

Virgin Atlantic Airways response to CAA consultation CAP 1914 - Economic regulation of Heathrow: programme update

Introduction

1. Virgin Atlantic welcomes the opportunity to respond directly to CAP 1914 - *Economic regulation of Heathrow: programme update* (CAP 1914). We also endorse the submission made jointly by the LACC and AOC on behalf of the airline community at Heathrow.

Chapter 1 – The strategic challenge

2. We agree that the combination of the Court of Appeal judgement and the severe impact of Covid-19 on aviation demand and the global economy has brought about new and considerable uncertainty into the H7 regulatory process. We share the view that traffic levels will recover over time. The challenge is predicting how and when.
3. We welcome HAL's decision to pause its expansion programme in March and curtail spending. It will be important to satisfactorily resolve the outstanding policy decisions around the regulatory treatment of Cat B and early Cat C spending in the best interests of passengers. It will also be important to maintain IFS and IPCR scrutiny of HAL's spend to date and to ensure governance with airlines is in place should HAL be incurring or intending to incur any additional spend following the Court of Appeal's judgement.
4. We welcome HAL taking several actions to reduce costs such as by halting unnecessary capital expenditure, reducing other expenditure and making use of the Covid Job Retention Scheme. Airlines and many other businesses across the aviation industry are doing the same. Although we recognise and appreciate that HAL offered aircraft parking charges support early in the Covid-19 crisis, we have been disappointed by the overall lack of general cost alleviation support offered by HAL during this unprecedented and devastating period for UK aviation, despite itself seeking alleviation from some of its own regulatory requirements to reduce costs. The CAA should consider whether stronger or new regulatory measures are required for H7 to incentivise a more collaborative commercial approach from HAL in future.
5. We strongly support the continuation of the CAA's work on H7. Consultation and decision-making on the Q6 price control period took place back in 2012-early 2014. So much has changed across multiple building blocks that a further extension of Q6 clearly would not be in the best interests of passengers.
6. We agree that the focus should be on the "two runways" airport. We welcome the alignment between HAL and the airline community on this point. We recognise that the CAA will need to retain the option of adjusting or resetting HAL's price control in the future should expansion become a viable and realistic prospect during the H7 period. Any such proposals in the future must be subject to significant stakeholder consultation and scrutiny.

Short term priorities for developing new price control arrangements

7. We welcome the CAA's recognition of the impact of Covid-19 on airlines.
8. We have consistently highlighted how HAL's airport charges have over time become amongst the highest in the world, particularly for long haul passengers. We agree that

airlines would be either unable or unwilling to pay any price increases that might arise from regulatory intervention. On the contrary: when demand stimulation is required lower charges/prices is the normal competitive response from an unregulated business.

9. Spare airport capacity across the south east of England would not enable us to avoid increased charges. We have announced that we will be consolidating our flying from the south east to Heathrow.
10. We welcome the CAA's focus being on developing the new price control arrangements for 2022 and beyond for a two runway airport. On 1 May 2020, HAL announced that it *'has £3.2 billion in liquidity, sufficient to maintain the business at least over the next 12 months, even with no passengers'*¹, suggesting the financeability of HAL is not a concern in the short term.

Dealing with uncertainty

11. We recognise there is unprecedented uncertainty right now and while some of the uncertainties will start to resolve in the coming months, they nevertheless present challenges to the price review process to which the CAA's approach to economic regulation must respond.
12. We support the CAA's proposal to develop and use scenarios. These should be jointly and comprehensively developed between the CAA, HAL and airlines during Constructive Engagement to ensure full confidence in their use and application.
13. We agree that HAL will need to develop forecasts of costs and revenues consistent with the different scenarios for passenger air traffic. These should be robustly assessed during Constructive Engagement by the CAA with external expert support if necessary, as well as airlines.

Impact on the form and duration of HAL's price control

14. We recognise that the CAA will need to consider and decide how to best deal with continuing uncertainty.
15. We are open to the use of trigger mechanisms to re-open or adjust the price control if circumstances turn out to be significantly different from those assumed in setting the price control.
16. We have concerns about traffic risk sharing. Airlines will be subject to their own significant risk and uncertainties over the next few years that they will have to manage independently. The regulatory approach should not seek to de-risk HAL completely, rather to ensure that it is subject to the same level of risk that similar business face in the current environment.
17. We recognise that it will be necessary to determine the most appropriate control period duration. Our initial view is that maintaining a five year period is preferable, but we are open to considering a slightly shorter period if the benefits to passengers are clear.

¹ <https://www.heathrow.com/latest-news/heathrow-first-quarter-2020-results>

18. We do not believe HAL's substantial market power has diminished since the last determination. Conversely it may have strengthened as a result of the Covid-19 crisis. Both British Airways and Virgin Atlantic have announced flying consolidations at Heathrow over Gatwick. Norwegian is not expected to fly from Gatwick in 2020. HAL's dominance in the cargo market has also meant that cargo-only flights operated by Virgin Atlantic and other airlines have been concentrated on Heathrow. A market power determination is not necessary and would not be possible within the timelines discussed.
19. Given the acknowledged unprecedented uncertainty, HAL's ongoing and potentially enhanced significant market power, and HAL's desire to return to expansion in the future, now is not the time to consider more fundamental changes to the form of the price control.

Chapter 2 – Next Steps

20. We recognise that timescales are compressed. We support greater informal stakeholder engagement and will be as flexible as our internal resource allows. However, the CAA must recognise that airline resources are currently severely constrained with employees on furlough and being made redundant, and budgets for external consultancy support reduced or eliminated.
21. It is more important than ever that the CAA is an active regulator. It may not be able to rely on the same level and depth of airline engagement as in previous price controls. This must not be misconstrued as a lack of airline interest but is an unfortunate outcome of the current circumstances.
22. We welcome the CAA seeking to minimise regulatory costs to the sector, but we support its use of external consultancies where internal resource lacks the necessary expertise or capacity. Previous experience demonstrates that HAL devotes significant internal and external resources on the price control review process. As airlines will be constrained, it is important that the CAA does not allow HAL to be the only participant able to draw on significant external expertise.
23. The CAA may wish to consider whether a cap on spending on external consultancies for HAL would be appropriate in the circumstances to ensure the process is not significantly imbalanced.
24. HAL agreed to allocate £300k in the capital budget for the airline community to spend on external consultants to support Constructive Engagement and the regulatory process. It is more critical than ever that this is maintained.
25. We agree that the benefits of Constructive Engagement between HAL and airlines must be captured. A lot of work has already been undertaken. Constructive Engagement must continue and be completed in a focussed and timely manner.
26. We agree that HAL should produce a high quality Revised Business Plan. This should be produced no later than October so that the CAA has enough time to scrutinise it before issuing its 'Way Forward' document in early 2021. It will be important to give clear guidance on what is expected, including defining 'high quality', especially as HAL's Initial Business Plan was lacking in detailed information in many areas.
27. The 2021 timetable looks challenging but deliverable. Enough time must be preserved for meaningful stakeholder engagement and feedback on both the initial and final proposals.