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9th August 2022

Dear Paul,

Economic regulation of Heathrow Airport Limited: H7 Final Proposals – H7 Price Control Consultation

1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

- 1.1 Thank you for the opportunity to provide comments on the "Economic regulation of Heathrow Airport Limited ("**HAL**"): H7 Final Proposals – H7 Price Control Consultation" (the "**Final Proposals**").
- 1.2 The consultation conducted by the Civil Aviation Authority (the "**CAA**") on its Final Proposals follows the earlier consultation on the CAA's initial proposals published in October 2021 (the "**Initial Proposals**"). Virgin Atlantic Airways ("**VAA**") makes reference where appropriate in this submission to the matters raised in its response dated 17 December 2021 to the Initial Proposals (the "**VAA IP Response**"), which its joint venture partner, Delta Air Lines ("**Delta**"), fully endorsed.
- 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 Final Proposals. 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).
- 1.4 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 2 (Passenger Forecasting) and in the accompanying **Appendix 1**. 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.
- 1.5 VAA recognises that there are a number of areas where the CAA has taken into account the views set out in the VAA IP Response (and the views set out by other airlines in response to the Initial Proposals) which has resulted in a decrease to the price cap. VAA welcomes these changes and supports the amendments to the building blocks which have resulted in the proposed decrease in the price cap.

These amendments go some way to furthering the interests of consumers, in accordance with the CAA's primary statutory duty in this regard.¹

- 1.6 VAA also welcomes the further work which the CAA has undertaken to ensure that the evidential basis for its proposed decision is robust. However, as explained below, there are a number of areas in which VAA remains concerned that the CAA's proposals are not sufficiently evidence-based or reasoned.
- 1.7 In addition, in some of the key substantive areas in the building blocks, VAA believes that the CAA's approach is materially flawed and accordingly ought to be amended to ensure that the CAA is taking a lawful and reasonable decision which adequately protects the interests of consumers.
- 1.8 VAA has been mindful of the limited time available to prepare this response and the late stage of the H7 consultation process. On that basis, in order to assist the CAA to further its statutory duties, in this response VAA has focussed on key aspects of the building blocks where it considers the CAA's Final Proposals merit further adjustment. In doing so VAA has sought both to provide high level comments and work through a 'bottom up' approach based on the best evidence available.
- 1.9 Consistent with this approach, jointly with Delta and British Airways ("**BA**"), VAA has instructed expert economists, AlixPartners ("**AP**"), to provide independent expert views on the matters within their expertise which are set out in the Final Proposals. AP has now produced a report accordingly, titled "*Analysis of the CAA's Final Proposals*", which is appended to this consultation response (the "**AP Report**") as **Appendix 2**.
- 1.10 VAA hopes that the AP Report, together with the matters raised in this response, will assist the CAA to reach an evidence-based decision which is in the interests of consumers. VAA and AP, as appropriate, would of course be pleased to assist the CAA further in this regard, in particular if the CAA has any queries as to the matters raised.
- 1.11 VAA considers it important to emphasise the overall context in which this price control is being conducted. VAA outlined in Section 1 of the VAA IP Response, the significant increase in the H7 price control already being proposed and the impact of the pandemic on the aviation industry. Those points, along with the other matters raised in that section of the VAA IP Response (such as in relation to HAL's financeability), remain valid and it will be important that the CAA continues to take them into account. To those matters VAA would now add reference to:
 - 1.11.1 The failure of HAL to plan its resources adequately for the entirely foreseeable recovery of consumer demand following the lifting of pandemic-related restrictions on travel. The CAA will be well aware of the ways in which this failure has manifested itself in operational disruption in the recent past leading to poor results for consumers. VAA has in mind in particular HAL's well publicised baggage failings and its recent decision to cap daily passenger numbers, in no small part as a result of its own resource constraints. As explained below, the CAA must take these issues into account when setting the price control. At a high level, it simply cannot be in the interests of consumers to allow HAL to profit from its failings in this regard (for instance by artificially depressing passenger numbers for 2022, perhaps in the hope that the CAA would correspondingly increase the price cap). The CAA must make its decision on the basis that the airport is being efficiently run. Otherwise there is no incentive (in the short term at least) for HAL to seek to operate its airport efficiently. More generally it would be perverse for HAL to benefit from its own inefficiencies.

¹ Section 1(1) of the Civil Aviation Act 2012.

- 1.11.2 The approach which HAL takes to interacting with airlines and taking their views (and, by extension, the views of consumers) into account. VAA is particularly concerned at HAL's approach to its Conditions of Use, which is the contractual framework on which the relationship between HAL and airlines is founded. Those Conditions of Use are an entirely one-sided set of obligations on airlines which are not the product of a negotiation and which do not reflect any form of commercial agreement between parties. This is all in a context where, as the CAA states in its Final Proposals, "*left unconstrained, [HAL's] market power has the potential to damage the interests of consumers*".² While VAA recognises that the terms of the Conditions of Use are not a matter which the CAA envisages focussing on as part of its H7 price control, this issue is an important part of the background. It illustrates VAA's concerns that, left unchecked, HAL behaves as a true monopolist, acting with apparent impunity to the detriment of airlines and consumers alike.
- 1.12 It will be apparent from the matters set out in this response that VAA considers that the CAA ought to depart from the price cap which it proposed in its Final Proposals. However, in any event, the timescale envisaged by the CAA for a final decision may indeed prove unachievably short, given VAA's contention that the HAL model should be opened to scrutiny by the airlines if the CAA proposes to continue to rely on it, and that further research should be commissioned by the CAA. In connection with this, VAA notes that, in its Final Proposals,³ the CAA states that "*the effect of section 22(7) CAA12 is to require us to re-consult before making a licence modification if the modification "differs significantly" from that proposed in these Final Proposals*". While VAA agrees with the CAA's observation about the need for re-consultation in these circumstances, VAA considers that a delay will likely be required in any event. VAA would urge the CAA to prioritise coming to the most robust and reasonably evidenced decision, over concerns in relation to any further delay.
- 1.13 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 Chapters in the CAA's Final Proposals.

Executive Summary

- 1.14 As noted above, VAA recognises that the price cap which the CAA now proposes is lower than the excessively high figure put forward in the Initial Proposals (which the CAA proposes to retain in place for 2022). However, it remains unsatisfactory.
- 1.15 In view of the matters set out below, an appropriate price cap for the H7 price control period is £18.31. This figure is reached by inputting the changes which VAA sets out below to the CAA's building blocks (as explained in Section 12 of this response). This figure is reasonable, proportionate, and based on the best evidence available. It also remains at a level which is financeable for HAL.
- 1.16 While VAA summarises below the detailed points which it makes on the individual Chapters of the Final Proposals, there are two particular cross-cutting issues which VAA wishes to emphasise.
- 1.17 First, once the building blocks are considered holistically, VAA is concerned that the cumulative effect of the various risk mitigation mechanisms proposed is to provide duplicative and overlapping levels of protection. This proposal would lead to HAL operating a business which is, in important respects, risk-free and from which it will continue to generate monopoly profits.

² CAA's Final Proposals, Summary, page 9, paragraph 27.

³ CAA's Final Proposals, Summary, page 30, paragraph 111.

1.18 Secondly, although this is an issue which the CAA touches on in the Final Proposals, VAA is concerned at the level of information asymmetry between the airlines and HAL which means that, in many respects, the airlines are not able to provide robust challenge to the positions put forward by HAL. This manifests itself most obviously in passenger forecasting (where VAA is very disappointed that the CAA continues to rely on HAL's model despite HAL having refused to provide it to airlines) but also arises in other areas (e.g. capital expenditure, operational expenditure, and commercial revenues). This modus operandi has also been evident this summer where HAL has failed to provide underlying data to airlines to justify enforced capacity restrictions. The consequence of this information asymmetry is that it was incumbent on the CAA to interrogate adequately HAL's proposals, but VAA is concerned that in material respects it has failed to do so.

1.19 By way of overview of the sections which follow:

1.19.1 **Section 2 – Passenger Forecasts:** For the reasons set out below, VAA remains of the view that the passenger forecasts relied on by the CAA in its Final Proposals are unrealistically pessimistic. The most stark example is in relation to the CAA's 2022-2023 forecast, which fails to take into account actual volumes for the year to date and reliable data for the months ahead (and which are lower than they would have been had HAL not put in place its current capacity restrictions). The unrealistic nature of the forecasts is also a problem for the remainder of the H7 period and VAA is particularly concerned that the CAA relies too heavily on HAL's forecast (which has not been disclosed and has thus been insulated from scrutiny and challenge). There is an alternative, and preferable, approach which the CAA should instead adopt, as set out below and as explained in Section 3 of the AP Report. VAA has put forward a more realistic forecast for the H7 period which is robust and evidence-based and which VAA urges the CAA to adopt.

1.19.2 **Section 3 – Traffic Risk Sharing ("TRS"):** VAA opposes the proposed TRS mechanism because it is unnecessary and would further add to the disproportionate protection afforded to HAL. VAA endorses AP's analysis of the proposed mechanism and its implementation in this respect. This demonstrates that (i) the proposed TRS mechanism has an asymmetric impact between the under-forecast scenario and the over-forecast one, (ii) the risk sharing rate of 105% proposed for the outer band is based on insufficiently robust calculations and could have severe unintended consequences for HAL's incentives to promote growth and recovery, and (iii) the CAA has not adequately assessed the impact of the TRS on the airlines. This cumulatively leads to proposals that are adverse to the interests of consumers. A model demonstrating an example of how this could lead to disproportionate protection of HAL is found at **Appendix 3** of this response. VAA therefore proposes that if the CAA is to retain its proposals to introduce a TRS mechanism, it should (i) implement risk sharing of 60%/40% to accommodate for the asymmetric impact of the mechanism on airlines as compared to HAL, (ii) drop the outer band rate of risk sharing, and (iii) holistically consider the impact of the increased risk to airlines, particularly in light of the other risk mitigating mechanisms which have been built into the Final Proposals and would transfer risk from HAL to the airlines. The CAA should consider this in light of its overarching duty to consumers. Finally, VAA proposes that the period of recovery of any TRS payments should be reduced from 10 years to 5 years and that the CAA should consider whether or not it can deliver adjusted charges sooner than two years.

- 1.19.3 **Section 4 – Allowance for Asymmetric Risk:** The introduction of the proposed additional allowance for asymmetric risk is unnecessary and over-protects HAL in light of other risk mitigation mechanisms. When taken together, the CAA's Final Proposals introduce excessive risk mitigation measures which transfer an unprecedented and disproportionate share of risk to airlines. This is not in the interests of consumers. Instead, the CAA should take a holistic view (across not only asymmetric risk but other building blocks including the proposed TRS mechanism, passenger forecasts and the WACC) as to the impact of the risk mitigations it has proposed. Taken together these measures provide disproportionate protection to HAL in the event of any shock that occurs during the course of the H7 control period, including pandemic-magnitude events. As to the overlapping nature of the protections, VAA urges the CAA to reconsider the annual shock factor and allowance for asymmetric risk in light of the additional protections offered by the proposed TRS mechanism, the calculation of the asset beta within the WACC and passenger forecasts. Further, VAA endorses the points made in the AP Report as to the annual shock factor and the fact that clear evidence has not been provided by the CAA in relation to whether these shock factors are properly justified.
- 1.19.4 **Section 5 – Weighted Average Cost of Capital ("WACC"):** VAA welcomes certain of the CAA's adjustments to the key parameters of the WACC (i.e., the asset beta and cost of debt). However, VAA agrees with the expert analysis set out in the AP Report that the CAA has made certain errors in relation to its approach/methodology in light of the evidence available and has also failed to take into account key considerations on specific aspects of the WACC such as the impact of the TRS mechanism on the asset beta. VAA therefore urges the CAA to reconsider its approach in these aspects in light of the AP Report. VAA endorses AP's conclusion in relation to a Vanilla of 2.37% and a pre-tax real WACC of 2.65%.⁴
- 1.19.5 **Section 6 – Operational Expenditure ("Opex") and Commercial Revenues:** VAA supports the expert view expressed in the AP Report that there are fundamental issues with the CAA's approach to both opex and to commercial revenues. VAA agrees with AP in its analysis that there is a distinct lack of transparency in respect of evidencing the proposals. VAA is also concerned about the adjustments made to the CEPA/Taylor Airey ("CTA") figures in relation to commercial revenues, and is concerned about the unilateral nature of any decision to increase the Terminal Drop-Off Charge ("TDOC") above 10%.
- 1.19.6 **Section 7 – Capital expenditure ("Capex") and Capital Incentives:** VAA considers that the CAA continues to place undue weight to HAL's proposals in relation to both the capital envelope and the balance of capital within the envelope, despite its concerns (which VAA shares) as to the quality of HAL's capex plans. VAA has serious concerns that the proposed capital envelope award process is skewed towards projects which favour HAL as a priority and that some projects have been mischaracterised.
- 1.19.7 **Section 8 – Outcome Based Regulation ("OBR"):** VAA supports, in principle, the move to a framework that is based on developing a set of outcomes with associated measures and targets. However, VAA is disappointed at the CAA's proposed approach on OBR implementation. Despite extensive engagement by VAA, the CAA's OBR proposals fail to engage or do not

⁴ AP Report, paragraph 10.4.7.

properly take into account the detailed submissions which VAA (as part of the airline community) has previously made. VAA is also concerned that the CAA has failed to adequately justify its approach to certain aspects of OBR. Prior to a final determination being reached, VAA expects the CAA to undertake further work on this issue and provide a clearer rationale for its proposals. This issue is of particular importance in light of the recent failings by HAL to deliver an adequate level of service, including (but not limited to) in relation to baggage and security, which demonstrates the importance of service standards to consumers.

- 1.19.8 **Section 9 – Other Regulated Charges ("ORC"):** VAA agrees that the fixed costs, allocated costs and costs for check-in facilities, IT, heating and gas should be reallocated from the ORC cost base to the regulated airport charge. Consistent with the CAA's Final Proposals, and with the CAA's movement to a marginal cost-based approach, VAA does not support the reallocation of those elements of business rates to aeronautical charges that are solely related to non-airline parties to the ORC cost base; these should be retained in the ORCs.
- 1.19.9 **Section 10 – Regulated Asset Base ("RAB") Adjustment:** VAA welcomes the CAA's conclusion in the Final Proposals not to make any additional adjustment to the RAB, but is disappointed at the conclusion not to reverse the £300 million adjustment, particularly in light of recent events whereby HAL has unilaterally acted to restrict the capacity of airlines due to its failure to put in place sufficient resources and/or to build adequate resilience within its infrastructure to meet passenger demand. Notwithstanding the above, VAA acknowledges the CAA's comments that it will undertake a review of the validity of the £300 million RAB adjustment if it considers it appropriate to protect the interests of consumers. VAA urges the CAA to commence this review in the interests of consumers, to complete its assessment before the CAA's Final Determination is taken, and to publish its decision to provide clear accountability and transparency to consumers.
- 1.19.10 **Section 11 – Financeability:** VAA agrees with the CAA's assessment in its Final Proposals that the proposed price cap will be financeable from both a debt and equity financeability perspective, and sets out comments regarding the CAA's approach to financeability and the profile of charges. VAA is satisfied that the alternative price cap proposal as outlined at Section 12 below is financeable in the longer term.
- 1.19.11 **Section 12 – Alternative price cap proposal:** As indicated above, in this Section VAA draws together the matters which are identified in this response and the AP Report in order to illustrate the effects of those proposals on the price cap. VAA considers that the proposed price cap set out in this Section and modelled in **Appendix 4**, which represents a modest reduction from the figures proposed by the CAA, should be adopted.

2. PASSENGER FORECASTING

- 2.1 This section responds to Chapter 1 of the CAA's Final Proposals, which concerns passenger forecasts.
- 2.2 As VAA noted at the Initial Proposals stage, accurate passenger forecasting is pivotal in achieving the ultimate proper pricing calculation, and the effect of that pricing calculation on consumers. VAA agrees with the CAA's observation in its Final Proposals that *"developing appropriate forecasts of passenger numbers is a*

fundamental step in allowing us to properly discharge our statutory duties, including furthering the interests of consumers".⁵

- 2.3 VAA also agrees with the CAA that the passenger forecast "remains at the core for setting an appropriate price control".⁶ notwithstanding the risk sharing mechanisms which the CAA proposes to put in place.
- 2.4 VAA recognises that (i) the Final Proposals provide for higher passenger forecasts than those set out at the Initial Proposals stage, and (ii) the CAA has said that it has placed materially less reliance on the forecast and model provided by HAL than at the Initial Proposals stage, instead drawing on a range of other sources. VAA welcomes these developments but, as explained below, remains concerned that the passenger forecasts used by the CAA are both insufficiently robust and unduly pessimistic. VAA also has concerns about the lack of quality assurance undertaken by the CAA in relation to the Final Proposals.
- 2.5 VAA's primary concern with the CAA's approach is that the CAA continues to rely heavily on HAL's model yet has not disclosed it to airlines. VAA does not consider that this is an appropriate manner in which to proceed. It should instead base its decision on the robust and evidence-based passenger forecasts which VAA puts forward in **Appendix 1**. In the event that the CAA continues to rely on HAL's forecast, in the interests of fairness and in order to permit scrutiny it ought to be disclosed to airlines without further delay, with sufficient time provided for proper consideration of such information.
- 2.6 In the remainder of this Section, VAA:
 - 2.6.1 Outlines its concerns with HAL's recent actions which have had the effect of artificially depressing passenger numbers;
 - 2.6.2 Explains its substantive response to the "weaknesses" identified by the CAA with the passenger forecast put forward in the VAA IP Response;
 - 2.6.3 Considers in more detail the concern which it has about overreliance on HAL's model; and
 - 2.6.4 Urges the CAA to engage in robust quality assurance.
- 2.7 In putting forward its views as set out below, VAA has been informed by the work of AP, who consider passenger forecasting in detail in Section 3 of the AP Report.

HAL's recent actions

- 2.8 By way of initial comment, it is necessary to address recent actions taken by HAL which have had the effect of unilaterally reducing capacity to an artificially low level in view of passenger demand (and the ability of airlines such as VAA to service that demand).
- 2.9 HADACAB (Heathrow ATM Demand and Capacity Balancing) and latterly, Local Rule A ("**LRA**") restrictions have been imposed on airlines since June 2022 leading to a requirement on VAA to cancel dozens of flights affecting thousands of passengers. Most acutely, on 11 July 2022, HAL took the unilateral decision to enforce capacity restrictions on airlines flying out of London Heathrow Airport ("**LHR**") under LRA, effective from 25 July 2022. Moreover, at the Joint Steering Board ("**JSB**") held between representatives of airlines and HAL on 3 August 2022, HAL informed the JSB that it was minded to further extend the implementation of LRA for a further period, until 29 October 2022. As noted in paragraph 2.12 below, there have also been

⁵ CAA's Final Proposals, Section 1, Chapter 1, page 5, paragraph 1.2.

⁶ CAA's Final Proposals, Section 1, Chapter 1, page 5, paragraph 1.4.

indications in public comments made by HAL that it may seek to extend the imposition of these restrictions for a year or more.

- 2.10 The capacity reductions imposed by HAL have had, and will continue to have, significant effects on actual passenger number data. The effect of HAL's actions is to limit daily seat capacity to 100,000 seats per day, a material decrease from an average capacity of more than 120,000 seats. This decrease artificially and dramatically skews the actual passenger numbers downward. The CAA must act to ensure that the H7 passenger forecast is reflective of the potential traffic flow through the airport as opposed to the current actuals which result from the artificially constrained capacity which HAL has imposed.
- 2.11 VAA and other airlines have repeatedly expressed to HAL the concern that HAL's plans to resource LHR in line with a pessimistic passenger forecast could be detrimental to consumers. The data and flying schedule which underpins the VAA IP Response was shared with HAL at a similar time as they were shared with the CAA (as part of the VAA IP Response) in December 2021. HAL responded to VAA that VAA's 2022 passenger forecast was overly optimistic and HAL otherwise failed to engage with airlines' concerns about its resourcing plans. In calculating the overall passenger forecast for H7, the CAA should prevent HAL from benefitting from its own self-interested actions (which are not aligned with the interests of consumers) in this way, i.e. limiting the available capacity at the airport with the object and/or effect of skewing passenger data downward for its own financial benefit.
- 2.12 VAA is concerned that public statements made by HAL's Chief Executive Officer indicate that, without intervention from the CAA, HAL may seek to keep a capacity cap in place for at least a further year.⁷ VAA is further concerned that such comments might have the effect of discouraging customers against travelling from LHR in 2022 and 2023 and serve only to further dampen the already-restricted demand.
- 2.13 Overall, VAA urges the CAA to:
 - 2.13.1 Take decisive action in regulating HAL to ensure that enforced capacity restrictions are lifted at the earliest opportunity.
 - 2.13.2 Refrain from factoring into its passenger forecasts either capacity reductions imposed by HAL or a dampening of demand reasonably attributable to HAL's actions and public statements. HAL's actions adversely affect the use of the airport, which in turn cascades into a detrimental effect to consumers.
 - 2.13.3 Ensure that, in calculating the overall passenger forecast for H7, it prevents HAL from benefitting from its own self-interested actions (which are not aligned with the interest of consumers), i.e. by limiting the available capacity at the airport in order to skew passenger data downward. VAA's concern in this regard is that throughout the H7 process, HAL has repeatedly projected a pessimistic passenger forecast which has the ultimate effect of keeping the maximum allowable yield high, and in HAL's favour.
- 2.14 To an extent, the CAA has recognised the forecast proposed by HAL as unduly pessimistic. However, HAL's actions to restrict capacity through spring and summer 2022 (actions which, on many levels, are not in the consumer interest) risk making it a self-fulfilling prophecy.

⁷ Oliver Gill, [The Daily Telegraph, "Heathrow Chief ignored airline warnings about summer travel surge" \(15 July 2022\)](#); Oliver Gill, [The Daily Telegraph, "Holidaymakers face another summer of disruption, Heathrow chief admits" \(26 July 2022\)](#)

The CAA's views on the forecast put forward by VAA at the Initial Proposals stage

- 2.15 In paragraph 1.30 of the CAA's Final Proposals, the CAA identifies three "weaknesses" with the forecast which VAA put forward, the thrust of which are that the forecast was an overestimate. The CAA described these "weaknesses" as being:
- 2.15.1 Airlines not having fulfilled all the flights which they had scheduled at the start of 2022, and load factors not being at 2019 levels in the early part of 2022.
 - 2.15.2 The AOC/LACC forecast being primarily derived from the Eurocontrol forecast, where this forecast represents the number of flights in UK airspace, as opposed to the number of passengers using those flights.
 - 2.15.3 The Eurocontrol forecast including UK overflights, and not being directly relevant to LHR traffic or passenger numbers.
- 2.16 VAA does not agree with the CAA's assessment of the weaknesses it states that it has found in the AOC/LACC forecasts.
- 2.17 The airlines' forecast has performed well against actual passenger numbers⁸ and, although those figures may have fallen marginally short of the forecast due to the shocks such as the impact of the Omicron variant, this forecast relative to actual figures nonetheless performed better than performance of the actuals against the CAA's published forecast, and on which the CAA relies in its Final Proposals. Had VAA not been prevented by HAL from flying all its services through 2022, VAA would be extremely close to delivering its passenger forecast from LHR. As 2022 has developed, passenger demand has come increasingly close to matching to the estimates put forward by airlines including VAA at Initial Proposals stage. This is shown at **Figure A** below.

Figure A – Current LHR Passenger Recovery⁹

	Capacity (m)	Pax (m)	Recovery vs 2019	"LF"
Jan-21	2.01m	0.68m	11%	34%
Feb-21	1.25m	0.46m	8%	37%
Mar-21	1.45m	0.54m	8%	37%
Apr-21	1.55m	0.54m	8%	35%
May-21	1.82m	0.68m	10%	37%
Jun-21	2.25m	0.96m	13%	43%
Jul-21	3.01m	1.51m	19%	50%
Aug-21	3.58m	2.23m	29%	62%
Sep-21	4.15m	2.57m	38%	62%
Oct-21	4.76m	3.04m	44%	64%
Nov-21	4.77m	3.07m	49%	64%
Dec-21	5.27m	3.12m	47%	59%
Jan-22	4.69m	2.60m	44%	55%
Feb-22	4.32m	2.86m	52%	66%
Mar-22	5.84m	4.20m	64%	72%
Apr-22	6.99m	5.08m	75%	73%
May-22	7.30m	5.34m	79%	73%
Jun-22	7.38m	5.99m	83%	81%

- 2.18 Indeed, applying the load factors achieved during Q2 for the remaining year, and based on capacities before forced cancellations and changed slot rules, the 2022

⁸ <https://www.heathrow.com/company/investor-centre/reports/traffic-statistics>

⁹ Figure A shows available seat capacity and actual passenger data from January 2021 to June 2022 with a calculated load factor and a 'recovery percentage' versus the same month in 2019, for all airlines.

passenger numbers would be 66.2 million. As a result, the airline forecast exceeds actuals by only 13%, despite the effects of the Omicron variant.

- 2.19 Further information, in particular 2022 actual data, in support of VAA's submission in relation to passenger forecasting is attached at **Appendix 1**.¹⁰

The CAA's overreliance on HAL's forecasting model

- 2.20 VAA remains of the view that it would be preferable for the CAA to have developed its own model. From a procedural perspective, VAA has particular concerns that the CAA continues to place significant weight on the forecasts provided by HAL in circumstances where HAL's model has still not been provided to airlines. These concerns are endorsed in the AP Report as explained below. VAA notes that, on behalf of the airlines including VAA, BA wrote to the CAA to request sight of this model on 20 July 2022 (and in that letter also sought a number of related clarifications). Regrettably VAA understands that no response has been provided by the CAA. VAA once again requests sight of this model. Without it, consultees remain unable to provide informed comments on a material aspect of the information on which the CAA proposes to rely.
- 2.21 AP have independently considered the Passenger Forecasting section of the Final Proposals in Section 3 of the AP Report.¹¹ Sections 3.2 to 3.4 summarise AP's understanding of the background to the H7 Consultation, Section 3.5 summarises AP's views on the improvements that the CAA has made since the Initial Proposals stage, and Section 3.6 explains the discrete areas of the Final Proposals which AP considers "raise concerns".
- 2.22 While it is essential that the CAA considers the AP Report in full, the "*material shortcomings*"¹² that it identifies in the CAA's approach to passenger forecasting include, in particular:
- 2.22.1 Continued overreliance on HAL's projections;
 - 2.22.2 Insufficient weight being given to external forecasts; and
 - 2.22.3 Arbitrary adjustments being made to account for industry risks.
- 2.23 The AP Report at paragraphs 3.4.4 to 3.4.8 outlines specific points which should be noted in relation to use of HAL's model. VAA supports the views put forward by AP (in the AP Report at Section 3.5) that some of the adjustments made to the HAL model are appropriate and sensible. However, VAA considers that these adjustments do not go far enough, as set out in Section 3.6 of the AP Report.
- 2.24 It is important to bear in mind that, if VAA were given access to HAL's model, in conjunction with AP, additional comments could be provided on a more informed basis. Without access to the model, VAA is unable to say what these comments might be. This is particularly unfair given that VAA disclosed the data and flight schedule on which its own forecast was based (as noted at paragraph 2.11, above). HAL therefore had the opportunity to interrogate and to comment on that forecast, which may have included interrogating assumptions on Covid-19 travel restrictions, passenger connectivity and the relationship between load factors and fare levels.
- 2.25 VAA also notes the AP Report's views as to overreliance on HAL's model. The issues created by HAL's ability to limit capacity for air travel are flagged at paragraph 3.6.10 of the AP Report.

¹⁰ This Appendix has been omitted from the copy of the joint response submitted by Delta because it contains information which is confidential to VAA.

¹¹ VAA notes that while Section 3 of the AP Report includes commentary and analysis related to asymmetric shock adjustments, VAA discusses this in the Allowance for Asymmetric Risk section of its response at Section 4.

¹² AP Report, paragraph 3.6.1.

- 2.26 The AP Report considers at paragraph 3.6.26 that "most of the CAA's deviations from the amended HAL RBPu2 model come from an arbitrary qualitative discussion. Therefore, the CAA final estimates are either driven by HAL's model, which are subject to HAL's incentives to under-estimate passenger volumes as described in the previous section, or by an arbitrary process, aiming to qualitatively measure factors that the CAA asserts are "not practicable to quantify", without any expert input or an appropriate model."
- 2.27 Insofar as the CAA has made adjustments to HAL's forecasting model, VAA endorses these criticisms. VAA urges the CAA to consider the AP Report at paragraphs 3.6.8 to 3.6.10 in respect of this and to give a greater level of credence to the forecasts offered by VAA as part of this submission.
- 2.28 Additionally, while VAA agrees with the CAA's general approach to "take into account a range of views and evidence before using our judgement to synthesise a passenger forecast for these Final Proposals",¹³ it has two principal concerns with this approach.
- 2.29 Firstly, VAA endorses the observations in paragraphs 3.6.17 to 3.6.23 of the AP Report as to the limited weight which the CAA has placed on such external forecasts. The result was only a marginal change in the CAA projections, for 2022 only.
- 2.30 As AP sets out in the AP Report, the adjustments made by the CAA were manual and ad hoc, which reflect its perception of industry risks instead of relying on external forecasts, and qualitatively considering a series of risks. The lower and upper bounds are ultimately derived from HAL's amended model with little, if any, input from independent forecasts.
- 2.31 Secondly, VAA considers that a different approach should be taken for the immediate/short term in 2022 and H2 2023. Given the data which is available for this period (e.g. on sale capacities) and the ability to devise accurate granular assumptions (for example as to seat load factors), a more bottom-up approach should be taken to this period. VAA has now undertaken this task and **Appendix 1** provides further details on this exercise.

Quality assurance

- 2.32 The CAA at paragraph 1.23 of Final Proposals notes that, "Forecasting future trends in business travel is very challenging given current uncertainties and we note that stakeholders have expressed wide-ranging views on this topic. We have sought external advice from Skylark on this complex issue."¹⁴
- 2.33 VAA agrees with the premise of the CAA's report that "quality assurance" is important. That is particularly so in circumstances where a range of views have been expressed.
- 2.34 However, VAA is concerned that Skylark's work is light touch and insufficient for these purposes. In particular, the Skylark June 2022 report, "Expert Review of the CAA Approach to H7 Traffic Forecasting" notes that "Skylark does not offer a view on the correctness of the outturn forecast values other than at a very high level, nor has it reviewed or audited the model(s) used to produce those values".¹⁵ Therefore, it is noted that the actual work results and work steps from the CAA's conclusions on business trends have not been audited by an independent body.
- 2.35 While VAA has (in conjunction with AP) done what it can to point out apparent issues, clearly VAA is limited in what it can say about the specifics of the CAA assessment because it has not had access to HAL's model.

¹³ CAA's Final Proposals, Section 1, Chapter 1, page 16, paragraph 1.33.

¹⁴ CAA's Final Proposals, Section 1, Chapter 1, page 12, paragraph 1.23.

¹⁵ Skylark report, "Expert Review of the CAA Approach to H7 Traffic Forecasting", dated June 2022, page 3.

2.36 In the circumstances VAA urges the CAA to conduct a more robust quality assurance process.

3. **TRAFFIC RISK SHARING**

3.1 This Section responds to the CAA's Final Proposals on a TRS mechanism at Section 1, Chapter 2. The CAA's Final Proposals retain the proposal to introduce a TRS mechanism and make further proposals as to the implementation of such a mechanism.¹⁶ While VAA could support the principle of risk sharing, VAA strongly opposes the TRS mechanism proposed by the CAA in its Final Proposals.

3.2 By way of overarching comment, VAA reiterates its comments in the Allowance for Asymmetric Risk section at Section 4 of this response, that the TRS mechanism and protection that it offers HAL must be considered in light of other aspects of the Final Proposals which are designed to protect HAL from the consequences of shock events. In light of these other protections for HAL as contained in the Final Proposals, VAA maintains its view that the TRS mechanism, as proposed, is unnecessary and would further add to the disproportionate protection of HAL. The protection given by the proposed TRS mechanism goes far beyond what HAL has received or required in previous price controls. In particular, VAA considers that the level of protection proposed in the Final Proposals in relation to the risk sharing for the outer band of the TRS, effectively removes any incentive for HAL management to mitigate downturns in traffic.

3.3 In the VAA IP Response at paragraphs 3.31 – 3.35, VAA outlined the reasons for which it strongly opposed the TRS mechanism as proposed at that time. These reasons were as follows (i) the TRS mechanism had not been taken into account to result in a reduction to the WACC, and (ii) given the CAA's pessimistic forecasts the TRS mechanism would result in a disproportionate amount of compensation to HAL, in the event that those forecasts turned out to be wrong. While VAA welcomes that the CAA has to some extent addressed these issues in the Final Proposals, it believes that further adjustment should be made in relation to the WACC and passenger forecasts. In particular:

3.3.1 In relation to passenger forecasts, the introduction of TRS insulates HAL from any deviation from the forecast. As currently proposed, the pessimistic passenger forecast works disproportionately in HAL's favour given that it results in a higher price control which is adverse to the interests of the consumer. Further detail on the passenger forecasts and the fact that they should in any event be higher based on independent forecasts is found at Section 2 of this response. While VAA expects the CAA to arrive at a forecast based on the best evidence available and robust analysis (as set out in Section 2, VAA also urges the CAA to view the forecast in light of other proposals for the building blocks, and in particular the fact that the proposed TRS mechanism (if it is to be retained), should mitigate risk of unexpected variations from such a forecast. Notwithstanding VAA's opposition to the TRS mechanism, if the CAA is to continue with the introduction of such mechanism, then the CAA can afford to take a more optimistic view of the passenger forecast in light of the fact that a proper TRS mechanism is designed to appropriately apportion risk should forecasts not eventuate due to a shock event.

3.3.2 In relation to the WACC, VAA would invite the CAA to make a further downward adjustment in light of the TRS mechanism in addition to correcting

¹⁶ CAA's Final Proposals, Section 1, Chapter 2, pages 38 - 39, paragraph 2.35.

the passenger forecast in line with paragraph 3.3.1 above. This is addressed in further detail at Section 2 of this response.

- 3.4 In addition to the overarching comments made above in relation to the TRS mechanism, VAA strongly opposes the proposed implementation of the TRS mechanism as contained in the Final Proposals. In this respect, the TRS mechanism within the Final Proposals is considered in the AP Report at Sections 1.3 and 4. In particular, Section 4.3 identifies the changes that AP consider enhance the effectiveness of regulation and Section 4.4 identifies the aspects of the proposed TRS mechanism which AP consider raise concerns. This concern is principally that *"in its current form, the TRS mechanism described by the CAA leads to:*
- 3.4.1 *an asymmetric impact between the under-forecast scenario and the over-forecast one;*
 - 3.4.2 *significant risk of unintended consequences from mis-calibration of the sharing factor in the outer band, whereby HAL could have limited incentives (or even negative incentive) to promote recovery".*¹⁷
- 3.5 Ultimately, AP states that *"the CAA has not adequately assessed the impact of the TRS on airlines and passengers."*¹⁸
- 3.6 VAA strongly endorses the independent expert views set out by AP in relation to the proposed TRS mechanism and would urge the CAA to carefully consider them. In particular, VAA would reiterate the views set out at Section 4.4 of the AP Report in relation to the way the currently proposed TRS mechanism raises concerns. Further detail as to these points is outlined below and should be read alongside the AP Report.

The asymmetric impact of the proposed TRS mechanism is to the detriment of consumers

- 3.7 In its Final Proposals, the CAA stated that the TRS mechanism is *"designed to ensure that the risks associated with variances between our forecast of passenger numbers and out-turn passenger numbers are shared between HAL and consumers in an appropriate way"*.¹⁹ Upon detailed consideration of the TRS mechanism proposed and in light of the evidence that has arisen so far from the Covid-19 pandemic, VAA considers that the mechanism proposed does not share risks in an appropriate way between HAL and consumers and would in fact have a disproportionate and asymmetric impact on airlines as compared to HAL, to the adverse effect of consumers. This asymmetric impact is outlined in further detail in the AP Report at paragraphs 4.4.2 – 4.4.6.
- 3.8 VAA considers that the TRS mechanism proposed could in reality present a mechanism by which the likelihood that HAL will receive excessive gains in a 'downside' shock event would be far greater than the likelihood of any gains to be received by airlines in an 'upside' scenario. This is evidenced by the CAA's own model used to calculate potential gains and losses under the proposed TRS mechanism. Using the CAA's own model, in a 'downside' scenario, the currently proposed TRS mechanism could lead to potential gains to HAL of up to £3.4 billion.²⁰ The worked example of this model is found at **Appendix 3** of this response. This £3.4 billion would represent a sum greater than that of the additional £2.5 billion RAB adjustment which HAL sought for the H7 period and which the CAA has considered is not justified. The CAA should also bear in mind that in this context, any benefit to consumers by virtue of a lower WACC as outlined in the Final Proposals, when properly adjusted for the

¹⁷ AP Report, paragraph 4.4.1.

¹⁸ AP Report, paragraph 4.4.1.

¹⁹ CAA's Final Proposals, Section 1, Chapter 2, page 31, paragraph 2.3.

²⁰ This is modelled on the scenario where impact similar to the Covid-19 pandemic occurs for 3 years, followed by a 1-year delay in traffic growth.

TRS mechanism as proposed in this response, only returns £0.7 billion to consumers per annum in lower charges. The balance of the TRS as proposed, particularly when coupled with further risk mitigation mechanisms, such as the asymmetric risk allowance, is inconsistent with any existing precedent and disproportionate when considering the CAA's duty towards consumers.

- 3.9 The CAA states that it considers the proposed TRS mechanism "*to be in consumers' interests as... it will reduce the risk of significant gains or losses for HAL that could arise from changes in passenger numbers over which it only has limited control*".²¹ However, a key and relevant factor which the CAA's Final Proposals appear to have failed to take into account relates to the asymmetric impact of the TRS mechanism in practice, given the capacity constraints which HAL is able to impose on airlines, which has the effect of HAL limiting passenger numbers. This point in relation to HAL's ability to distort forecasts is considered at paragraphs 3.6.10 and 4.4.2 of the AP Report.
- 3.10 By way of further detail, as the CAA will be aware, during the months of July and August 2022, HAL has implemented restrictions on airlines' flight capacity in large part due to its inability to resource increased air travel demand. HAL has taken this decision unilaterally, and this issue is ongoing. However, it also poses a threat to passenger traffic gains in the foreseeable future whenever HAL encounters similar resourcing issues or potentially other issues which mean it is unable to cope with rising demand. Clearly, such actions will have a direct impact on whether the passenger forecasts used by the CAA can be exceeded by airlines. HAL has demonstrated it does not have the capability to be flexible enough to meet upturns in demand in the near to medium term, rendering the TRS as proposed, inherently imbalanced.
- 3.11 VAA and other airlines predict a return to pre-Covid-19 pandemic levels of passenger demand in 2023. However, the ability of HAL to impose capacity restrictions means that any 'upside' scenario could have limited benefits for the airlines; the restrictions could severely impair the ability of airlines to exceed forecasts by 10% and thereby access gains under the TRS mechanism in such an 'upside' scenario. In contrast, even in the event that there is the expected return to pre-pandemic demand, HAL's ability to impose capacity restrictions could mean that a 'downside' scenario is more likely to occur than any upside scenario under the TRS mechanism. In that 'downside' scenario HAL is excessively protected from negative shocks and could recover 105% of its costs according to the Final Proposals which have increased the risk sharing factor for the outer band from 90-100% in the Initial Proposals.²² VAA further addresses this outer band below.

Unintended consequences of the outer band

- 3.12 As outlined in further detail in the AP Report, the 105% rate appears to have been based on assumptions that are insufficiently robust and the CAA appears to have failed to properly take into account the analysis of the CAA's own independent experts, Deloitte, who reviewed the TRS mechanism. VAA would reiterate the quote from Deloitte in the AP Report that given the uncertain assumptions in calculating a robust risk sharing rate for the outer band, "*It is therefore possible that the outcomes (e.g. in respect of HAL's revenue, EBITDA and airport charges) could be materially different to those currently forecast by the CAA (and potentially not as desired). This could result in HAL being over-compensated or under-compensated through the TRS, potentially significantly.*"²³ Notwithstanding this analysis from its experts, the CAA

²¹ CAA's Final Proposals, Section 1, Chapter 2, pages 38-39, paragraph 2.35.

²² CAA's Final Proposals, Section 1, Chapter 2, page 42, paragraphs 2.43 – 2.44.

²³ AP Report, paragraph 4.4.7.

in its Final Proposals has opted to increase the risk sharing rate for the outer band, leaving "insufficient margin for error".²⁴

- 3.13 The CAA's calculations as to an outer band risk sharing rate of 105% fails to provide incentives for HAL to achieve cost efficiency and will likely act to disincentivise HAL to take actions to facilitate traffic growth if it is able to achieve more than full recovery in the event of a 'downside' scenario. Such an approach would be adverse to the interests of consumers and as stated by AP, the "miscalibration will have severe consequences on HAL's incentives to promote recovery".²⁵
- 3.14 In addition, as outlined in further detail at paragraphs 4.4.10 - 4.4.11 of the AP report, this level of risk sharing in the outer band has no regulatory precedent from similar mechanisms in other airports.

The CAA has not adequately assessed the impact of the TRS on airlines and passengers

- 3.15 VAA reiterates paragraphs 4.4.12 – 4.4.13 of the AP Report. AP states that it sees "no evidence"²⁶ of assessment of the impact of the increased risk to airlines and the proposal to shift the risk in such an extreme way from HAL to airlines. The asymmetric impact of the TRS mechanism and flaws in relation to the calibration of the outer band rate, are a key consideration which the CAA's Final Proposals have failed to properly take into account when considering their potential consequences, but which could render the implementation of the proposed TRS unjust and arbitrary. VAA would therefore urge the CAA to take this into account and to reconsider the currently proposed TRS mechanism according to the alternatives set out below.

VAA's alternative proposals to reduce the asymmetric impact of the proposed TRS mechanism

- 3.16 Given the above points, VAA would endorse the points outlined by the AP Report at paragraphs 4.4.5 - 4.4.13, namely:
- 3.16.1 To address the asymmetric impact due to HAL's capacity constraints "[t]he CAA should implement an asymmetric sharing, with a 60/40 rather than 50/50 sharing agreement, for difference up to 10 per cent of forecast allowed revenues. This would counteract the asymmetry that exists in HAL's favour when it decides to cap capacity available to airlines when traffic growth is strong, and rebalance the risk to a fair bet between HAL and airlines and consumers."²⁷
- 3.16.2 To address the unintended consequences of miscalibrating the outer band rate of risk sharing, "[t]he CAA should drop its use of an outer band with 105% sharing. Even though the CAA highlights that projections suggest that falling outside the 10% range will be a rare event, it is likely to affect years in the H7 period, as HAL and airlines are facing high uncertainty about the speed of recovery of passenger traffic post-Covid, and miscalibration will have severe consequences on HAL's incentives to promote recovery."²⁸
- 3.16.3 Overall, "the CAA must consider the impact of the increased risk to airlines, particularly in a scenario when the 10% threshold has been triggered."²⁹ VAA would add that this should be done in light of the other risk mechanisms which

²⁴ AP Report, paragraph 4.4.8.

²⁵ AP Report, paragraph 4.4.9.

²⁶ AP Report, paragraph 4.4.13.

²⁷ AP Report, paragraph 4.4.5.

²⁸ AP Report, paragraph 4.4.9.

²⁹ AP Report, paragraph 4.4.12.

have been built into the Final Proposals and which have been designed to transfer risk from HAL to airlines.

The period of any recovery

- 3.17 The CAA's Final Proposals outline that the risk shared for each year will be recovered over a period of 10 years and will only start to be recovered from 2 years in arrears.³⁰ VAA welcomes that the CAA has, to some extent, taken into account the views presented in the VAA IP Response as to why any adjustment to charges should not be delayed until H8. However, notwithstanding that VAA has outlined above why it believes that in practice any 'upside' scenario which would result in benefits for consumers under the TRS mechanism is highly unlikely to occur, VAA believes that any such benefit should in principle be returned to passengers over 5 years rather than 10 years. Adjusting the recovery such that it is provided to consumers sooner and within the H7 period would be consistent with the CAA's primary duty to consumers.
- 3.18 In addition, VAA acknowledges that the CAA has proposed to adjust charges two years after the original divergence between forecast and out-turn traffic levels, as seen in other risk sharing mechanisms. However, in the best interests of consumers, VAA asks the CAA to consider whether it is able to deliver adjusted charges sooner than two years after the original divergence and if not, to explain why.

The use of the TRS mechanism should not set a precedent for future control periods

- 3.19 Finally, the CAA has proposed the introduction of the TRS mechanism "*in view of the significant uncertainty still affecting the H7 period*".³¹ VAA would therefore reiterate to the CAA the areas outlined above where the CAA should correct the flaws in the mechanism if it insists on retaining it. In addition, VAA would remind the CAA that any points made above in relation to the TRS mechanism are due to the unprecedented situation that has been caused by the Covid-19 pandemic. Therefore, if the CAA maintains its intention to introduce the TRS mechanism for the H7 price control period, this should not set a precedent for future price control reviews.

4. ALLOWANCE FOR ASYMMETRIC RISK

- 4.1 This Section responds to the CAA's Final Proposals on allowance for asymmetric risk as contained in Section 3, Chapter 11 and also addresses the implications of the multiple layers of risk mitigation mechanisms for HAL, contained in the Final Proposals.
- 4.2 The CAA has decided to continue with its proposal to introduce allowance for asymmetric risk in its Final Proposals. This is notwithstanding the views put forward by VAA and other airlines in responses to the Initial Proposals, in particular, that the introduction of such an allowance is unnecessary and over-protects HAL in light of other risk mitigation mechanisms. VAA has outlined below specific points in relation to the Final Proposals on allowance for asymmetric risk, making reference to points made in the VAA IP Response where appropriate. VAA also outlines below why the CAA's Final Proposals, when taken holistically, represent excessive risk mitigation measures which transfer an unprecedented and disproportionate share of risk to airlines and are ultimately not in the interests of consumers.

³⁰ CAA's Final Proposals, Section 1, Chapter 2, page 39, paragraph 2.36.

³¹ CAA's Final Proposals, Section 1, Chapter 2, page 31, paragraph 2.3.

There are multiple aspects of the Final Proposals which lead to over-protection of HAL, of which Asymmetric Risk is one

- 4.3 VAA notes, but cannot accept, the CAA's view that "We do not agree with the airlines' view that allowances for asymmetric risk are unnecessary and duplicative".³² While VAA has no objection to the principle of risk sharing in shock scenarios, (as stated in Section 3 of this response) and in principle recognises that an allowance for asymmetric risk could provide an 'insurance policy' to allow for pandemic-magnitude events, it considers that the other risk mitigation mechanisms in the Final Proposals are already designed to protect HAL in such scenarios. These take the form of shock factors and an asset beta in the WACC which factors in implicit risks to HAL. In addition, the CAA has proposed a new asymmetric risk allowance and the TRS mechanism for H7; these proposals represent additional and unprecedented mitigations to insulate HAL from risk, over and above the existing protections.
- 4.4 Therefore, when taking the CAA's Final Proposals for the various building blocks together, there remain an unnecessary number of aspects of the Final Proposals which are designed to protect HAL in shock events, of which asymmetric risk allowance is one. Each of these protections has the stated purpose of ensuring that the risk of shock events is appropriately apportioned between airlines and HAL. However, when taken cumulatively, the number of risk sharing mechanisms and their proposed implementation, culminates in a disproportionate and almost complete protection of HAL in the event of a downside shock, which could include both pandemic-magnitude events and events which have less impact but nonetheless result in a downside shock. While, as the AP Report notes, "the CAA have appeared to apply these protections consistently, taking account of the interactions, they do nevertheless represent a significant reduction in overall risk for HAL compared to Q6"³³ in which HAL bore 100% of the risk. VAA considers this represents a failure by the CAA to properly apportion risk between the airlines and HAL and a failure to consider the overall implications of the Final Proposals on consumers.
- 4.5 Where the 'overall package' of protections is disproportionately in favour of HAL (which VAA considers is the case in the Final Proposals), it has the effect of over-compensating HAL and disincentivising it to promote growth and/or to achieve further cost efficiency. Such a consequence would clearly be adverse to the interests of consumers.
- 4.6 VAA therefore considers that the CAA has failed to properly assess the cumulative impact of its Final Proposals which shift almost all risk from HAL to airlines in H7, and the ultimate implications the Final Proposals would have on the interests of consumers. VAA outlines below, in the context of asymmetric risk, where this over-protection occurs when considering the cumulative effect of all the building blocks within the Final Proposals.

(i) Allowance for non-pandemic shocks

- 4.7 The Final Proposals continue to apply an annual 'shock factor' of -0.87% to the H7 traffic forecasts in light of 'non-pandemic' shocks.³⁴ VAA recognises that the annual shock factor has decreased from the previous figure of -1.07% in the Initial Proposals, however, VAA continues to strongly oppose the inclusion of 'shock factors' within traffic forecasts. VAA would reiterate its points made in relation to this opposition as detailed at paragraphs 3.40 - 3.42 of the VAA IP Response, principally that the inclusion of shock factors is disproportionate and unnecessary given that such shocks should have been accounted for already in the asset beta for the WACC (as well as the CAA's proposed TRS mechanism).

³² CAA's Final Proposals, Section 3, Chapter 11, page 114, paragraph 11.23.

³³ AP Report, paragraph 10.1.3.

³⁴ CAA's Final Proposals, Section 3, Chapter 11, page 115, paragraph 11.31.

- 4.8 In addition, the AP Report identifies concerns in relation to the inclusion of an annual shock factor. Paragraphs 3.6.47 – 3.6.52 of the AP Report outline this in further detail. VAA endorses these points and would urge the CAA to consider the AP Report thoroughly. In particular, the AP Report outlines, amongst other points, that:
- 4.8.1 Such shock factors are unjustified unless the CAA has clear evidence that their effects are not already embedded in the underlying passenger forecasts, as would be the case if the models were built on data that included these shocks. The CAA has failed to provide clear evidence in this regard in the Final Proposals.
 - 4.8.2 The calibration of shocks must include the possibility of delayed journeys in the months following the shocks, otherwise the quantum of the shocks will be overestimated. Again, the CAA has failed to provide clear evidence in this regard in the Final Proposals.
 - 4.8.3 It is unclear whether the asymmetric adjustment applied to the forecast used by the CAA takes into account the TRS mechanism, which will have the effect of dampening any magnitude of future shocks.
- 4.9 VAA endorses AP's conclusion that, *"Without reassurance on each of these points, the asymmetric shock factor is invalid and will result in a downward bias to the passenger forecast."*³⁵ VAA therefore invites the CAA to consider and provide evidence in relation to the above, or, in the absence of such evidence, to remove the annual shocks proposed.

(ii) Allowance for pandemic-magnitude events

- 4.10 In addition, the CAA proposes to retain a separate allowance for 'pandemic-magnitude' shocks. The CAA attempts to justify this in its Final Proposals when it states that, *"historical experience suggests that the risks that HAL could encounter sudden downside shocks to traffic, such as those experienced during the pandemic, are not likely to be accompanied by an equal and offsetting set of possible upside events"*.³⁶ However, when viewing the Final Proposals cumulatively, it is clear that there are now multiple mechanisms proposed that are designed to protect HAL in the face of any sudden downside shocks. According to the CAA's Final Proposals, protection for HAL in pandemic-magnitude events is provided for through: (i) the TRS mechanism, (ii) an allowance for asymmetric risk, and (iii) the asset beta within the WACC. In addition, further protection for HAL is being offered in the form of overly-pessimistic passenger forecasts, with an annual shock factor applied, being built into the final H7 price control.
- 4.11 As outlined in the AP Report at paragraph 10.1.2, the risk of pandemic-magnitude events *"has always existed and, although of smaller magnitude than Covid-19, have occurred throughout HAL's history...These have always been implicitly reflected in HAL's WACC through its asset beta, without application of any adjustment other than the shock adjustment to traffic forecast. Therefore, the new asymmetric risk adjustment should be considered as an additional risk allowance over and above that which has been applied in previous settlements"*. In light of insufficient downward adjustment to the asset beta within the WACC, a TRS mechanism which could excessively benefit HAL in practice, additional allowance for shocks and asymmetric risk, and an overly pessimistic passenger forecast, VAA considers that there is a disproportionate imbalance in the risk sharing between airlines and HAL, particularly in relation to pandemic-magnitude events.

³⁵ AP Report, paragraph 3.6.52.

³⁶ CAA's Final Proposals, Section 3, Chapter 11, page 110, paragraph 11.2.

4.12 In relation to the TRS mechanism, VAA acknowledges that the CAA has said it has taken this proposed mechanism into account in the calculation of the proposed allowance for asymmetric risk;³⁷ the CAA states that it has "*account[ed] for the protection that the new TRS mechanism will offer*".³⁸ However, VAA considers that the CAA's reasoning in relation to the protection that is required for HAL in light of the TRS mechanism is flawed:

4.12.1 Firstly, VAA does not agree with the CAA's view that the TRS mechanism does not remove asymmetry between the risks faced by airlines and HAL. The CAA states that, "*The TRS is intended to reduce the incremental profits and incremental losses that HAL can encounter when traffic volumes turn out to be higher or lower than we forecast at the time of a periodic review. However, the TRS does not fully protect HAL from traffic risk*".³⁹ As outlined in Section 3, VAA is of the view that the TRS mechanism as proposed would in fact disproportionately result in the risk being borne by airlines as opposed to HAL in a shock event. In particular, in the event that passenger out-turn is over 10% less than the forecast used, the TRS mechanism proposed would result in a 105% risk sharing. Contrary to the CAA's statement, this in fact would fully protect HAL from traffic risk in that scenario, at the expense of airlines. Even in the event that passenger out-turn is 10% or less reduced than the forecast, the proposed TRS mechanism ensures that HAL only bears 50% of the risk and that the airlines bear the other 50%.

4.12.2 Further, it is disproportionate and contrary to the interests of consumers for the CAA's aim to be to "*fully protect HAL from traffic risk*". The CAA has not offered explanation as to why, in its role as an independent regulator, it requires that in the event of traffic risk there is almost complete protection of HAL, and that such risk is shifted to airlines. The CAA's own calculations, when taking into account the protection offered by the proposed TRS, evidence the disproportionate level of protection which would be provided to HAL in another pandemic-magnitude event during the H7 period. For example, if there was a pandemic-magnitude event in 2025 which started in 2024, the CAA predicts that HAL could experience possible in-period losses of c.£1.7 billion but that its proposals would enable HAL to accrue back c.£1.4 billion in payments from the proposed TRS mechanism alone.⁴⁰ Such payments would be greater than the RAB adjustment offered by the CAA in light of the current pandemic. It would also be at the expense of the airlines and may ultimately benefit HAL's shareholders.

4.12.3 However, the CAA's calculations reflect a proposal to go even further in the protection of HAL by layering additional protection in the form of allowance for asymmetric risk. The Final Proposals therefore go on to make calculations for the probability-weighted, expected net loss to HAL due to pandemic-magnitude events, after taking into account the sums which HAL could receive from TRS payments alone.⁴¹ The CAA states that these calculations represent the amounts of revenue that it considers "*we have to provide for in the H7 cap calculation in order to compensate HAL for the expected loss of profit arising from a future pandemic-magnitude event*".⁴² However, this allowance represents a complete protection of HAL according to the CAA's calculations and contrary to the CAA's statement, its role as an independent

³⁷ CAA's Final Proposals, Section 1, Chapter 2, page 43, paragraph 2.50.

³⁸ CAA's Final Proposals, Section 3, Chapter 11, page 117, paragraph 11.38.

³⁹ CAA's Final Proposals, Section 3, Chapter 11, pages 114-115, paragraph 11.28.

⁴⁰ CAA's Final Proposals, Section 3, Chapter 11, page 116 - 117, Tables 11.2 and 11.3.

⁴¹ CAA's Final Proposals, Section 3, Chapter 11, page 120, Table 11.5.

⁴² CAA's Final Proposals, Section 3, Chapter 11, page 120, paragraph 11.45.

regulator is not to fully compensate HAL for any expected loss of profit. Such compensation is directly at the expense of consumers given the allowance for compensating for HAL's possible revenue-loss is built into the H7 price cap calculation. VAA therefore considers that the CAA's priority to compensate HAL to a disproportionate level in a pandemic-magnitude event, at the expense of consumers, is contrary to the CAA's duty to further the interests of consumers.

The estimated traffic loss that HAL might expect to encounter if a pandemic-magnitude event occurs

- 4.13 The CAA references the airlines' view about the unprecedented nature of the restrictions on air travel that have been imposed during the Covid-19 pandemic. VAA understands the CAA's view that "*there is considerable uncertainty what the next pandemic-magnitude event will entail or how individuals and policymakers will respond*". While there can be no certainty over future recovery, VAA would urge the CAA to give further consideration to the likelihood that any future pandemic-magnitude event would benefit from learnings taken from the Covid-19 pandemic which was unprecedented but which has resulted in greater familiarity within the aviation industry and governments as to how to respond and quickly recover from such a significant shock event, such that the impact of future shock events on traffic reduction may be less profound and/or long-lasting.
- 4.14 In addition, the CAA states that it "*do[es] not consider that the airlines have presented us with a better evidenced, alternative benchmark for how a future pandemic-magnitude event might unfold than the experience of the last three years.*"⁴³ If the CAA is to use the last three years of experience as its benchmark for a future pandemic-magnitude event, then it should also take into account the data in relation to the swift return of significant volumes of domestic and international air travel given the rapid lifting of travel restrictions in the last six months following the submission of the VAA IP Response. Unfortunately, such significant return of air travel has been met by HAL's inability to react to this demand, leading to significant operational disruption and unprecedented numbers of flight cancellations, which has the effect of suppressing traffic.

Implementation of the allowance for asymmetric risk

- 4.15 VAA notes that the CAA has calculated the amounts of revenue that it considers it would have to provide for in the H7 price cap calculation in order to compensate HAL for the expected loss of profit arising from any future pandemic-magnitude event.⁴⁴ For example, according to the CAA's calculations, the allowance for asymmetric risk in 2026 based on the probability-weighted, expected net loss to HAL due to any pandemic-magnitude event is £27 million.⁴⁵ If, following the cumulative consideration of all risk-sharing proposals and taking careful account of VAA's views above, the CAA retains the allowance for asymmetric risk, VAA would urge the CAA to separately hold in escrow the annual value that HAL is to receive pursuant to the allowance for asymmetric risk. This is because such an amount would be for the purpose intended for HAL's risk protection in the event of a potential future pandemic-magnitude event, and the airlines should not be required to provide additional funding to HAL in any future pandemic-magnitude event.

Conclusion

- 4.16 For the reasons set out above and in the VAA IP Response, VAA strongly urges the CAA to carefully consider the cumulative effect of all of its proposals in relation to

⁴³ CAA's Final Proposals, Section 3, Chapter 11, page 115-116, paragraphs 11.34.

⁴⁴ CAA's Final Proposals, Section 3, Chapter 11, page 120, paragraph 11.44, Table 11.5.

⁴⁵ CAA's Final Proposals, Section 3, Chapter 11, page 120, paragraph 11.45 and Table 11.5.

risk-sharing and the disproportionate protection they provide to HAL in any shock that occurs during the course of the H7 control period. VAA would urge the CAA to reconsider its passenger forecasts as further detailed in Section 2, the proposed TRS mechanism as detailed in Section 3 and the calculation of the asset beta within the WACC as detailed in Section 5, to correct some of this imbalance in the risk sharing. In addition, VAA considers that the annual shock factor and allowance for asymmetric risk in relation to a pandemic-magnitude event should be re-considered in light of the above.

5. **WEIGHTED AVERAGE COST OF CAPITAL**

5.1 This Section responds to the CAA's Final Proposals on the WACC and the WACC parameters at Section 3, Chapter 9. VAA welcomes the CAA's Final Proposals to make two key changes since its Initial Proposals in relation to calculating the WACC, being:

5.1.1 A reduction to the asset beta to reflect a larger downward adjustment in respect of the TRS mechanism which is now applied to the entirety of the asset beta and not solely the pandemic-related component; and

5.1.2 A reduction in the real cost of embedded debt due to inflation.⁴⁶

5.2 Notwithstanding the changes proposed by the CAA's Final Proposals, VAA considers that some flaws remain as to the CAA's approach and/or methodology which has resulted in a higher point estimate for the WACC than is justified.

5.3 Given the importance of the WACC in calculating the overall price control figure, as acknowledged by the CAA⁴⁷ and reiterated in the VAA IP Response,⁴⁸ VAA jointly with BA and Delta have asked AP to independently consider the CAA's Final Proposals in relation to the WACC. Given the limited time available to respond to the Final Proposals, the AP Report has focussed on the following key aspects of the WACC: (i) the cost of equity or asset beta, (ii) the cost of debt, and (iii) the mid-point estimate for the WACC. These are discussed in detail at Sections 8 to 10 of the AP Report as follows:

5.3.1 Section 8: Cost of Equity, which is divided into (i) an overview of the Capital Asset Pricing Model ("**CAPM**"), (ii) a summary of the changes from the Initial Proposals, (iii) the changes that "*enhance the accuracy of the cost of equity*", and (iv) the aspects of the Final Proposals that "*raise concerns*".

5.3.2 Section 9: Cost of Debt, which is divided into: (i) a summary of the changes from the Initial Proposals, (ii) the changes that AP considers "*enhance the accuracy of the cost of debt estimate*", and (iii) the aspects of the Final Proposals that "*raise concerns*".

5.3.3 Section 10: WACC, which is divided into: (i) a summary of the changes from the Initial Proposals, (ii) the changes that "*enhance the accuracy of the WACC estimate*", and (iii) the aspects of the Final Proposals that "*raise concerns*".

5.4 VAA agrees with the expert reasoning and conclusions in the AP Report. VAA would urge the CAA to retain the areas where the CAA has made significant improvements to its approach but also to reconsider its approach and/or methodology in the areas outlined by the AP Report. This could lead to a reduction in the point estimate for the

⁴⁶ CAA's Final Proposals, Section 3, Chapter 9, page 12, paragraphs 9.21 and 9.23.

⁴⁷ CAA's Final Proposals, Section 3, Chapter 9, page 8, paragraph 9.1.

⁴⁸ See paragraphs 3.2 - 3.3 of the VAA IP Response.

WACC from 3.26% to 2.37%.⁴⁹ This would represent a point estimate based on an accurate and balanced view of the evidence and comparators available, as well as an appropriate forward-looking allowance for H7, which is in the best interests of consumers.

- 5.5 VAA would urge the CAA to thoroughly review and consider the AP Report. While VAA does not propose to repeat the detail in the AP Report, it outlines below the key areas which the CAA should consider.

Asset beta

- 5.6 Section 8.4 of the AP Report outlines the changes in relation to the asset beta which it supports within the Final Proposals. These are:

5.6.1 That the CAA has made reasonable judgments and applied an appropriate methodology in setting most of its CAPM inputs. Further detail on this can be found at the AP Report, paragraphs 8.4.1 - 8.4.2.

5.6.2 That the CAA has changed its methodology in relation to estimating the asset beta.

- 5.7 The VAA IP Response made the point that the impact of the TRS mechanism (if it was to be introduced) should be taken into account when calculating the WACC and particularly the asset beta.⁵⁰ The impact of other proposed risk mitigations in the Final Proposals and specifically the TRS mechanism and its impact on the asset beta, is clearly a "critical issue" for the CAA to determine, as outlined in the AP Report.⁵¹

- 5.8 VAA therefore welcomes the CAA's position in the Final Proposals that, "[w]e have reconsidered our approach in the light of stakeholder feedback, and now consider that it would be appropriate to explicitly estimate the impact of the TRS on the pre-pandemic asset beta, notwithstanding the significant degree of judgement that this involves".⁵² The AP Report outlines in further detail why "the change in the asset beta is where the CAA makes significant improvements in its methodology for assessing the impact of the new H7 TRS mechanism".⁵³ Reasons as to why this methodology is reasonable are outlined at paragraphs 8.4.3 - 8.4.8 of the AP Report.

- 5.9 VAA notes the CAA's statement that, "[w]e have carefully considered the most appropriate method for estimating the impact of the TRS mechanism on the H7 asset beta".⁵⁴ However, while VAA considers that the CAA has found a reasonable methodology by which to assess the impact of the TRS mechanism, there are serious concerns (as identified by AP) in relation to how the CAA has calibrated its methodology. The CAA assumes that traffic risk accounts for between 50% and 90% of difference in asset betas.⁵⁵ However, Section 8.5 of the AP Report outlines in further detail why the CAA has incorrectly assumed that compared to UK energy and water networks, HAL is exposed to additional risks other than traffic variability. There is no reason for this as outlined by AP.

- 5.10 VAA would urge the CAA to rectify this incorrect assumption, which would lead to an asset beta range of 0.43-0.54 and a reduction of the overall WACC by 0.33%, as set out in the AP Report.⁵⁶

⁴⁹ AP Report, paragraph 10.4.7.

⁵⁰ See paragraphs 3.32 and 3.15.3 of the VAA IP Response.

⁵¹ AP Report, paragraph 8.2.7.

⁵² CAA's Final Proposals, Section 3, Chapter 9, page 36, paragraph 9.144.

⁵³ AP Report, paragraph 8.3.4.

⁵⁴ CAA's Final Proposals, Section 3, Chapter 9, page 37, paragraph 9.153.

⁵⁵ CAA's Final Proposals, Section 3, Chapter 9, pages 39, paragraph 9.158, bullet point 2.

⁵⁶ AP Report, paragraph 8.5.4, Table 8.3.

Debt beta

- 5.11 VAA does not consider that any further compelling new evidence has emerged regarding the H7 debt beta and considers it is reasonable for the CAA to retain its estimate of 0.05-0.10.⁵⁷

Cost of debt

- 5.12 VAA welcomes the reduction in the lookback period used to estimate the notional benchmark from a 20-year collapsing average when calculating the cost of debt. Section 9.3 of the AP Report contains further detail as to why this position of a reduction in principle by the CAA is reasonable and should be maintained.
- 5.13 However, Section 9.4 of the AP Report outlines further detail as to why a reduction of such a lookback period to a 13.5-year collapsing average does not go far enough, based on the evidence available in relation to HAL's Class A debt. Instead, the evidence suggests that a 10-year lookback period should be used.
- 5.14 Finally, paragraph 9.4.3 of the AP Report outlines why there is no justification for the addition of the 0.08% "HAL-specific premium" as set out in the Final Proposals.⁵⁸

Choice of a point estimate

- 5.15 VAA acknowledges that the CAA has an "important element of judgment in finalising our estimate of HAL's WACC".⁵⁹ However, such judgment must be exercised in light of the evidence reasonably available. In particular, VAA would endorse points made in the AP Report in relation to why, when taking into account the significant risk mitigation changes for HAL in the Final Proposals, a significant reduction in HAL's WACC should be made.⁶⁰
- 5.16 The CAA has set out in its Final Proposals reasons as to why the assumption of a stable TMR may give rise to an upward skew within the parameter range and warrants a degree of aiming down on the choice of the WACC estimate. VAA agrees that this aiming down would be "potentially material", using the CAA's own words. This is supported by Section 10.3 of the AP Report.
- 5.17 However, VAA disagrees with the CAA's analysis in relation to other aspects of the point estimate which raise concerns. In particular:
- 5.17.1 VAA agrees with paragraph 10.4.1 of the AP Report as to why the welfare effect and investment considerations over the H7 price control should not warrant 'aiming up' but in fact should result in 'aiming down'; and
- 5.17.2 The CAA states that "we do not consider that there is any material uncompensated asymmetry remaining within the H7 price control. Although we consider that HAL is subject to significant asymmetric risk associated with passenger volumes due to one-off shocks, we have explicitly taken account of this through the application of a shock factor and asymmetric risk allowance".⁶¹ However, the CAA has failed to take into account the relevant considerations as to information asymmetries that exist as between HAL and the CAA in respect of the three key areas of (i) passenger forecasts, (ii) opex, and (iii) commercial revenues. The reasoning and analysis as to why this should result in aiming down is set out at paragraphs 10.4.2 – 10.4.3 of the AP Report.

⁵⁷ CAA's Final Proposals, Section 3, page 42, Chapter 9, paragraph 9.180.

⁵⁸ CAA's Final Proposals, Section 3, Chapter 9, pages 64 and 68, paragraphs 9.307 and 9.329 respectively.

⁵⁹ CAA's Final Proposals, Section 3, Chapter 9, page 9, paragraph 9.6.

⁶⁰ AP Report, paragraphs 10.1.1 – 10.1.6.

⁶¹ CAA's Final Proposals, Section 3, Chapter 9, page 82, paragraph 9.412.

- 5.18 Based on the evidence available and taking into account all relevant considerations, VAA would support AP's expert conclusion that there is a strong basis for aiming down in the WACC range, unless the CAA takes action to address the information and incentive asymmetries discussed in the AP Report.

Conclusion

- 5.19 As set out above, VAA welcomes certain of the CAA's adjustments to the key parameters of the WACC, being the asset beta and cost of debt. However, VAA agrees with the expert analysis set out in the AP Report that the CAA has made certain errors in relation to its approach/methodology in light of the evidence available and also has failed to take into account key considerations in specific aspects of the WACC, as set above.
- 5.20 VAA would therefore urge the CAA to reconsider its approach to these aspects in light of the AP Report. As suggested in the AP Report, amendments should be made to the WACC as a consequence of the concerns raised in relation to the asset beta and cost of debt. This would result in a reduction in the WACC point estimate from 3.26% to 2.65%, taking a mid-point of the range on the assumption that issues of information asymmetry in forecasts have been addressed by the CAA so no aiming down is necessary. However, as the AP Report details, when adopting the lower cost of embedded debt in both the low and high case, it could be argued that the mid-point WACC should reduce further to 2.37%.⁶² Such a reduction would be based on a robust methodology and calibration, which results in a lower overall price charge per passenger and so would further the interests of consumers.

6. OPERATIONAL EXPENDITURE AND COMMERCIAL REVENUES

- 6.1 This Section responds to Chapters 4 and 5 of the CAA's Final Proposals, which concern opex and commercial revenues.
- 6.2 VAA recognises that, in material respects, the CAA has updated its approach from the Initial Proposals stage and, broadly, is supportive of the CAA's decision now to base its proposals more closely on the work undertaken by its consultants, CTA. Nevertheless, and as explained below, in a number of discrete respects VAA has some concerns with the CAA's approach.
- 6.3 VAA's views in this regard have been informed by the work of AP, which has considered the CAA's assessment of opex and commercial revenues in sections 5 and 6 of the AP Report. Sections 5.1 and 6.1 summarise AP's understanding of the background to the H7 Consultation; Section 5.2 and 6.2 summarise AP's views on the improvements that the CAA has made since the Initial Proposals; and Sections 5.3 and 6.3 explain the discrete areas of the Final Proposals which AP considers "raise concerns".

Opex

Fundamental issues with the opex approach

- 6.4 VAA endorses the two "fundamental issues" with the CAA's approach to opex,⁶³ which are set out in the AP Report. These are that:
- 6.4.1 While AP supports the CAA's decision not to adopt a weighted average of the CTA's and HAL's estimates, the starting point of CTA's original assessment of HAL's opex was based on a high-level assessment of HAL's top-down

⁶² AP Report, paragraph 10.4.7.

⁶³ AP Report, paragraph 5.4.3.

financial model and the absence of a bottom-up analysis limits the CTA's ability to challenge HAL's costs.⁶⁴

- 6.4.2 The CAA has relied on selective information provided by HAL in justification of certain cost increases, which have been applied to the revised estimate.⁶⁵

Lack of transparency as to evidence of the proposals

- 6.5 VAA supports AP's expert view set out in paragraphs 5.4.3 - 5.4.5 of the AP Report in relation to the CAA's flawed assessment of HAL's opex forecasts. In particular, VAA agrees with AP's view that the CAA's approach relies on a selection of information provided by HAL in order to justify certain cost increases. Meanwhile the airlines, including VAA have suffered from a lack of visibility in relation to HAL's RBPu2 forecasts and any subsequent documentation that may be submitted by HAL in advance of the Final Proposals. Such a process leads to a clear risk that HAL has 'cherry picked' key information which provides a favourable outcome to HAL in respect of justification of costs and is not in the interests of consumers.⁶⁶
- 6.6 Further, VAA is concerned that opex (and commercial revenues) information has been consistently withheld from public scrutiny due to 'commercially sensitive' information incorporated into the documentation. It is unclear on what basis commercial confidentiality is asserted and whether the extent of the lack of disclosure is reasonable. The consequence of this lack of disclosure is that the CAA must become more reliant on the advice of its external advisors as a proxy for external scrutiny relative to other building blocks.
- 6.7 As the AP Report states, "*Effectively, HAL is being rewarded for providing poor quality information at the outset*".⁶⁷ VAA would reiterate the AP Report's suggestion that, "*At this juncture, there would appear to be strong merit in the CAA revisiting all of HAL's opex forecasts, as well as disclosing to the airlines the precise basis of these estimates so that they can be challenged.*"⁶⁸ To do otherwise would be to give undue weight to HAL's forecasts, particularly in light of the inability for airlines and/or public scrutiny to play a proper part in holding HAL's forecasts accountable.

Commercial revenues

- 6.8 The AP Report further sets out two specific concerns with the CAA's assessment of HAL's commercial revenues forecasts:⁶⁹
- 6.8.1 The need for retailers to adopt mitigating strategies to offset charges on retail revenues.
- 6.8.2 The proposed inclusion of a low (1%) management stretch target.
- 6.9 While VAA requests that the CAA reviews the arguments put forward by AP on these points in full, it also makes a number of linked points, as set out below.

Concerns as to adjustments made to CTA figures

- 6.10 VAA notes the CAA has "*continued to work very closely with CTA to establish updated forecasts for Final Proposals*"⁷⁰ and VAA supports the use of independent experts in this area. VAA therefore agrees with the approach in placing more weight on this expert analysis and considers that the CAA's approach is reasonable when it

⁶⁴ AP Report, paragraph 5.4.3

⁶⁵ AP Report, paragraph 5.4.4.

⁶⁶ See for example, <https://www.caa.co.uk/media/l03hju3k/a20-rbp-update-2-redacted.pdf>

⁶⁷ AP Report, paragraph 5.4.5.

⁶⁸ AP Report, paragraph 5.4.6.

⁶⁹ AP Report, paragraphs 6.4.2 – 6.4.3.

⁷⁰ CAA's Final Proposals, Section 2, Chapter 5, page 43, paragraph 5.52.

states that, "[w]e therefore consider that CTA's overall commercial revenues projects provide us with an appropriate set of evidence on which to base our Final Proposals. These estimates, in the round, appear to represent an appropriate level of efficient revenues for HAL for H7. As such we consider that these provide an appropriate basis for setting an allowance for commercial revenues for HAL at a level that is in the interests of consumers and which will promote economy and efficiency on the part of HAL".⁷¹

- 6.11 Notwithstanding this generally reasonable approach, VAA is concerned about the CAA's decision to make "targeted adjustments" which have resulted in adopting the lower end of CTA's targets in relation to specific items where the CTA could not reach conclusions for its work, including in relation to management stretch.⁷²
- 6.12 As to the management stretch, VAA does not agree with the CAA's view that "on balance, a 1% management stretch is reasonable for HAL for H7, while noting that CTA's analysis showed that a higher level of management stretch could also be justified".⁷³ VAA notes that the CAA itself outlines that "CTA concludes that its econometric analysis implies that a management stretch target for H7 could reasonably lie in the range 1-2%".⁷⁴ This is considered by AP at paragraphs 6.4.3 - 6.4.8 which VAA fully endorses.
- 6.13 For the reasons provided in the AP Report, including given the range offered by its own independent experts, VAA does not regard that the CAA has provided sufficient justification or robust reasoning as to why a stretch target of 1% is more appropriate and reasonable, rather than at least the mid-point of the range which would be 1.5%. In connection with this, VAA notes that paragraph 6.4.8 of the AP Report records AP's view that adopting the bottom end of CTA's range is flawed and that it would be prudent and in the interests of consumers to choose a higher, yet still achievable, target.

Unilateral notification of TDOC increase above 10%

- 6.14 VAA refers to the Final Proposals in respect of TDOC revenues as set out at paragraphs 5.77 – 5.78. VAA strongly opposes the proposed plan for "HAL to notify airlines and the CAA of any increases of the charge beyond 10% of the baseline levels noted above, but not to require HAL to formally agree any charge increase in advance with the CAA or airlines, consistent with our approach to car park charges".⁷⁵
- 6.15 VAA considers that the TDOC only exists due to the scarce nature of terminal forecourts. As such, VAA strongly disagrees with the unilateral notification mechanism suggested in the Final Proposals, which would enable HAL to decide any charge increases without challenge. This leads to a risk that charges may be increased to a level whereby passengers are deterred from flying, or instead fly from an alternative airport which has a lower set of passenger charges. VAA is concerned that allowing this risk would not be "consistent with furthering the interests of consumers" as the CAA suggests the opex proposals should be, at paragraph 4.82 on page 29 of Section 2, Chapter 4 of the CAA's Final Proposals.
- 6.16 As an alternative, VAA considers that airlines should have a right of veto in the event that HAL's proposals exceed an increase of 10%. This is on the basis that HAL is a monopoly price-setter and has the ability to choose its prices without direct competition in the market.

⁷¹ CAA's Final Proposals, Section 2, Chapter 5, page 46, paragraph 5.59.

⁷² CAA's Final Proposals, Section 2, Chapter 4, page 46, paragraph 5.60.

⁷³ CAA's Final Proposals, Section 2, Chapter 5, page 46, paragraph 5.60.

⁷⁴ CAA's Final Proposals, Section 2, Chapter 5, page 40, paragraph 5.34.

⁷⁵ CAA's Final Proposals, Section 2, Chapter 5, page 52, paragraph 5.78.

7. CAPITAL EXPENDITURE AND CAPITAL INCENTIVES

- 7.1 This Section responds to Chapters 6 and 7 of the CAA's Final Proposals, which concern capital expenditure and capital incentives.
- 7.2 VAA recognises that the CAA has materially increased its assessment of the efficient level of baseline capex for H7 as compared to the Initial Proposals, which amounts to an increase of £1.1 billion. Given this material proposed increase, and as emphasised below, it is of paramount importance that capex proposals are subject to robust scrutiny and are sufficiently evidenced. VAA shares the CAA's concerns at the lack of evidence provided relating to a number of areas and would urge the CAA, prior to making a final determination as to capex, to interrogate these matters further.
- 7.3 As further detailed below, AP has independently considered the assessment of capex and capital incentives section of the Final Proposals in Section 7 of the AP Report. Section 7.2 of the AP Report summarises AP's understanding of the background to the H7 Consultation, Section 7.3 summarises AP's views on the improvements that the CAA has made since the Initial Proposals and Section 7.4 explains the discrete areas of the Final Proposals which AP considers "raise concerns". VAA urges the CAA to read AP's analysis carefully alongside the points made below.

Capex

Undue weight placed on HAL's proposals in relation to the capital envelope

- 7.4 VAA's primary concern with the capex budget is that it appears that the CAA has placed undue weight on HAL's proposals. The CAA must ensure that any such proposals are subject to robust scrutiny and sufficiently evidenced. However, the CAA has stated in the Final Proposals that "*the information that HAL has provided frequently still falls short of our expectations*".⁷⁶ VAA shares the CAA's concerns in relation to the quality of HAL's capex plans and reiterates its concerns in this regard.
- 7.5 Given the consistent failure to provide good quality information in relation to capex on HAL's part, it is in the interests of consumers that the CAA does not place undue weight on HAL's proposals. Unfortunately, it appears that the CAA has done so in the Final Proposals. For example, it is clear from Table 6.3,⁷⁷ related to Figure 6.2 and Table 6.5,⁷⁸ that the CAA has relied too heavily on evidence from HAL as to the reasons why certain capex categories have been funded (without explaining adequately why it has done so). This approach is flawed: HAL's resources will be directed to projects that will maximise gain for HAL, at the expense of projects that may benefit the overall LHR community.
- 7.6 VAA has serious concerns that the capital envelope award process as proposed in the Final Proposals is skewed towards those projects that HAL, and only HAL, has identified as a priority. This is not a reasonable approach when considering that HAL's motives for prioritising a project may not necessarily align with the best interests of consumers.
- 7.7 An example of the imbalance in the capital award process is HAL's short-term desire to exit Compass House and relocate into the Terminal Buildings, for which the CAA has awarded a budget under the 'Efficient Airport' programme. However, neither VAA, nor the other airlines, have had sight of any detailed costs estimates for other projects within the 'Efficient Airport' programme that do not align with HAL's priorities but which VAA considers would clearly benefit consumers, such as self-boarding gates and self-service bag-drop machines.

⁷⁶ CAA's Final Proposals, Section 2, Chapter 6, page 64, paragraph 6.46.

⁷⁷ CAA's Final Proposals, Section 2, Chapter 6, page 72.

⁷⁸ CAA's Final Proposals, Section 2, Chapter 6, page 73.

Undue weight placed on HAL's proposals in relation to the balance of capital within the envelope

- 7.8 It is also important that within the capital envelope, the CAA considers the fair balance of capital spend across different areas. Regrettably, VAA considers that the process of allocating the capital envelope is overly reliant on HAL's stated prioritisation of projects, without sufficient regard to the views of airlines or the interests of consumers.
- 7.9 In particular, VAA refers to the list of projects for which the CAA considers HAL has provided justification to pursue,⁷⁹ including, by way of example only, the allocation made to Carbon and Sustainability. Although the CAA notes that Carbon and Sustainability projects are 'discretionary', they have been automatically awarded a "Type 2" status and are therefore included in the baseline, rather than the discretionary "Type 3" status which would only be in the "High case".⁸⁰ The CAA's own decision tree⁸¹ does not provide any route by which this category should be automatically awarded "Type 2" status. Indeed, this particular example appears to constitute a misapplication of the CAA's own decision making process as set out in the Final Proposals. In these circumstances VAA would urge the CAA to revisit the categorisation of each project to ensure that the process has been accurately followed.
- 7.10 While VAA does not wish to undermine the importance of carbon and sustainability projects in principle, this is an example of where the capex assessment approach lacks transparency and robust scrutiny from the CAA, resulting in a lack of accountability on HAL's part. Such an approach is not in the interests of consumers and VAA considers that the approach should be adjusted such that a more balanced consideration of the projects, which may be in the best interests of consumers, can be achieved. For example, VAA notes the very significant increase to the Carbon and Sustainability envelope whereas the increase to Efficient Airport is more modest.⁸² Benefits cases for Efficient Airport are premature and therefore have been discounted; however, investments in those projects should not be precluded relative to other areas where the cases have been unilaterally developed by HAL (because it is in HAL's interests to do so) at the expense of other projects and programmes that may be more in line with the interests of consumers.
- 7.11 VAA considers that a reasonable approach would be for the CAA to enable airlines and HAL to work together to find the most appropriate mechanism to split out the proposed total capital envelope across the different capex categories more appropriately than the CAA have so far advised subject to the requisite benefits cases being established. VAA would not envisage such a process of itself delaying the CAA's Final Determination, rather it could be conducted within existing governance processes following Final Determination.

Capital Incentives

Level and symmetry of the incentive rate

- 7.12 VAA supports AP's view that the balance incentive sharing rate for overspend should be 50%,⁸³ based on their analysis as to higher sharing rates increasing incentives for efficiency, and providing incentives for information revelation.⁸⁴ VAA agrees with AP's reasoning that (i) HAL should face downside risk under incentive-based

⁷⁹ CAA's Final Proposals, Section 2, Chapter 6, page 75, paragraph 6.66.

⁸⁰ CAA's Final Proposals, Section 2, Chapter 6, page 68, Table 6.3.

⁸¹ CAA's Final Proposals, Section 2, Chapter 6, page 66, paragraph 6.51, Figure 6.2.

⁸² CAA's Final Proposals, Section 2, Chapter 6, page 73-75, Table 6.5.

⁸³ AP Report, paragraph 7.4.4.

⁸⁴ AP Report, paragraph 7.4.2 – 7.4.3.

regulation as this provides incentives to be efficient; and (ii) HAL is most likely to seek to deliver capex projects more efficiently, in light of potential undefined "unanticipated" adverse effects.⁸⁵

An ex ante approach across all capex categories and the CAA's approach to delivery obligations

- 7.13 As outlined at paragraphs 7.16 and 7.17 of the VAA IP Response, VAA continues to strongly support the *ex ante* approach taken to capital incentives. VAA agrees with the AP Report at paragraph 7.4.5 which outlines the need for *ex ante* incentives in order to incentivise capex delivery at a lower cost.
- 7.14 VAA is fully supportive of the CAA's reasonable approach in the Final Proposals to "use performance against delivery obligations on a project-level basis as a means of adjusting the capex baseline. These project-level delivery obligations are to be established at G3, as part of the process of agreeing the capex baseline for each project".⁸⁶ However, VAA urges the CAA to ensure the approach to delivery obligations is fully executed as part of HAL's proposed changes to the programme methodology and includes the service enhancements that the capex was expected to deliver.
- 7.15 VAA welcomes that the CAA has recognised VAA's and other airlines' concerns in relation to delivery obligations.⁸⁷ VAA urges the CAA to continue to take into account these concerns as capex projects progress. In particular, VAA notes in the CAA's Final Proposals that in the event that HAL may elect to under-deliver on a project's scope, the CAA's current proposals "would not apply any additional penalty to HAL other than a reduction to their capex baseline".⁸⁸ This is due to the CAA's position that incentives "could be further strengthened at the H8 price control review if the need arises". In light of its decision not to impose additional penalties, VAA expects that the CAA will carefully monitor the effectiveness of the incentives during the H7 price control in order to assess if the need for strengthening them in the H8 price control arises.

Timing incentives and triggers

- 7.16 VAA strongly supports the continued use of triggers within the capital framework⁸⁹ and requests the CAA to reconsider this position for H7 Final Determination. VAA would reiterate paragraphs 7.24 and 7.25 of the VAA IP Response in this respect. In addition, VAA understands that the airline community response to the Final Proposals is intending to set out clearly the views of the airline community (including VAA) on triggers. VAA endorses the position put forward by the airline community on this matter but does not seek to repeat it here.
- 7.17 VAA notes the CAA's decision "not to apply separate timing incentives associated with the delivery of projects against agreed deadlines".⁹⁰ VAA would invite the CAA to consider the re-instatement of timing incentives as part of H8 if the current methodology is proven to not drive the desired behaviour.
- 7.18 VAA disagrees with the CAA's view that it would not be "practicable to set milestones at a category-level and on an ex ante basis".⁹¹ To the contrary, VAA considers that the interests of consumers would be furthered by HAL and airlines working together

⁸⁵ AP Report, paragraph 7.4.4 – 7.4.5.

⁸⁶ CAA's Final Proposals, Chapter 7, page 98, paragraph 7.102.

⁸⁷ CAA's Final Proposals, Section 2, Chapter 7, page 102, paragraphs 7.114 - 7.116.

⁸⁸ CAA's Final Proposals, Section 2, Chapter 7, page 102, paragraph 7.116.

⁸⁹ CAA's Final Proposals, Section 2, Chapter 7, page 102, paragraph 7.117.

⁹⁰ CAA's Final Proposals, Section 2, Chapter 7, page 102 paragraph 7.117.

⁹¹ CAA's Final Proposals, Section 2, Chapter 7, page 103, paragraph 7.121.

to be as prescriptive as possible at the project level to ensure capital spend is governed appropriately and accurately.

Capex envelope uncertainty mechanism

- 7.19 VAA agrees that it is important to have governance arrangements in place to deal with any reassessment of the capex envelope, in which the CAA will be involved as an independent regulator.⁹² VAA agrees with the CAA's proposal to "develop and publish specific guidance on the detailed requirements for a submission"⁹³ with a view to the framework being implemented for Q4 2022. In light of this, VAA expects the CAA to meet this deadline to ensure that implementation of these delivery obligations is not delayed any further into H7.
- 7.20 More generally, VAA also reiterates, in particular paragraphs 7.10 - 7.15 of the VAA IP Response in which VAA indicated that there should be a transparent process or opportunity for airlines and HAL to agree any additional capex spend. In this regard VAA notes, and endorses, the proposal put forward by the airline community to the CAA on 18 July 2022 in connection with HAL procurement and the approach to specification building.

8. OUTCOME BASED REGULATION

- 8.1 This Section responds to Section 1, Chapter 3 of the CAA's Final Proposals. Overall, VAA supports in principle the move to a framework that is based on developing a set of outcomes with associated measures and targets. However, VAA is disappointed at the CAA's proposed approach on how to implement OBR. In particular, despite extensive engagement by VAA on this area of regulation over a long period of time (VAA notes that the CAA's first consultation on OBR was in 2016, to which VAA responded), the CAA's Final Proposals on OBR do not appear to properly take into account and/or fail to engage with the detailed submissions which VAA (as part of the airline community) has previously made on OBR and more work could be done by the CAA to explore the issues at hand.
- 8.2 VAA is particularly concerned about the CAA's approach to OBR in circumstances where there have been a number of recent, high-profile, and disruptive operational failures caused by HAL, notably in relation to baggage. VAA is concerned that a failure to implement a sufficiently rigorous OBR regime would let HAL 'off the hook' in this regard and VAA would accordingly urge the CAA to introduce an adequately robust system.
- 8.3 VAA considers that the CAA should do more in this area to gather the relevant research and data, in order to drive decisions based on impartial and robust information. In some areas of the OBR Proposals, it is regrettable that the CAA does not yet appear to have done so. Independent consumer research and expert analysis is currently lacking in relation to the ability to move to daily measurements and in certain areas, the CAA's OBR proposals suggests a lack of knowledge and awareness of essential operational elements of the airport, such as baggage movements, that are critical to the overall consumer journey.
- 8.4 Building on VAA's previous submissions, VAA sets out below its views in response to the OBR proposals on: (i) the proposed outcomes, (ii) the proposed measures, including the need to move to daily averages, (iii) the proposed targets, and (iv) the proposed incentives. In addition, VAA fully endorses the paper submitted by the AOC in response to the Final Proposals on this topic.

⁹² CAA's Final Proposals, Section 2, Chapter 7, page 103, paragraph 7.124.

⁹³ CAA's Final Proposals, Section 2, Chapter 7, page 104, paragraph 7.132.

- 8.5 VAA also relies on the AP Report, which in Section 12 sets out a number of observations on the CAA's proposed approach to OBR. VAA endorses the points which are made by AP, which include that:
- 8.5.1 The CAA has relied insufficiently on the evidence submitted by Arcadis, and has not explained adequately its rationale for departing from a number of the recommendations put forward by Arcadis; and
 - 8.5.2 The CAA has not adequately addressed a number of the shortcomings previously identified by the airlines.

Proposed Outcomes

- 8.6 The CAA's Final Proposals outline that it proposes to adopt the outcomes put forward by HAL. VAA does not agree with this approach and does not view these outcomes as fit for purpose. VAA refers to its previous submissions on this matter,⁹⁴ which gave detailed reasoning as to why the outcomes proposed by HAL (and now adopted by the CAA in its Final Proposals relating to OBR) are not in the best interests of consumers and should be refined and/or amended. Overall, this is because the current proposed outcomes are not specific enough to provide a clear definition of the best outcomes for the consumer, and because the CAA has provided insufficient evidence to support its proposed outcomes.
- 8.7 From the material which the CAA has published, VAA is concerned that the CAA has not paid detailed regard to VAA's previous submissions which include carefully considered proposals for alternative outcomes. Those proposals are based on work done to best reflect what consumers need and value from their airport experience, using recognised and comprehensive customer journey mapping analysis, tools and techniques.
- 8.8 As stated to the CAA in July 2021, "*[t]hrough our engagement on the H7 OBR scheme, the Airline Community have voiced concerns about the level of precision and tangibility of Heathrow's proposed outcomes and have provided an updated view of consumer outcomes for H7*". VAA remains concerned that the CAA has not adequately engaged with the alternative proposals provided; it is due to the very fact that HAL's proposed outcomes were so broad that VAA, as part of the airline community, concluded they were not fit for purpose. VAA's alternative proposals, unlike HAL's, were carefully considered and are deliberately specific. For example, VAA's previous submission entitled "*H7 OBR – Interim position update*", sent on 16 July 2021 from VAA to the CAA, sets out 12 pages of detailed submissions that are based on comprehensive customer journey analysis in order to try and put forward the best possible outcomes with the consumer in mind.
- 8.9 VAA considers that it is outcomes which form the foundation of the proposed shift to outcome-based regulation. On that basis, VAA is disappointed that the CAA appears to have failed to engage with VAA's submissions on alternative proposed outcomes.
- 8.10 VAA does not consider that it is an answer to this issue to state that the outcomes proposed by HAL "*cover the main aspects of airport operation services that are important to customers ... Nevertheless it may be useful to revisit these at the time of future period reviews, drawing on the experience of applying OBR in practice at Heathrow, to consider whether any changes would be useful*". Such a response does not offer any explanation as to why the proposed outcomes should not be clarified

⁹⁴ In particular, "*High level Outcomes 1106*" sent on 11 June 2021 from VAA to the CAA; "*H7 OBR – Interim position update*" sent on 16 July 2021 from VAA to the CAA; "*Outcome Based Regulation*" sent as part of the document titled "*Annex 6.1 – Heathrow H7 RBP Feedback – Airline OBR Response_Final*" which was submitted as part of the airlines' response to the RBP to the CAA in February 2021; and the VAA IP Response.

and refined now, particularly given the detailed explanations and alternatives that VAA and the other airlines have offered. Unfortunately, and contrary to the CAA's stated intention to move to an OBR approach for the sake of consumers, its proposals reflect an approach which gives very little weight to having effective outcomes. This is nothing more than a slightly modified Service Quality, Rebate and Bonus scheme ("**SQRB**") which is labelled as OBR.

- 8.11 It is important that the outcomes in OBR are derived from the best possible understanding of what consumers want when using LHR in the context of regulation of HAL's performance, prioritising factors such as punctuality and reliability. The CAA's responsibility as regulator is to regulate HAL's performance, however, the current proposed outcomes fail to do this by setting vague and imprecise outcomes, some of which are even outside of the scope of HAL's control. VAA's previous submissions outline how these outcomes can be refined by reference to consumers' expectations of performance from HAL. By failing to engage with the consumer-based proposals that VAA has offered, the CAA has not adequately considered the best interests of the consumer.

Proposed measures

- 8.12 The measures (as the CAA itself recognises) are crucial to setting the performance level that consumers expect and should be offered when using LHR, and are designed to keep HAL accountable for the services it provides. However, VAA disagrees with the CAA's approach to the proposed measures. VAA is concerned that the CAA has not engaged with the substance of VAA's previous submissions and has not demonstrated how the proposals it has put forward are in the interests of consumers.
- 8.13 In particular, VAA is concerned that the recent serious baggage system failures experienced by customers at LHR during the summer 2022 season demonstrate that an unacceptably high number of passengers who pass through the airport do not travel with their bags. The average missed bag ratio at LHR is currently 13.2 missed bags per 1000 passengers (13.2:1000). By way of a worked example, at an average bag to passenger ratio of 1.08, there were 87,500,000 bags processed by HAL's baggage systems in 2019. That equates to 1,069,200 missed bags at 2019 passenger levels. Of the 87.5 million bags processed, 1 million would not fly with their passengers, so a total of 11.4% of bags would not make their flight at current performance levels.
- 8.14 VAA is concerned to note that the Final Proposals include the baggage misconnect rate in Table 3.2 as a measure not subject to financial incentives. VAA does not agree with this categorisation. It is clearly in consumers' interests to provide a financial incentive for HAL to improve this metric.
- 8.15 VAA notes that the CAA proposes to exclude baggage belts from the availability of check-in infrastructure measure. However, in VAA's experience in Terminals 2 and 3 of the airport, baggage belt failure is frequently the biggest problem with check-in infrastructure. The AOC submission also refers to regular and repeated failures which in effect limit desk capacity.
- 8.16 VAA strongly urges the CAA to re-consider its position on the proposed measures and to take further time to gather the necessary evidence and information which properly considers the measures that will best further the interests of consumers.

Proposed targets

- 8.17 As explained above, VAA does not consider that the outcomes or measures proposed by the CAA are appropriate. In these circumstances, and as noted above, VAA expects the CAA to carry out a further review of the proposed outcomes and measures. In addition, VAA proposes that, as part of its review, the CAA should consider amending the proposed targets. Overall, VAA makes the following

observations which it hopes will assist the CAA when considering these matters in further detail.

- 8.18 Firstly, VAA notes that the CAA has expressly decided not to adopt fully the conclusions made by Arcadis. In particular, the CAA has retained its approach of setting targets at the bottom end of the possible range of stretch targets suggested by Arcadis. In the absence of any specific basis for this approach, VAA does not consider it to be defensible. It is also evident that this decision will have a clear detriment to consumers and the CAA has provided scant reasoning as to why being cautious should lead to it adopting targets at the bottom end of the range proposed by Arcadis. It is further unclear why the CAA considers additional caution to be required in circumstances where Arcadis appears to have been largely aware of the issues said to give rise to the CAA's caution (insofar as that can be determined).
- 8.19 VAA is however limited in the observations which it is able to make in this regard because the CAA has not adequately explained its rationale for departing from the conclusions made by Arcadis. Insofar as the CAA elects to maintain the position which it currently proposes to take, VAA expects the CAA to explain more clearly, and on an item-by-item basis, why it has chosen the targets it has and why it has not adopted the conclusions proposed by Arcadis.
- 8.20 Secondly, even without an adequate understanding of the CAA's reasons for proposing particular targets, it is clear from the face of the proposals that there are a number of significant difficulties with them. The CAA should consider setting higher targets for HAL given that many of the current proposed targets are in fact lower than the level of performance which HAL has consistently been able to reach, to date.
- 8.21 In particular, VAA notes and supports the submission of the AOC in respect of targets for security performance. Arcadis states that HAL has consistently exceeded its targets across Q6 and that if unchanged the targets are achievable in H7. It would not be appropriate to retain the same targets for HAL in H7 if they are already easily achievable. VAA notes in this connection that HAL and the CAA expect significantly fewer passengers to flow through the terminals than was the case through the Q6 period which should be easier to service.

Proposed incentives

- 8.22 In relation to the proposed targets and bonuses, VAA reiterates the comments made in its previous submissions. In particular, VAA disagrees fundamentally with the suggestion that bonuses should be payable to HAL for delivering its services. VAA considers that delivery should be the expectation, with rebates payable if service levels are not met, but does not agree that bonuses should be payable for delivery. VAA notes and supports, in particular, the submission of the AOC on security and cleanliness bonus targets.

Continuous improvement and implementation

- 8.23 The Final Proposals state that the CAA expects to carry out a mid-term review of the OBR framework, and that there will be benefits in undertaking it before the half-way point of H7. VAA agrees that a mid-term review should be conducted and is of the view that the review should occur in 2023.
- 8.24 VAA considers that it will be important for the mid-term review to include consideration of the topics flagged in the Final Proposals in addition to consideration of whether a move to daily performance measures is beneficial to the consumer. It is essential to include consideration of whether demand is driving security (and control post) performance, and therefore whether moving to a daily performance standard would drive an increase in opex, or whether improved performance could be achieved at no extra cost by moving to a daily standard. It is important to assess

whether the introduction of a daily standard would incentivise HAL to produce a more consistent daily performance standard, at the same cost as today and to the overall benefit of consumers. VAA notes and supports the submissions of the AOC in respect of the proposed scope of the review.

- 8.25 It will be important for the CAA to instruct HAL to provide relevant data so that airlines can properly review it within the timeframes of the mid-term review. VAA concurs with the indication of the required data provided in the AOC response. VAA requests that the CAA publish a timetable for the mid-term review process with a clear indication of the topics to be considered.

9. **OTHER REGULATED CHARGES**

- 9.1 This Section responds to Chapter 8 of the CAA's Final Proposals. As a headline comment, VAA is generally supportive of the proposed marginal cost-based approach to ORC. VAA is strongly of the view that any modification in scope of the ORC should be fully consistent with this approach.
- 9.2 Accordingly, VAA agrees that the fixed costs, allocated costs and costs for check-in facilities, IT, heating and gas should be reallocated from the ORC cost base to the regulated airport charge. Consistent with the CAA's Final Proposals and the switch to a marginal cost-based approach, VAA does not support the reallocation of those elements of business rates that are solely related to non-airline parties to the ORC cost base. It accepts however, that the element of business rates associated with solely non-airline users should be retained in the ORC.
- 9.3 VAA supports the CAA's approach in relation to bus and coach services.
- 9.4 VAA is further supportive of the proposed changes to the governance arrangements. In particular, HAL supports the development of further guidance on ORC protocols and dispute resolution process starting in Autumn 2022, in the form of high-level principles that HAL, airlines and other ORC users can use as a framework to help develop the new ORC protocols and the binding dispute resolution process.

Marginal cost-based approach

- 9.5 VAA confirms its support for a transition to a marginal cost-based approach for the calculation and management of ORC. VAA agrees that this is an appropriate and effective method through which to achieve the minimisation of price fluctuation (through better management of passenger volume fluctuations) and fair and accurate payment of ORC costs. VAA further notes the secondary benefits of such an approach, including in strengthening the governance process, the simplification of unit cost calculations, and achieving efficiencies in the approach to regulation.

Changes to the scope of the ORC

- 9.6 VAA agrees with the proposed reallocation of fixed and allocated costs from the ORC cost base to regulated airport charges on the basis that these costs are generally applicable to all passengers. VAA particularly agrees that the scope of costs included within the ORC should reflect how airlines can influence these costs, as well as the actual use of the services and facilities provided.
- 9.7 VAA agrees with the CAA that business rates do not represent a marginal cost and that reallocating them from the regulated airport charge to ORC would be inconsistent with the proposed shift in approach. VAA is, however, in agreement that the element of business rates associated with solely non-airline users should be retained in the ORC. VAA agrees that it is not appropriate to apply an incentive mechanism for the H7 price control period, and that HAL should continue to be incentivised to negotiate on business rates that will come into effect for the H8 period.

Governance arrangements

- 9.8 VAA supports the proposed changes set out in the Final Proposals for governance arrangements, in particular the proposal to develop, consult and agree governance and consultation arrangements for the ORC, establish clear rules, processes and information requirements to allow the scrutiny of charges that are subject to Condition C2, provide a report on the proposed revisions, and provide a suite of governance documentation to cover the proposed requirements.
- 9.9 VAA is further mindful of the current obstacles faced by operation of the existing dispute resolution mechanisms which have been experienced since the onset of the Covid-19 pandemic in March 2020. VAA, therefore, also welcomes the CAA's proposal to not only review and make improvements to the existing governance protocols, but also to make amendments to the ORC licence such that HAL is expressly required to agree to and comply with any such protocol, including with regard to cost allocation and pricing principles. VAA is also supportive of clarity on the CAA's role in relation to any dispute, and a greater degree of CAA involvement in that regard.
- 9.10 VAA agrees in principle to the proposed amendments to the ORC licence and corresponding enhanced protocols, but reserves the right to comment on the documents in due course in the expectation that it will have an opportunity to feed into the revised ORC licence.

Forecast of ORC revenues

- 9.11 VAA notes that the CAA has accepted HAL's approach to base its forecast on the proportion of ORC charges relative to HAL's opex base as "*a reasonable starting point*" for H7 forecasting purposes,⁹⁵ subject to certain adjustments. Due to HAL's inherently pessimistic forecast (as outlined in Section 2 of this response), VAA considers that a further adjustment should be made to use the CAA forecast for the H7 period as the baseline for the passenger forecast which drives the ORC charge, unless mutually agreed by HAL and the airline community on an annual basis.

10. REGULATED ASSET BASE ADJUSTMENT

- 10.1 This Section responds to Section 3, Chapter 10 of the CAA's Final Proposals. In line with the VAA IP Response, VAA remains firmly opposed to the CAA's decision in April 2021 to make an upwards RAB adjustment of £300 million, on the basis that this ultimately has a distorting effect on the calculation of the H7 price change, and that it would be inappropriate to make such an artificial change. VAA is disappointed by the CAA's comments in the Final Proposals that its April 2021 decision was intended to be the CAA's final decision on this matter, and at the lack of proper reasoning for the CAA's conclusions in the Final Proposals not to reverse the £300 million adjustment, particularly in light of recent events at LHR where HAL has unilaterally acted to restrict the capacity of airlines due to its failure to put in place sufficient resources to meet passenger demand. Notwithstanding the above, VAA understands that the CAA is currently reviewing the validity of the £300 million RAB adjustments and whether it was used for the objectives it was intended. VAA urges the CAA to complete this review before the CAA's Final Decision is taken and to publish its decision to provide clear accountability and transparency to consumers.
- 10.2 VAA welcomes the CAA's confirmation in its Final Proposals that it does not intend to make any further increase beyond the £300 million already made, but VAA continues to believe that there should be a structured reversal of the £300 million adjustment. It is not clear what use, if any, HAL made of the £300 million RAB adjustment previously, but in light of the severe operational difficulties at LHR in the

⁹⁵ CAA's Final Proposals, Section 2, Chapter 8, page 127, paragraph 8.86.

course of 2022, it certainly does not appear that it has achieved the objectives for which it was intended, and it would be a serious error on the part of the CAA to 'throw good money after bad' by making any further increases to the RAB as HAL has requested and not is therefore in line with the CAA's statutory duty to further the interests of consumers.

£300 million RAB adjustment in April 2021

- 10.3 Having closely considered the CAA's comments in the Final Proposals, VAA's position remains unchanged that the £300 million RAB adjustment should never have been made in light of the negative consequences which such an adjustment would cause.
- 10.4 In the VAA IP Response,⁹⁶ VAA explained that the increase to HAL's RAB would not incentivise HAL to maintain service quality and provision of capacity in anticipation of increasing passenger traffic. VAA's position has been entirely borne out by the operational challenges at LHR this year, which have culminated in HAL unilaterally requiring airlines to reduce their capacity at HAL during the busiest period of the year. This has resulted in severe disruption for consumers seeking to travel from LHR, which: (i) undermines consumer confidence in aviation travel at the time when the industry needs to rebound strongly from the Covid pandemic; and (ii) negatively impacts airlines both reputationally and from a financial perspective.
- 10.5 HAL was repeatedly told by airlines in 2021 that demand for travel would rebound strongly in 2022 (i.e. that the rebound would be delayed from 2021 to 2022) and that HAL needed to start scaling up in 2021 to meet this demand. HAL was fully aware of the steps that it would need to take, including the need to recruit, train and obtain security clearances for staff, and the timeframe that this would entail. HAL's failure to take the necessary steps at the relevant time and its insistence on maintaining unduly pessimistic passenger forecasts (which it belatedly revised) either demonstrates a catastrophic error on the part of HAL's management team or a self-serving attempt to create a narrative that would be beneficial to it as part of this H7 process. In either case, there is no indication of how HAL used the £300 million RAB adjustment, and certainly not that HAL put the £300 million to any use in 2021 that would meet the objectives set by the CAA of preparing for a higher-than-expected increase in passenger demand.
- 10.6 The approach of the CAA to this point in the Final Proposals is unsatisfactory:
- 10.6.1 The CAA does not explain how it has reached its conclusion that reversing the adjustment would not be in the interests of consumers as it could increase investor perceptions of risk, increase the cost of capital and put upward pressure on airport charges.⁹⁷ The Final Proposals do not contain a proper discussion of the analysis underpinning this conclusion and are therefore insufficiently reasoned.
- 10.6.2 VAA notes the CAA's position that "*the April 2021 RAB Adjustment Decision was intended to be our final decision*"⁹⁸ and that "*bearing this in mind, there is a relatively high evidential threshold for us to consider reversing this decision*".⁹⁹ The suggestion that, instead, the relevant route for airlines to raise their concerns is to appeal this decision to the CMA if they disagree with the CAA's approach and reasoning¹⁰⁰ is not a proper alternative to the CAA considering and reasoning its analysis properly in its Final Proposals, not least

⁹⁶ See paragraph 2.3 of the VAA IP Response.

⁹⁷ CAA's Final Proposals, Section 3, Chapter 10, page 107, paragraph 10.99.

⁹⁸ CAA's Final Proposals, Section 3, Chapter 10, page 100, paragraph 10.61.

⁹⁹ CAA's Final Proposals, Section 3, Chapter 10, page 101, paragraph 10.62.

¹⁰⁰ CAA's Final Proposals, Section 3, Chapter 10, page 101, paragraph 10.62.

as the CAA proceeds to note that the "reversal of amounts previously included in the RAB has also been explicitly proscribed in a previous CMA appeal".¹⁰¹

10.7 The CAA's suggestion ignores the wording of the CAA's response to HAL's initial request for a Covid-RAB adjustment which made clear that:

10.7.1 "Given:

- *the high degree of uncertainty over, and the strength and speed of the recovery of passenger traffic; and*
- *therefore, whether the RAB adjustment required to meet our duties and objectives might turn out not to have been required we have considered additional protections we should put in place for the interests of consumers";*¹⁰²

10.7.2 "We would expect HAL to respond to our decision on the RAB adjustment in 2021 by taking proactive steps to prepare for a higher than expected increase in passenger traffic. If evidence were to emerge that HAL was not delivering an appropriate quality of service in 2021, we would conduct a review of these matters";¹⁰³

10.7.3 "In this review, we would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in an efficient and timely way and maintained service quality";¹⁰⁴

10.7.4 "In the event that this review showed that HAL had not responded appropriately or maintained service levels, we would look to introduce additional protections around service quality in H7. We would also consider reducing the £300 million RAB adjustment or make an offsetting reduction to revenues, making sure not to:

- "double count" any SQRB penalties that HAL might have incurred; or
- disallow any efficient costs that HAL had incurred to meet the increased demand experienced."¹⁰⁵

10.7.5 "We would look to provide further guidance on this review as part of the H7 price control review. The SQRB metrics will provide useful information to signal any potential issues with service quality."¹⁰⁶; and

10.7.6 "...if evidence were to emerge of HAL failing to deliver on quality of service then we will take steps to further protect the interests of consumers by conducting a review of these matters (and we would seek to protect consumers from the costs of any such failures). This should help further incentivise HAL in delivering an appropriate level of investment and quality service to consumers."¹⁰⁷

¹⁰¹ CAA's Final Proposals, Section 3, Chapter 10, page 101, paragraph 10.63.

¹⁰² CAP2140, page 46, paragraph 4.21.

¹⁰³ CAP2140, page 46, paragraph 4.22.

¹⁰⁴ CAP2140, page 46, paragraph 4.23.

¹⁰⁵ CAP2140, page 46, paragraph 4.24.

¹⁰⁶ CAP2140, page 46, paragraph 4.25.

¹⁰⁷ CAP2140, page 7, paragraph 4.

- 10.8 In the context of the ongoing issues at LHR, VAA wrote to the CAA in April 2022 to request that the CAA conduct such a review. The CAA has now indicated in the Final Proposal that it will conduct a review of HAL's operational performance in the Autumn, "if it is appropriate" to ensure that the interests of consumers are protected.¹⁰⁸ In light of the issues at LHR identified in paragraph 10.5 above, it is not only manifestly appropriate for the CAA to conduct such a review, but the CAA would fail consumers if it did not do so.
- 10.9 VAA urges the CAA to complete this assessment in advance of the CAA's final determination in respect of the H7 price control,¹⁰⁹ so that it can be taken into account in finalising the charges for H7. In the event that the review is still ongoing at the time the final determination of the H7 price control is published, the CAA must provide clarity on how the outcome of its review will be applied within the H7 price control. Indeed, as noted above, CAP2140 envisages that further guidance on the review will be provided in the H7 price control period and that, if there is evidence that HAL has not responded appropriately or maintained service levels, then the CAA would look to include additional protections around service quality in H7.¹¹⁰ It will be important for the CAA to publish the findings of its review once complete so that: (i) there is clear accountability and transparency in respect of the review, and (ii) consumers and airline users of LHR can understand how HAL has used the £300 million RAB adjustment, which will ultimately be borne by consumers via the H7 charges.

Further RAB adjustment requested by HAL

- 10.10 VAA welcomes and strongly agrees with the CAA's clear and unconditional decision that making an additional RAB adjustment of the magnitude requested by HAL would not be in the interests of consumers and therefore not in line with the CAA's statutory duty as it would result in additional costs to consumers that would not be sufficiently offset by any associated benefits to consumers.
- 10.11 As set out in the VAA IP Response, VAA considers the repeated request from HAL to substantially increase the size of the RAB adjustment (amounting to a total £2.5 billion) to be inappropriate and unjustified. Such an increase would be likely only to benefit HAL's shareholders which have no need of funding and which, as the CAA has recognised in its Final Proposals, "have not supported the group with additional equity finance, in contrast to the shareholders of many aviation businesses",¹¹¹ despite the very severe shock to the industry caused by the pandemic.
- 10.12 Further, any additional increase to the RAB would have wide-ranging negative impacts on the H7 price charge and how this is calculated. It would also set an unfortunate precedent and disincentivise HAL from providing and maintaining proper service levels. Any increase would therefore fail to promote economy and efficiency on the part of HAL, a matter to which the CAA is bound to have regard under s.1(3)(d) of the Civil Aviation Act 2012.
- 10.13 VAA agrees with the CAA's conclusions in its Final Proposals that allowing the recovery of historical losses would not be in the interests of consumers as the costs of it would not be sufficiently offset by a lower cost of capital, more investment or better service quality, indeed, as outlined in Section 10 above, there is no indication that the £300 million RAB adjustment previously granted by the CAA in 2021 led to any of these outcomes or met the CAA's objectives as set out in CAP2140 for which it was granted.

¹⁰⁸ CAA's Final Proposals, Section 3, Chapter 10, page 104, paragraph 10.87.

¹⁰⁹ CAP2140, page 46, paragraph 4.24 – 4.25.

¹¹⁰ CAP2140, page 46, paragraph 4.24 – 4.25.

¹¹¹ CAA's Final Proposals, Summary, page 21, paragraph 72.

- 10.14 VAA further refers the CAA to the representations that VAA made at paragraphs 2.2 - 2.28 of the VAA IP Response in support of the CAA's decision in its Final Proposals not to make a further RAB adjustment in favour of HAL. Below, VAA sets out its further views on certain additional aspects of the CAA's decision as discussed in its Final Proposals.

Recovery of efficiently incurred investment / effect of the pandemic on assets utilisation and asset lives

- 10.15 It appears that HAL has attempted to justify further its supposition that it would be appropriate for the CAA to permit a full recovery of historical expenditure and historical losses and regulatory depreciation incurred in 2020 and 2021 via a further RAB adjustment within this price control in order to avoid damaging investor confidence in regulation.¹¹²
- 10.16 As explained in VAA's comments in the VAA IP Response, whilst VAA recognises the impact of the Covid-19 pandemic on the operations of HAL, the effect of HAL's proposal would simply be to insulate HAL and its investors (who did not put any further equity into the business during the pandemic, unlike shareholders of many other aviation businesses) from commercial risk to the detriment of consumers, airline users of LHR and the recovery of the aviation industry sector generally. This is not in line with the objective of the CAA's statutory duties, which place the interest of consumers at the heart of the CAA's activities, not the protection from any risk of an airport operator with market power and its well-resourced shareholders. In this regard, VAA considers that the CAA is correct that there is no guarantee or fundamental principle (absent a specific term in the regulatory framework, which does not exist in respect of LHR) of UK regulation that companies are guaranteed a recovery of regulatory depreciation.
- 10.17 In any event, the CAA's Final Proposals already include a wide range of mechanisms that operate so as to mitigate uncertainty for investors, and so there is no need for any further adjustments to the RAB to be made to guard against any perceived risk that the inability of investors to rely on the return of historic capital invested could result in "*materially damaging confidence in regulation and increasing risk*". See further paragraph 10.18 below.

Financeability

- 10.18 VAA understands that HAL has sought to include the historical losses that it incurred due to the pandemic in its financeability analysis by including 2020 and 2021 within its financeability assessment.¹¹³ The aim of this appears to be to manufacture support for a narrative that, absent a further increase in the RAB, key financial metrics fall below relevant thresholds.
- 10.19 VAA agrees with the CAA that, in meeting its obligations under its statutory duties, what is most relevant is whether HAL can finance its activities within the price control period (rather than recoup losses from previous periods and shield itself and shareholders from risk, particularly when its shareholders have not made any investment in HAL during the pandemic and were receiving sizeable dividends even in 2020) and therefore that the CAA's analysis should be based on forward looking metrics and thresholds. In Section 11 of this response, VAA sets out its views that HAL's activities will be readily financeable under the CAA's proposed price cap.

¹¹² See, in particular, HAL's arguments as summarised in CAA's Final Proposals, Section 3, Chapter 10, pages 97-99, paragraphs 10.47 and 10.51-10.52.

¹¹³ CAA's Final Proposals, Section 3, Chapter 10, page 97, paragraph 10.44.

Existence of other de-risking measures

10.20 VAA notes that the CAA has considered the impact of its other proposals when considering HAL's request for a further adjustment to the RAB, comprising (i) the proposed TRS mechanism, (ii) the provision for an allowance of asymmetric risk, and (iii) a determination of a higher asset beta given the impact of the pandemic, when calculating the WACC.¹¹⁴ TRS (as discussed in more detail in Section 3 above) does not share risks in an appropriate way between HAL and consumers, will overcompensate HAL in the event of a significant shock and can be gamed by HAL to procure outcomes beneficial to it. TRS, the allowance of asymmetric risk and an inflated asset beta together provide a disproportionate and inappropriate 'triple count' of protection for HAL, and there is certainly no need for a further RAB adjustment alongside these mechanisms. In fact, a properly calculated asset beta in the WACC will account for this risk without need for the other mechanisms, including any further adjustment to the RAB. VAA sets out its further representations on these proposals in Section 5 of this response.

11. FINANCEABILITY

11.1 This Section responds to Section 3, Chapter 13 of the CAA's Final Proposals. VAA agrees with the CAA's assessment in its Final Proposals that the proposed price cap will be financeable from both a debt and equity financeability perspective. Indeed, VAA has proposed an alternative price control model (see Section 12 below) with a lower price cap which would still be financeable for HAL.

11.2 In the remainder of this Section, VAA sets out below certain comments regarding the CAA's approach to financeability and the profile of charges.

Approach to financeability

11.3 In the VAA IP Response, VAA sets out a number of errors in the CAA's financeability assessment at the Initial Proposals stage. VAA makes the following comments in relation to the CAA's approach to these matters in its Final Proposals:

11.3.1 **Equity financeability – dividends:** the CAA's assessment of dividends under its price control model at Initial Proposals stage erred in considering whether the projected notional dividends under its model were reasonable by comparing their size to the very high dividend payments made by HAL between 2015 and 2019. VAA acknowledges the CAA's confirmation in its Final Proposals that the CAA does "*not infer from this analysis alone whether the projected level of dividends is appropriate*",¹¹⁵ and that the CAA's projected profile of dividends in its base case is lower than the average dividend payment by HAL in the period 2015-2021.¹¹⁶ Notwithstanding this, the average yield of the CAA's projected dividend profile remains significantly in excess of the average yield of FTSE 100 companies,¹¹⁷ suggesting that the dividend profile remains generous to HAL's investors. VAA remains concerned that this is an inappropriate benchmark for a reasonable dividend in the future, noting also the CAA's overriding statutory duty to further the interests of consumers, not HAL's financial position.

11.3.2 In any event, considering whether, under the proposed price control, HAL will be able to return to paying dividends relatively quickly should not be viewed as a primary measure of determining whether the price control provides a reasonable return to investors, without also considering the other

¹¹⁴ CAA's Final Proposals, Section 3, Chapter 10, page 107, paragraph 10.98.

¹¹⁵ CAA's Final Proposals, Section 3, Chapter 13, page 152, paragraph 13.77.

¹¹⁶ CAA's Final Proposals, Section 3, Chapter 13, page 166, paragraph 13.125.

¹¹⁷ CAA's Final Proposals, Section 3, Chapter 13, page 166, paragraph 13.124.

benefits received by HAL's shareholders. Dividends are simply one way in which investors gain a return on their investment (and as the Final Proposals acknowledge, shareholders should generally be indifferent to the timing of dividend payments as this does not affect the value of the business).¹¹⁸ Rather, value to investors should be considered in the round, including in light of the projected dividend profile as well as the full H7 package and the other mechanisms to protect HAL from risk, such as the adjustment to the RAB, the TRS, and the asymmetric risk allowance. It is clear that, when considered on this basis, it is unquestionable that HAL's activities will be financeable from an equity perspective.

- 11.3.3 **Shareholder cash injection:** VAA raised concerns in the VAA IP Response that the CAA had not given proper weight to, or adequately investigated, whether HAL's shareholders should be expected to provide a cash injection. VAA welcomes the CAA's updated analysis in its Final Proposals, insofar as the CAA's stress testing does now take account that in a stress situation it would be reasonable to assume that shareholders in the notional company would be willing and able to provide the additional liquidity required¹¹⁹ (in the same way that many shareholders of airline businesses have made cash injections in light of the depth of the trading difficulties presented by Covid-19 pandemic). VAA considers that such an assumption is not only reasonable and appropriate given the cash injections by airline shareholders noted above, but in line with regulatory precedent (see paragraph 8.21 of the VAA IP Response). VAA, however, does not agree with the CAA's conclusions that a cash injection would be of limited benefit in supporting the net debt/EBITDA ratio, since it would clearly reduce HAL's net debt and avoid/minimise the need for HAL to raise debt at all. Nor does the CAA appear to have taken any account of the VAA IP Response (see paragraph 8.23) as to the qualitative weight that credit ratings agencies would place on a shareholder cash injection.

Profile of charges

- 11.4 VAA acknowledges the benefits of smoothing the charges profile but is concerned by the CAA's proposal to weight the charges towards the earlier years of the price control period. A charges profile that is flatter and is not weighted to providing charges to HAL earlier in the price control period would be the most appropriate and reasonable approach.
- 11.5 It would not be in the interests of consumers, or appropriate for passengers travelling earlier in the price control period to have to bear greater charges, with the primary aim of returning money to HAL more quickly during the period. HAL has missed out on additional revenue from lost passengers (which would have made it more financially secure) as a result of mandating that airlines must reduce capacity at LHR in IATA summer season 2022, in light of its own failures to prepare in time for the increased passenger demand anticipated by the airlines and in giving credence to unduly pessimistic passenger forecasts. It would now be highly inappropriate if consumers during this early phase of the price control period, who will in some cases also be the passengers affected by these failures, had to bear higher charges with a view to improving HAL's revenues, where this is a situation of HAL's own making. The CAA must find solutions to disincentivise this behaviour from HAL so that customers do not 'pay the price' for HAL's actions.
- 11.6 Further, the CAA should consider how its proposed profile affects the incentives of HAL. VAA's view is that weighting the charges towards the earlier period of the price

¹¹⁸ CAA's Final Proposals, Section 3, Chapter 13, page 165, paragraph 13.121.

¹¹⁹ CAA's Final Proposals, Section 3, Chapter 13, page 171, paragraph 13.138.

control: (i) does not properly incentivise HAL to encourage passenger growth; (ii) will lead to higher prices for consumers; and (iii) will only be to the benefit of HAL and its cash position.

Credit ratings

- 11.7 VAA does not agree with the Final Proposals that an assessment of financeability should be based on a target of a credit rating of BBB+. There is no requirement that the CAA should ensure that HAL is financeable at a particular credit rating at the expense of consumers. VAA further considers that it is unreasonable for the CAA to target a credit rating of BBB+ early in the price control period, particularly when the Houlihan Lokey report submitted in the VAA IP Response made clear that creditors would consider the outlook for HAL over a longer period.
- 11.8 Further, aviation as an industry and consumers generally are dealing with a number of adverse challenges, including the recovery from Covid-19, high fuel costs and the cost of living crisis. Against this backdrop, VAA is concerned that the CAA has wrongly placed too much weight on HAL attaining a BBB+ credit rating at the cost of consumers. If the CAA is seeking to protect consumers in considering the financeability of HAL as it suggests, there would be better means of doing so than ensuring the HAL can achieve a BBB+ credit rating in the short-term, particularly when there is evidence that HAL would be financeable even at a lower credit rating and that credit ratings agencies consider a longer-term horizon when determining ratings.
- 11.9 Finally, VAA notes that the need for HAL to procure debt would be reduced to the extent that shareholders were to make an equity injection in HAL (as many shareholders of aviation companies did during the pandemic, whilst in contrast HAL's shareholders not only made no injection but also received a sizeable dividend in 2020). The ability for HAL to raise cash via such other methods means that the credit rating of HAL is less relevant in any event, such that is not reasonable for the CAA to target a higher credit rating when HAL would be financeable at a lower credit rating.
- 11.10 For completeness, VAA is satisfied that the alternative price cap proposal as outlined at Section 12 below is financeable.

12. ALTERNATIVE PRICE CAP PROPOSAL

- 12.1 It will be apparent from the sections set out above that VAA and AP have identified a number of areas in the Final Proposals where the CAA should adjust its approach. In these circumstances, VAA has drawn together the various changes which it considers ought to be made to the CAA's building blocks, in order to illustrate the effects of those amendments on the price cap. In the interests of assisting the CAA as far as possible, VAA has, to the best of its efforts, sought to illustrate these effects by using figures adjusted from the CAA's own PCM model. This model is set out at **Appendix 4** to this response. VAA would invite the CAA to consider this and also to further discuss the adjustment of any figures within this model with VAA, if the CAA considers appropriate.

- 12.2 By way of summary, the appended PCM model makes the following adjustments:
- 12.2.1 Updated passenger numbers as per Section 2;
 - 12.2.2 Removal of an allowance for Asymmetric risk as per Section 4;
 - 12.2.3 A WACC adjusted to 2.65%¹²⁰ as per Section 5;
 - 12.2.4 Reduction in opex cost line for pension and 5% improvement on revenues (£23 million per annum) as per Section 6; and
 - 12.2.5 An opening RAB reduced by £300 million as per Section 10.
- 12.3 The outcome of this process is a modest reduction in the price cap; an average price across the H7 period within the range of £18 to £19 per passenger. This is based on figures that are reasonable, proportionate, based on the best evidence available and which remain at a level which is financeable for HAL. Ultimately, VAA considers that this figure would be in the best interests of consumers.

Yours sincerely,

Virgin Atlantic Airways and Delta Air Lines

¹²⁰ VAA has used figure of 2.65% being the pre-tax real WACC.