Civil Aviation Authority
Westferry Circus
Canary Wharf
London
EH14 4HD

To: economicregulation@caa.co.uk

1st May 2024

Dear Sir / Madam,

Economic regulation of Heathrow airport: H7 final issues
CAP2980

1. Introduction

1.1 Virgin Atlantic ("VAA") welcomes the opportunity to respond to the Civil Aviation Authority's ("CAA") consultation on H7 Final Issues (CAP2980) which follows the Competition and Markets Authority's ("CMA") decision on the appeals brought by Heathrow Airport Limited ("HAL") and airlines (British Airways, Delta Air Lines and Virgin Atlantic) last year.

1.2 We appreciate the CAA's efforts to implement the CMA decision and to finalise the H7 price control in a timely manner. However, we have some serious concerns about some of the CAA's proposals, which we believe are inconsistent with the CMA decision, the principles of incentive regulation, and the interests of consumers. In this response, we set out our views on the following issues:

- The AK factor;
- The index linked premium in the cost of debt;
- The passenger forecast shock factor;
- The business rates allowance for H7;
- The pension deficit repair allowance;
- Changes to HAL's licence.

1.3 We have relied on the analysis provided by AlixPartners, our economic advisers, to support our arguments and we attach their report as Appendix A to this response.

2. The AK factor

2.1 The AK factor is a mechanism to adjust HAL's revenues in H7 to account for the over or under recovery of revenues in 2020 and 2021, the pandemic years. The AK factor considers three components: development capex, business rates, and volume mix. We agree with the CAA's proposal to follow the CMA decision and calibrate the AK factor for the development capex and business rates components for 2020 and 2021. However, we strongly disagree with the CAA's proposal to allow HAL to retain 50% of the additional revenue that it received from the volume mix component. We believe that this proposal is unjustified, unfair, and creates perverse incentives for HAL.

2.2 The volume mix component of the AK factor reflects the fact that HAL collected more revenue per passenger than allowed by the price cap. This was a result of HAL's own forecasting errors in setting the annual charges, not a consequence of the pandemic. Therefore, HAL should not be rewarded for its over-recovery, but rather be required to refund it in full to the airlines and consumers. This would be consistent with the regulatory contract, whereby HAL was regulated on a yield per passenger basis and bore the risk of lower traffic volumes during that period.

2.3 The CAA's proposal to share the over-recovery 50/50 with HAL is arbitrary and unsupported by any evidence or rationale. It effectively transfers the risk of lower traffic from HAL, a monopolist, to the airlines and consumers. It also undermines the principles of incentive regulation, by giving HAL windfall revenue gains that fail to reflect its efficient costs or performance, and by creating an incentive for HAL to game its forecasts in future years, hoping to retain some of the gain over and above the regulated price cap.

2.4 We note that the CMA decision questioned whether HAL should be responsible for compensating airlines for a higher average revenue per passenger following variances from forecast in volume mix due to the pandemic. However, the CMA did not make a definitive finding on this issue and remitted it back to the CAA for further consideration. We think that the CAA should have considered this issue more carefully and concluded that HAL should refund the over-recovery based on the revenue it actually received in 2020 and 2021, for the reasons we have explained above.

2.5 Therefore, we urge the CAA to revise its proposal and require HAL to repay 100% of the over-recovery for volume mix. This would result in an increase in the AK factor for 2020 from £29 million to £37 million, and for 2021 from £48 million to £65 million, based on the calculations provided by AlixPartners.

3. <u>The index linked premium in the cost of debt</u>

3.1 The index linked premium is an adjustment to the cost of debt allowance to reflect the difference in the cost of index linked debt relative to fixed nominal debt, given that both types of debt are used in the notional financing structure of HAL. The CMA found that the CAA's estimate of a positive index linked premium of 15bps was not justified by the data and analysis available to it and so had no factual basis. The CMA remitted this issue back to the CAA to either produce a revised estimate based on sufficiently robust data or, if not possible, simply remove the index linked premium.

3.2 The CAA, on reconsideration, agreed that there was insufficient evidence to support a positive index linked premium, and proposed to remove it from the cost of debt allowance. We agree with this proposal, as it is consistent with the CMA's decision and the regulatory precedent in other sectors. However, we also believe that the CAA should have considered the possibility of a negative index linked premium, as suggested by the analysis provided by AlixPartners.

3.3 In their analysis, AlixPartners show that there is clear evidence from the market for government gilts that investors require a lower return for inflation index linked bonds rather than equivalent nominal/fixed bonds, as the former do not bear any inflation risk. This implies a negative index linked premium, which averaged 0.57% for embedded debt from 2009 and 0.78% for new debt from 2022. AlixPartners also show that there is some evidence for a negative index linked premium in the corporate bond market, especially for regulated companies, such as HAL, which could issue index linked debt on the basis of their index linked RAB. AlixPartners estimates that a negative adjustment of around 10bps would be appropriate at the lower end of a range.

3.4 Therefore, we believe that the CAA should have taken into account this evidence and applied a negative index linked premium of at least 10bps to the cost of debt allowance, rather than simply removing the positive premium. This would be more consistent with the CMA's instruction to apply a revised index linked premium calculated using appropriate and robust evidence.

4. The passenger forecast shock factor

4.1 The passenger forecast shock factor is an adjustment to the passenger forecast to allow for temporary shocks to HAL's traffic caused by factors such as meteorological, geological, security and/or public health events. These events will generally (but not always) have a negative impact on passenger traffic. The CMA found that the CAA was not wrong to accept the principle of a passenger shock factor in HAL's forecasting methodology but did fail to properly validate whether HAL's calculation of a factor of 0.87% was correct. The CMA remitted this issue back to the CAA to validate the estimate.

4.2 HAL has subsequently provided the CAA with details of its computation and the CAA proposed to retain its estimate of 0.87% and make no further adjustments to HAL's price control for this issue. We disagree with this proposal, as we believe that HAL's and subsequently, the CAA's, calculation is flawed and overestimates the passenger shock factor. Together with AlixPartners, we have reviewed HAL's statements providing its justification for the 0.87% shock factor and have identified the following problems:

- The estimate is contaminated by economic downturns which should be excluded, as they are already accounted for in the econometric models that HAL uses elsewhere in its forecasting procedure;
- There is insufficient evidence that the base traffic forecasts don't already reflect "shocked" traffic, which would imply a double counting of expected traffic shocks;
- The methodology ignores the possibility of "positive rebounds" following negative shocks (e.g. because of delayed travel), which would reduce the net impact of shocks on passenger traffic.

4.3 We think that the CAA should have addressed these problems and revised the passenger shock factor accordingly. We estimate that, based on HAL's model, excluding economic downturns and assuming 100% traffic rebound for shocks of less than 12 months would reduce the shock factor from 0.87% to 0.56%. This would be a more accurate and robust estimate of the expected impact of non-economic shocks on passenger traffic.

5. The business rates allowance for H7

5.1 The business rates allowance for H7 is the amount of cost that HAL is allowed to recover from its regulated revenues to pay for its business rates liability. The CMA decision reduced HAL's business rates allowance by £85 million, based on the actual business rates relief that HAL received in 2020 and 2021. However, the CMA also recognised that HAL's business rates may increase in a material way following the

2026 revaluation by the VOA and remitted this issue back to the CAA for further consideration.

5.2 The CAA proposed not to make the downwards adjustment to the H7 business rates allowance set in the Final Decision, but rather to "log up" this amount against any future increase in business rates following revaluation and "true up" the position as part of the H8 price control review when the results of the revaluation will be known. We disagree with this proposal, as we believe that it lacks transparency, efficiency, and consistency.

5.3 The CAA's proposal lacks transparency, as it defers the recovery of costs to a future regulatory period, rather than reflecting the costs incurred in the current period. We understand that HAL may not actually be liable for any increase in business rates from the VOA's revaluation process until the start of H8. Therefore, it would be more transparent and accurate to reflect the actual business rates costs in H7 and H8 respectively.

5.4 VAA has increasing scepticism that the H8 price control will start on time on the 1st January 2027. Therefore, to ensure regulatory certainty for consumers, we expect the CAA to revise its decision by confirming that the true cost of business rates for the H7 period are fully reflected in the charges for H7 only.

6. Allowance for Pension Deficit Repair Contributions

6.1 The CAA's pensions advisers have indicated that there appears to be no case for HAL to make Pension Deficit Repair Contributions ("PDRC") until towards the end of H7 at the earliest. Therefore, the CAA proposes to remove £84 million of PDRC costs from the opex allowance for H7 and recalculate and reduce HAL's maximum allowed yield for 2025 and 2026 to reflect this. If HAL needs to incur PDRCs towards the end of the H7 period, the CAA proposes to address this through the H8 price control.

6.2 As a consequence, we agree with the current approach outlined by the CAA in its H7 Final Issues proposals.

7. The correction of an arithmetic error in the CAA's proposals

7.1 We have identified an arithmetic error in paragraph D9 of the CAA's proposals, which leads to an understatement of the negative H7 adjustment by £0.067 in 2025 and £0.076 in 2026. AlixPartners have corrected the error in its calculations of the AK and H7 factors, as shown in the Appendix.

8. Changes to HAL's license

8.1 Together with AlixPartners, we have performed the calculations necessary to change the AK and H7 factors to reflect our views and recommendations expressed in this response. We have followed the approach of the CAA's proposals, but corrected for an arithmetic error, the negative index linked premium, the reduction in business rates, and the repayment of volume mix variances. Details of our calculations are shown in the appendix.

8.2 The licence changes required to implement our view of the AK factor are in condition C1.22(b) as follows:

- C1.22(b)(i) OR2020 is equal to £37 million in 2020 RPI-real prices; and
- C1.22(b)(ii) OR2021 is equal to £65 million in 2021 RPI-real prices.

8.3 The licence changes required to implement our view of the H7 factor are in condition C1.23 as follows:

- For 2025, H72025 = -1.684; and
- (b) for 2026, H72026 = -1.755

8.4 We also note that a material subscript error needs to be rectified in licence condition C1.6 (Xt-1 for Xt). We agree with the CAA's commentary and proposal to correct this manifest error.

8.5 Finally, as discussed in paragraph 7.24 of the CAA's consultation, we are of the view that the inclusion of HAL's one-off £0.25 per passenger service quality bonus in the 2023 base average yield per passenger from which the 2024 price cap is calculated lacks transparency. Since this was a one-off-bonus, it should not appear in the base price from which the maximum charge is calculated for the following year. We understand that the calibration of the currently used PCM allows for this distortion, but nevertheless we believe that the approach lacks transparency.

9. HAL's proposed amendments to their license

9.1 HAL wrote to airline community members of the Joint Steering Board (JSB) on the 19th April 2024 'in the spirit of transparency and collaboration'[1] outlining 3 issues it had raised directly with the CAA:

- Queuing times for vehicles (security)
- Application of the Terminal Drop-off Charge (TDOC) recovery mechanism
- Operational certificate of adequate resources

9.2 With regards to queuing times for vehicles, we are satisfied that the CAA should make the suggested amendments to the license as advised by HAL to provide clarity to all parties.

9.3 In relation to our thoughts on HAL's proposals regarding TDOC, it is our understanding that CAA's H7 Final Decision included a risk sharing mechanism for the TDOC revenues. However, the CAA's licence drafting only applied the risk sharing mechanism to the period 2025-2026, whereas HAL argues that it was the CAA's intent for the risk sharing mechanism to apply for the whole period including 2022-2024.

9.4 We recognise that the CAA is in the best position to comment on the intent of the risk sharing mechanism, and whether it was meant to cover the risk of shortfalls as well as over-recoveries, particularly for the period 2022 and 2023 inclusive. However, from an economic incentive perspective, we believe that the risk sharing mechanism should only apply to elements of over- or under-performance that are outside the control of HAL, such as net volumes of traffic to and from the airport. The CAA excluded TDOC

[1] Letter to JSB members 'CAA consultation on H7 Final Issues (CAP2980): Other Outstanding Issues' 19th April 2024

revenues from HAL's traffic risk sharing mechanism and expected HAL to adopt a commercial approach to establishing the TDOC and maximising future TDOC revenues. Indeed, HAL have confirmed to airlines that the shortfall in 2022-23 is not due to uncertainties in volumes but due to HAL not being able to hit the forecast revenues set by the CAA. To the extent that any revenue shortfall is due to HAL's own decision making on pricing or any operational inefficiency, it should be excluded from any historical true-up of the risk sharing mechanism.

9.5 It is important to note that the CAA needs to take account of the fact that terminal drop-off traffic will be a direct substitute for HAL's revenues from car parking and commercial interests in public transport to and from the airport. Under-performance in terminal drop-off traffic may be associated with higher car park visits or revenues on public transport. Our assessments would suggest that both of these commercial revenue streams outperformed in the period. The CAA needs to consider these issues in the round and take into account the impact of TDOC revenues on HAL's other public transport revenues.

9.6 The whole principle of the introduction of TDOC was to incentivise consumers away from the use of cars onto other modes of transport. In this respect, we note that the CAA signalled that it will be conducting a review of TDOC revenues in 2024 and it may be that the most appropriate solution at this stage is that this item remains unresolved until after the review later this year.

9.7 Regarding the operational certificate of adequate resources, we don't feel that it is appropriate for the regulated entity to be the party that is ultimately responsible for signing off its own certification. We would expect an independent third party to conduct this activity. For example, before airlines qualify for their operating license, the CAA assign an 'oversight team'[2] to assess the suitability of airlines conducting a series of desktop and on-site audits and inspections. This type of process could be mirrored for HAL in this instance.

10. Conclusion and recommendations

10.1 Although we agree with some of items raised in the CAA's proposals in CAP2980, we found several issues that we believe are inconsistent with the CMA decision, the principles of incentive regulation and the interests of consumers.

10.2 We approve of the CAA's proposal to remove the PDRC allowance from the opex allowance for H7 and address any future PDRC costs in the H8 price control. We also agree with HAL's proposal to make some amendments to its licence in relation to vehicle queuing times.

10.3 However, we urge the CAA to revise its proposals on the following issues in line with the AlixPartners report: the AK factor, the index linked premium in the cost of debt, the passenger shock factor, and the business rates allowance.

10.4 With regards to, HAL's position on TDOC revenue recovery, we disagree with HAL's proposal to apply the TDOC recovery mechanism retrospectively at this stage until at least after the CAA has conducted a more rounded review of TDOC revenues later

[2] Air Operator License Certification process

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this year to understand the extent to which any shortfall in revenues were due to HAL's own decision making which should be excluded from any true-up mechanism.

10.5 In summary, our proposals outlined in this response, supported by AlixPartners, would derive an outcome that is overall, better for consumers and remains in line with the CMA's expectations. We expect the H7 maximum allowable yield for 2025 to be reduced by a further £0.886 and for 2026 by £0.930 respectively compared to the CAA's original proposals. In totality, this equates to an overall reduction in charges of £186m.

10.6 To ensure consumers are correctly compensated, the CAA must conclude the remittals and associated license amendments in advance of the publication of HAL's 2025 charges consultation later this summer so that the new maximum allowable yield is reflected in the new year.