Virgin Atlantic Response: Discussion paper on the regulatory treatment of issues associated with airport capacity expansion

Introduction

Virgin Atlantic (VAA) welcomes the opportunity to respond to the CAA's discussion paper on the regulatory issues associated with airport capacity expansion.

This is a critical issue for airlines and our passengers to ensure that the funding for any new capacity is efficient and fair with the appropriate balance of risk between passengers and airport shareholders.

Given the importance of this issue we are disappointed with the short timescale for responses. We hope the CAA will be open to further representations over the summer as our thinking evolves.

Virgin Atlantic supports the joint airline submission that has been led by the ACC at Gatwick and LACC at Heathrow. Rather than repeating all the questions responses, therefore, this short submission highlights a few of the key points raised in that response.

Summary

VAA welcomes the initial assessment set out in the CAA's discussion paper. However, whilst there are a number of areas where our views are aligned with the CAA's thinking, we believe that there are some areas which require further consideration by the CAA. In particular:

- VAA is concerned that, under current plans, there is no firm view by the CAA on how it will carry out cost scrutiny in order to meet its primary duty to passengers. This warrants urgent consideration given the high level of detail already submitted to the Airports Commission.

- VAA does not believe that funding for additional capacity should begin until that capacity is in use. This is at odds with the CAA's decision to allow GAL to collect R2 funding during Q6.

VAA is still considering the appropriate regulatory mechanism for the funding of additional runway capacity, there are a number of principles we believe need to be taken into account in the development of such a mechanism to ensure it is the interest of our passengers. These are:

- There should be no pre-funding or revenue advancement – airport capacity should only be paid for once in use.

- Only efficient costs should be passed through. It is not in passengers interests to reward airport shareholders for inefficient investment.

- There should be no 'gold plating' of proposals – investments need to have sound cases and show clear passenger benefits.

- Inter-generational equity needs to be taken into account – this is a very long term investment with multi-generational benefits.

Finally VAA cannot see any rationale for a change in the CAA's primary duty to further the interest of passengers. This duty should therefore guide all interventions by the CAA in this process.

Chapter 2: Competition, regulation and market power

There are a range of issues that affect whether or not an airport has market power, one of which is capacity.

VAA agree with much of the assessment set out by the CAA. It is too early in the process for additional runway capacity for the CAA to 'hypothesise' about how competitive constraints may change. In our view there must be 'facts on the ground' for the CAA to come to a view on competitive constraints. Without changes in underlying economic conditions we do not see how the CAA can declare that there has been a Material Change in Circumstance (MCC) at either Heathrow or Gatwick, as it is the underlying economic conditions that drive the market position of the airports.

VAA believe it is unlikely that economic conditions at either airport will change until at least there is new capacity in place. However, it is clear that addition of new capacity of itself does not create MCC, but it can potentially be a factor that would need to be taken into account along with the other factors set out by the CAA.

Chapter 3: Airport expansion and market power determinations

VAA can see benefits in the CAA publishing information on the main factors in a market power assessment, effectively a summary of the factors relevant to its earlier market power assessments. This would simply be a summary of the current position.

However, it is important that the CAA provides a clear factual basis for any analysis by CAA of market power issues. The airlines are concerned that where information is subject to a high level of uncertainty it can become potentially misleading.

Chapter 4: Risk, regulation and finance

Risk allocation is a significant consideration given the size and duration of the investment than for smaller incremental projects and it is therefore worth addressing explicitly to ensure appropriate incentives are provided to deliver a runway in passenger interests.

When allocating risk, VAA believes the CAA needs to be driven predominantly by its primary duty to further the interests of passengers, while taking account of other relevant secondary duties and promoting competition where appropriate. In light of the primary duty to further the interests of passengers, it is fundamental that risks to passengers are optimised and that any risk allocated to them is balanced by a clear and commensurate benefit. If this cannot be achieved, the onus must be placed on the airport to redesign its proposed approach.

Long term profit guarantees or advance payments are especially damaging because they increase demand risks and they reduce the airport's incentive to build in an efficient way to meet customer needs and they can generate distorting inter-generational cross-subsidies. Such regulatory intervention would be disproportionate and damaging.

Therefore we agree with the CAA's view that risk cannot be transferred from airports to airlines without clear benefit. Such benefit should be distributed in a way that does not create inefficiency or competitive distortions (inter-temporal or otherwise). In competitive markets, it should be noted that customers do not bear development risks unless they choose to do a commercial deal with the supplier.

The CAA should also take account of the fact that transferring risk to airlines may in fact result in a less efficient outcome for passengers. For example, reducing airport risks by allowing pre-funding could increase total costs to passengers if airline cost of capital is higher than airport cost of capital.

The approach to regulation would need to be adapted to take account of the need to allocate risks in a way that creates the best incentives and produces the best outcomes for passengers.

It would be premature to conclude for either airport that a RAB based approach is not appropriate. It is too early to state a position on this. However, VAA is interested in exploring alternative approaches, such as a separate RAB or special purpose vehicle.

Given the short timeline for responses to this consultation and importance of the issues being considered, we expect to be able to return to the CAA with further thoughts on this ahead of the publication of the autumn policy statement.

We would not expect the CAA to settle on one type of regulatory structure at this stage, but to set out an approach that could accommodate different options (eg RAB based, SPV, hybrid ownership structure, longer control periods etc). As discussed in answer to 4.5 above, the regulatory structure should be designed only after the best risk allocation and incentive structure is assessed.

Chapter 5: Inter-generational issues

VAA believes each user should pay their own costs and not expect a subsidy from other users. Otherwise the demand is unsustainable and should not be catered for.

There should be no pre-funding of airport investments, so users should pay for new infrastructure only once the assets come into use. Pre-funding makes users who are not benefitting from the new infrastructure pay for it- this is fundamentally unfair and anti-consumer. Prefunding may also distort incentives for driving cost efficiency.

While prefunding can smooth costs, other better approaches can and have been used to smooth the impact on user charges. A better approach would be to alter the depreciation profile so that returns reflected the usage of the new runway, which largely removes inter-generational distortions.

Chapter 6: High-level options for the recovery of costs

VAA believes that, in order to meet its primary duty, the CAA needs to ensure that the costs that will ultimately be passed through to passengers are efficient and represent good value for money.

This is an area that warrants urgent consideration by the CAA and Airports Commission. The schemes under consideration have already submitted a high level of information around the design and costs. The airlines are concerned that if the CAA were to scrutinise the costs after a decision is made by the Commission, next summer, this will be too late to influence the design and overall costs and could furthermore introduce a degree of regulatory risk.

Moreover, airlines have had no detailed view of the costs being fed into the Airports Commission process and under the current plans would have no sight of these until the October consultation from the Airports Commission.

Chapter 7: Cost recovery principles and practice

Airlines disagree with the CAA's view that there should be any recovery of costs during Q6. It is not clear why passengers should be funding something that should be carried out at the risk of shareholders, as is the case with the Heathrow Hub proposal.

Moreover, VAA is concerned that the current process could lead to costs of the schemes not being properly scrutinised before they are finalised. A form of Constructive Engagement before a decision is made by the Airports Commission could be one way to overcome this risk and enable the CAA to meet its primary duty.

If Constructive Engagement is to occur, VAA believes that, given its experience in leading a similar process for the Q6 process, the CAA is best placed to run this process and it should be given a mandate by the Airports Commission to do so.

If Constructive Engagement does not occur before a recommendation is made by the Airports Commission, the CAA needs to urgently consider how proper cost scrutiny can occur to enable it to meet its primary duty to passengers.

Chapter 8: Slot allocation

VAA recognise that slot allocation is likely to play an important role in which airlines provide services following the introduction of new capacity. However, the CAA should not assume that any changes can be made to slot rules to allow it to better achieve its objectives.

Chapter 9: The CAA's statutory duties

The CAA's statutory duties, outlined in the Act, should provide the framework for all interventions. While there is no formal role for the CAA in the Airports Commission decision making process, the CAA will clearly have a role in determining a fair price path and regulatory regime (if any) for the successful option, once decided. Moreover, it has a wider primary duty to protect the passenger interest and therefore needs to ensure that the process being carried out will lead to that duty being met. It is clear that the overarching rationale for CAA intervention must be to meet its primary duty to the passenger.

Airlines can see no rationale for changing the primary duty of the CAA. If, for example, infrastructure and investment were prioritised over the passenger, it could lead to sub-optimal and inefficient investments being made.