructure industry monopoly networks*," whether water pipes or electricity grids or railway tracks.[9] 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.

3.6. 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)[10] 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.

3.7. Seen in that context, the CAA's 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 most, if not all, of the problems with Heathrow.

3.8. The draft Method Statement is largely silent on the challenges posed by RAB regulation, and assumes *a priori* that it will grow, albeit in a way that is "sustainable":

> *"A number of airlines have expressed concerns about the size of HAL's RAB. We note that HAL is proposing to expand the capacity of the two-runway airport, requiring further investment during the regulatory period. We will consider how we balance the level of charges in the shorter-term and the allowances for regulatory depreciation with a sustainable growth of the RAB. To the extent there are further initiatives that might reasonably reduce the size of the RAB, such as taking account of the proceeds of the sale of non-core assets, then we are open to considering these matters as part of the price control review."*

3.9. While it is welcome that the CAA is open to considering initiatives to reduce the size of the RAB, we believe these are likely to be relatively limited in scope. Indeed, proposals put forward during 'Constructive Engagement' to move some non-core assets outside of the single till are immaterial.

3.10. In *CAP3000* the CAA concluded that a reduction in the RAB may not be in the interests of consumers, as it would lead to higher charges. The CAA said that it "*remain[s] committed to using the RAB as the basis of our price control decisions*" in part because, "*consumers benefit from the investment and the lower charges that result from the incentives to reduce costs*"[11]. It suggests that "[*T*]*here are interventions that*

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[8] 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)
[9] Oxera, Stern, 'The Regulatory Asset Base and Regulatory Commitment' (Feb 2014)
[10] CC's Report, paragraph 6.18
[11] https://www.caa.co.uk/publication/download/22776

could be made to reduce the size of the RAB while acting in a way consistent with the reasonable expectations of investors... but these measures would need to be considered carefully as they might lead to higher charges".

3.11. Virgin Atlantic strongly disagrees with the implicit acceptance that the RAB based model is a driver of efficient investment or provides any incentive to reduce costs at Heathrow. Whilst the growth of the RAB to date may have met "*expectations of investors*", it has not delivered correlating quality of service and infrastructure – and there is little protection for consumers to ensure value for money versus the cost of use they pay. For the CAA to reach the above conclusion it is necessary to fully examine the outcomes, actions and incentives that the model today creates.

4. **Structural incentives of the RAB model**

4.1. The commercial return HAL can achieve is based on a permitted rate of return (consisting of its weighted average cost of capital plus its operating costs and depreciation) recovered against the value of its RAB. As the denominator for the 'return on RAB' equation, HAL has a structural incentive to continuously increase its real-term value through capex spend. Against the value of the RAB, HAL is also incentivised to seek the highest possible WACC. For example, during the H7 process, at the Final Proposal stage HAL's proposed 'vanilla' WACC was 6.9%, versus Alix Partners' (airline community's independent economic advisors), 2.65%. The Final Decision on H7 WACC was 3.18%[12].

4.2. Even if steps were taken to reduce the RAB as proposed in the Method Statement – such as moving to a nominal rather than real-terms indexation – this would be compensated by commensurate increases in the WACC to achieve the permitted rate of return. Either way, passengers will still be paying the highest charges in the world, even before Heathrow's future capex plans are realised.

4.3. [redacted]

4.4. The regulatory regime is not designed, nor can it adequately scrutinise the efficiency nor effectiveness of a capex masterplan delivered over twenty years, equivalent to four price control periods. The key driver of RAB inflation – inefficient capex – can only be scrutinised by the CAA and the airline community piecemeal, rather than as a whole, with a lack of clarity of the alternative long-term options available, the long-term consequences for passenger charges, or the additional future capex it implies.

[12] https://www.caa.co.uk/publication/download/20193

Supporting capex in H8 – such as enabling works for potential future development – all but guarantees that when subsequent capex proposals are brought forward in H9, they will be the only practical and affordable options available. The sequencing of masterplan versus H8 capex plan deliberations do not support transparency or effective scrutiny. Given their substantial long-term investment and increased costs the masterplan implies, airlines and the CAA must be afforded sufficient opportunity for formal evaluation of alternative options.

4.5. [redacted]

4.6. Throughout the H7 process and subsequent appeal to the CMA, HAL defended its passenger forecasts and modelling as robust. This was despite their publicly announced monthly passenger volumes consistently outstripping their own forecasts throughout that period. [redacted]

4.7. [redacted] In the draft method statement, the CAA proposes:

> *"HAL would earn a small reward if it provides a high-quality business plan. If HAL's business plan is not assessed to be high quality, then there would be no reward and/or a potential penalty....For areas where airlines raise concerns around provision of information, we would expect airlines to discuss these issues with HAL to seek resolution. We expect HAL to try and respond constructively to airline requests and all parties to take pragmatic and reasonable steps to resolve differences.*
>
> *"Each capex programme should be described in detail including the work that has supported the development of the programme – including the needs case, strategic optioneering, estimates of efficient costs by each year and key cost drivers, outputs and consumer benefits. Also, HAL's views on the breakdown of programme costs between "core" and "development" capex should be provided."*

4.8. Throughout H7 airlines consistently engaged HAL but were either unable to obtain information, or received it so late in the process, it could not be subject to effective scrutiny. [redacted] As outlined above, the proposals to split the masterplan delivery across four price control periods can only further obscure capex plans from effective scrutiny; an assessment of H8 capex split by "*cost each year and key cost drivers*" cannot capture the implications and associated costs that will inevitably follow in future price control periods.

4.9. [redacted]

4.10. [redacted]

5. Objectives

5.1. The objectives set out in the draft method statement prioritise the needs of investors and conflate this with meeting the needs of consumers. The draft method statement identifies the CAA's objective as:

> *"We are seeking to further the interests of consumers by providing a stable and predictable regulatory regime that supports ongoing investment as required to allow HAL to provide the airport operation services that consumers want. To achieve this, we propose to take a similar broad approach to financial issues as we took at H7, updated to take account of new market evidence, regulatory precedent and emerging issues."*

5.2. We disagree that the interests of consumers can be narrowly defined in this way. There is little if any consideration of affordability, which given the context of Heathrow, is an unfortunate omission. The CAA could, for example, set as an objective providing consumers with airport services that are affordable and comparable to international peers. More prosaically, this approach precludes lower charges at the outset, with higher charges already assumed: "*ensuring current and future consumers and airlines face airport charges that are no higher than necessary, including through incentivising cost efficiency and ensuring that any growth in HAL's RAB is sustainable*".

5.3. In its role as regulator, the CAA is required to meet the objectives and duties set out in section 1 of CAA12. Specifically, the CAA has a primary duty to further the interests of users of airport transport services (i.e. passengers and customers of cargo) including securing that reasonable demands for airport operation services are met and the need to promote economy and efficiency in the provision of such services (as would happen in a competitive market where airport operators provide services demanded at minimum cost)[13]. This emphasis on consumers, competition, and affordability should deliver airport investment and operations akin to a competitively functioning market i.e. representing commercial value, competitive pricing, and service quality for users.

5.4. Within this context, the primary objective for economic regulation of Heathrow should be clear: to drive competitive like dynamics that serve users and consumers, meeting the duties as set out in CAA12. This should deliver a reduction in passenger charges to bring them into line with the service and infrastructure quality provided, or an increase in the quality of the service and infrastructure commensurate with the existing level of charges. The current model cannot achieve this, and the objectives set out within the Method Statement are equally limited, overly focussed on "investors", and do not adequately consider the interests of consumers [redacted]

6. Pricing freedom and Departing Passenger Charges

6.1. The application of the Departing Passenger Charge (DPC) is an area of significant concern for Virgin Atlantic and one which the CAA should address. The pricing freedom afforded to HAL creates significant opportunity, within the scope of the Airport Charges Regulation 2011 (ARC), to adopt a differential and discriminate pricing structure across users without a clear rationale or objective justification.

6.2. In 2010 HAL identified the rationale for its charging structure as reflecting "cost to serve", applying a basic assumption on the physical space used by a short or long haul passenger (itself a derivative of HAL's terminal space and allocation of airline operators).[14] This justification was abandoned in 2017[15], and by 2022 HAL determined that "*long-haul passengers should shoulder 75% of the total DPC cost and European and domestic UK passengers the remaining 25%*"[16], a ratio that appears arbitrary and without objective justification.

6.3. Consequently, the trajectory of long-haul versus short-haul departing passenger charges has been extraordinary. The charges paid by a passenger from Heathrow to Boston has gone from being the same as that paid by a passenger to Paris in 2010/11[17], to 40% more expensive in 2015[18], to 148% more expensive in 2023.[19] This is not in the interests of long haul customers, nor is it a situation that would be expected to occur in a market with effective competition. [redacted]

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[13] https://www.legislation.gov.uk/ukpga/2012/19/pdfs/ukpgaen_20120019_en.pdf
[14] HAL, 2010, 'Restructure of Airport Charges Consultation Document 2010'
[15] 34 https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/doing-business-with-heathrow/flights-condition-of-use/structure-of-charges-decision/Airport_Charges_Decision-5-August-2015.pdf
[16] 35 https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/doing-business-with-heathrow/flights-condition-of-use/consultation-documents/2023%20Airport%20Charges%20Consultation%20Document%20-%20Final.pdf
[17] 36 HAL, 'Conditions of Use including Airport Charges from 1 April 2010' (29 Mar 2010), paragraph 5.2 (international passengers: £22.97)
[18] HAL, 'Conditions of Use including Airport Charges from 1 January 2015' (31 Oct 2014), Schedule 5 paragraph 2.1, (European destinations: £29.59, other destinations: £41.54)
[19] 38 HAL, 'Conditions of Use including Airport Charges from 1 January 2015' (31 Oct 2014), Schedule 4 paragraph 2.4, (European charge: £22.07, other destinations: £54.70)

7. Consumer engagement

7.1. A further weakness of the regulatory framework identified by the CC 2009 Report in the context of the BAA investigation was the CAA's "*lack of responsiveness to the airline interest*"[20] which would not be expected in a business competing in a well-functioning market. It found the CAA gave insufficient weight to airline views and it adopted a light touch approach to regulating the airport operator with a reluctance to address the consequences of its conduct. The CC found that airlines have specific knowledge and experience that is of special value to the regulator, in particular in regulating airports with substantial market power (such as HAL). The CC had therefore recommended introducing an ancillary duty into the CAA's substantive statutory duty, to "*consult and to have regard to the views of airlines*"[21]. This recommendation was not introduced in CAA12. Virgin Atlantic considers that a gap remains in the regulatory framework as a result, particularly in the absence of any market competition at LHR and given the CAA's overreliance on HAL's evidence, data, and modelling.

7.2. The proposed approach for H8 remains largely unchanged. The draft method statemen states that:

> *As set out in the 2024 Review, we expect HAL to carry out its own research and engagement with consumers, local community groups and other stakeholders....Airlines and other stakeholders may also have important insights into consumer priorities and we will consider any wider information that we receive on these matters as part of the price review process. It will also be important for HAL and airlines to give full weight to consumer priorities during the CE process discussed above.*

7.3. It is unclear if the failure to identify these issues and provide potential remedies through the regulatory framework is a consequence of the CAA's own view on the value of airline input, or a failing of the regulatory framework. Regardless, the CAA must address this urgently, and propose regulatory remedies that seek to address these.

[redacted]

[20] CC's 2009 Report, paragraph 10.297
[21] see paragraph 10.299 of the CC's 2009 Report