

3rd February 2014

Virgin Atlantic Response: Airport Commission final consultation on shortlisted options for new capacity

Introduction

Virgin Atlantic (VAA) welcomes the opportunity to respond to the Airports Commission's final consultation on shortlisted options for new capacity.

VAA welcomes the extensive assessment process that has been undertaken by the Airports Commission in preparing this final consultation. As well as this response, we also support the joint airline submission from BATA and the majority of the points raised in the response from the LACC at Heathrow.

Given the extensive analysis presented, this response necessarily focuses on selected areas of the consultation of particular relevance to VAA. However, we remain open to speaking to the Commission on any other areas not covered by this response.

Overview

Virgin Atlantic has maintained through the Airport Commission's process that it is the UK's chronic hub capacity shortage that needs to be addressed and therefore expansion at Heathrow is likely to offer the greatest economic benefits. This assertion has been backed up by the analysis presented by the Airports Commission.

However, there are a number of areas that need to be addressed to ensure that these benefits are maximised and the consumer benefits of additional capacity are felt:

- Competition: New capacity should enhance competition and choice for passengers. Not lock in historical dominance.
- Cost: Costs need to be scrutinised further. Incentives need to be placed on the scheme promoters to manage and try to actively reduce these costs in the delivery of capacity. Passengers should not be paying for inefficiency or gold-plating.
- Funding mechanism: Capacity should only be paid for when it's in use. This is a critical issue for passengers to ensure that the funding for any new capacity is efficient and fair with the appropriate balance of risk between passengers and airport shareholders.
- Risk allocation: Appropriate risk allocation is key in the delivery of efficient infrastructure. Risk allocation is a more significant consideration given the size and duration of the investment and appropriate incentives should be provided to deliver a runway in passenger

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interests. Airlines believe that risks should be allocated to those parties who are best able to manage it.

VAA also recognises that growth must be within environmental constraints that recognise the externalities associated with expansion. It is essential that noise compensation and mitigation actually delivers effective results for residents around the airport. There are a number of ways this could be undertaken in an economically efficient way, these are highlighted further in this paper.

Finally it is worth noting that capacity is only one issue that limits the competitiveness of UK connectivity:

- APD: Even after the welcome recent changes, the highest air passenger tax in the world limits the competitiveness of the UK aviation sector and the UK's connectivity. In order to ensure that new capacity delivers the economic benefits set out, APD needs to be significantly reduced and abolished over the long run to ensure the UK can support and sustain links to emerging economies.
- Visas: A competitive visa regime is also important. VAA has always worked cooperatively with the Home Office and the Shadow team through regular meetings and working groups as VAA seek to achieve the same goal of increasing prosperity whilst protecting our borders. Over this Parliament, the Home Office has made extensive improvements in the visa application process for China, and increasingly in India. This is to be commended. VAA would welcome and encourage a similar focus on other key markets such as South Africa.

Consultation questions

Q1. What conclusions do you draw, if any, in respect to the three short listed options?

The Commission's analysis supports VAA's view that increased hub capacity is likely to provide the greatest economic benefits to the UK. The UK's ability to compete for global trade will continue to be damaged without additional hub capacity and we believe this would be best achieved through expansion at the UK's existing hub, Heathrow.

However, VAA believes that there are a number of areas that need to be addressed to ensure that the benefits of this capacity growth to consumers are maximised. These are set out in further detail in this submission.

Finally, VAA notes the increase in costs of all the options presented by the Airports Commission analysis. There needs to be appropriate scrutiny of these costs both before and after a decision is made to ensure they are reasonable and offer value for money for the passengers who will be funding them. With this in mind there also needs to be an appropriate funding mechanism in place to ensure that any costs are fairly disseminated.

Q2. Do you have any suggestions for how the short listed options could be improved i.e. their benefits enhanced or negative impacts mitigated?

VAA notes that there are a number of areas that need to be addressed to ensure that the economic benefits of capacity are delivered and consumer benefits are maximised:

Competition

VAA believes that in order for the benefits of additional capacity to be maximised, it needs to be delivered in a way that enhances competition across the aviation market. Having two home based long-haul carriers competing at the hub is a unique feature of the UK aviation market and has demonstrably provided significant competitive benefits to passengers. In order for consumers to reap the full benefit of additional capacity, it must provide an opportunity to correct for historic market dominance caused by IAG's slot portfolio inheritance and traffic distribution rules.

In its analysis, the Commission appears to assume that current ACL slot allocations rules will also apply to the allocation of the slew of new capacity delivered by an additional runway. ✕

VAA has addressed the OECD's airline competition papers published by the Airports Commission in response to question eight of this submission.

Cost

As noted by the Commission, user charges are a significant element of airline costs. The scale of user charge increases described by the Commission (c.60% at Heathrow and c.100% at Gatwick) will create significant impact on airlines (particularly base carriers). It is not clear how this impact has been assessed in the traffic forecasts and analysis produced to date by the Airports Commission.

The economic and connectivity benefits outlined in the consultation paper will only be delivered if airlines can sustain profitable routes and can therefore invest in starting up new routes, competing with indirect services, and maintaining key links for the UK.

If the cost increases put the UK further out of step with charges at alternative hubs, airlines may not be able to increase fares or absorb the cost increase. This could lead to a reduction in frequencies, and/or the cancellation of marginal routes. This has three major negative implications for the Commission's objective to maintain or increase UK connectivity:

- New marginal long haul routes to emerging economies, such as secondary points in China, will be less viable.
- Services connecting the UK regions to world markets will become less viable. The Commission may therefore want to consider ways to ensure regional feed continues.
- Higher fares will also reduce the attractiveness of the UK. The World Economic Forum currently ranks the UK 139th of 140 countries in relation to the competitiveness of its ticket taxes and charges. Further increases to APD and airport charges will make the UK a more expensive, and less attractive, destination for business and leisure passengers alike. As well as suppressing outbound demand.

It is therefore concerning that the costs of all schemes have increased since this process started. It could be concluded that costs will continue to escalate, even after the Commission has completed its work, as airports further develop their proposals in parallel with Government policy and planning conditions. There must therefore be continued pressure on the scheme proposers, even after a decision has been made, to ensure that proposals are value for money and that strict scrutiny and management of costs is maintained.

Funding mechanism

VAA recognises that this is an issue the Commission is leaving to the CAA and that airlines are already involved in discussion with the CAA on the appropriate regulatory and funding mechanism for any new runway capacity.

However, given both airports under consideration have been assessed to have market power and are therefore subject to economic regulation by the CAA, there are a number of key principles that should be taken into account when assessing the business cases put forward. These are:

- There should be no pre-funding or revenue advancement – airport capacity should only be paid for once in use, so that the airport has an inbuilt incentive to start delivering benefits early and to defer costs where possible.
- Only efficient costs should be passed through and this should be done fairly. It is not in the passengers' interests to reward airport shareholders for inefficient or poorly timed expenditure.
- There should be no 'gold plating' – investments need to take account of airline and passenger needs, with sound business cases showing clear passenger benefits.
- Innovation (by the airport and users) is stimulated by the regulatory framework for the betterment of consumers, with airport productivity gains shared fairly with consumers.
- Inter-generational equity needs to be addressed – this is a long-term investment with multi-generational benefits. Temporal cross subsidies are unequitable and can create inefficiencies in the market to the detriment of passengers.
- Consideration of capacity utilisation is required when passing on costs to users.

Aircraft Noise and Airspace Configuration

Airlines are aware that operations at the airport may have an adverse environmental impact on communities however this must be balanced with the economic benefits when considering expansion. VAA believes that the noise modelling, presented by the Commission, carried out appears thorough and reasonable. However we note the following points, where there are opportunities to further mitigate the negative impacts associated with the proposals:

- A potential anomaly in Fig 4.28 and Fig 4.30 N60 Contours (P100 & 101 of Jacobs Noise Local Assessment report) in that both show an isolated "25 contour" to the north east of Heathrow due to "the possibility of applying thrust in the turn". Whilst this would be true to maintain level flight, the reality is that aircraft fly mandatory "Continuous Descent Approaches" at Heathrow, with the thrust at or near idle at this phase of flight. Thus we believe the actual noise impacts will be less than currently modelled.

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- VAA also notes the concept of a ‘noise envelope’ which could be used to help share the benefits of quieter aircraft technology between industry and local communities whilst increasing capacity at the same time. VAA believes further consideration needs to be given to the potential remit and parameters of such an approach, along with the process for implementation. We would, however, welcome further discussion of such a concept.
- VAA also notes the proposals to establish an independent aviation noise authority (IANA) raised in the Airports Commission Interim Report, as an additional potential method of mitigating the negative impacts associated with expansion. We believe further evidence-based work must take place prior to the case for an IANA being made. Only once this has been completed and an IANA is deemed appropriate should the remit, role and function of the body be scoped out. VAA would welcome taking part in this evaluation process going forwards.
- Future airspace design will play a vital role in evaluating the proposals and the potential impact on local communities. Thus far the assessments refer to “optimised flight paths” however, at this stage there remains a significant degree of uncertainty around how this will be delivered and what the final impact will be. Therefore there may well be the opportunity for such flightpaths to be optimised to deliver even further reductions for communities than currently suggested. The extent of the noise impact will also be dependent on the approach adopted by Government under concentration of flight paths versus dispersion. Either way it is important that land use planning is used as a tool to mitigate the impact of noise and should be considered closely with airspace change.

There is further detail on VAA’s night flights in Annex A of this submission.

Q3. Do you have any comments on how the Commission has carried out its appraisal?

VAA welcomes the extensive assessment process that has been undertaken by the Airports Commission in preparing this final consultation.

We have not been able to respond to all elements of the assessment in this submission; however, we remain open to discussing further elements in more detail with the Commission.

Q4. In your view, are there any relevant factors that have not been fully addressed by the Commission to date?

Speed of capacity release

Whilst the Commission has published traffic forecasts for the options, these have focussed on more macro level demand rather than the more practical element of when capacity and terminal capacity is operational.

There are a number of reasons why it is important to consider this bottom-up perspective:

- Previous experience at both airports has shown that there are limits to the rate of feasible, efficient capex spend in any one year by HAL and GAL and therefore it's important to ensure that the build timetables are realistic and deliverable.
- Opening of major infrastructure (e.g. terminals, baggage systems etc.) has often been subject to delays. In order to assume a resilient plan, the Airports Commission should therefore be conservative with their assumptions around capacity release and the business cases should be designed accordingly.
- It is important that the rate of scheme build is in line with passenger demand at that location, to avoid building white-elephant capacity. Furthermore, front-loading too much of the development, will also put more strain on airport charges.

Finally, there may also be environmental reasons why slower capacity release would be considered.

It is therefore important that passengers are not bearing the risks for delays to delivery that may be due to unrealistic plans or changes to the scheme design.

Risk Allocation

VAA notes that the Airports Commission has very little consideration of risk management in their assessment. It is clear from previous examples at Heathrow and Stansted, where passengers are still funding elements of costs of additional runway proposals that were never realised, that there needs to be a better way to manage this risk during this process.

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

As shown by the increase in costs of the proposals that has already occurred, as a result of the Commission's ongoing scrutiny, there needs to be a mechanism to ensure that the scheme promoters are incentivised to manage risks and costs effectively and efficiently. VAA believes that risks should be allocated to those parties who are best able to manage it. Misallocation of risk will create inappropriate incentives to developers and would be likely to undermine the CAA's primary duty to further passenger interests.

However, the current approach incentivises an inefficient approach, whereby all risk is passed through to passengers and investment is remunerated fully. This approach puts airport shareholders above passengers and discourages long-term planning. Further work is needed to identify the best risk allocation and incentive structure. These options need to be reviewed to ensure lessons are learnt from previous experiences:

- T5 pre-funding showed that generous funding treatment is highly inefficient. It led to complex regulatory interventions and regulatory uncertainty. It is also ineffective in its primary purpose of incentivising delivery, given the gains that accrue from delay.
- The STN runway 2 approach removed some of these issues by requiring the airport to proceed at their own commercial risk and by disallowing some of the inefficient investment into the RAB, with a policy of revenue deferral. Nevertheless, significant planning and property purchase costs were allowed into the RAB and no benefit accrued to airlines and passengers from this wasted investment.

Finally, VAA believes that the Government is best placed to underwrite political risk in the period until planning permission is granted. Government action can have significant financial implications at all stages. Policy risks arise because Government can change aviation policy, standards, regulations or taxes at any time and is also responsible for providing surface access links to airports. Government action can therefore stop the development or undermine the net benefits. These risks arise to some extent in all businesses, but to a much greater degree than most in infrastructure, and to an even greater degree in airport infrastructure specifically given previous experience. Therefore there is a need for Government to play a positive role by creating an enabling environment that reduces political risks. The national policy statement should facilitate this, for example by making clear political commitments, by coordinating surface access inputs and by addressing force majeure events.

Interaction with other Government policy

It is also worth noting that capacity is only one issue that limits the competitiveness of UK connectivity:

- APD: Even after the welcome recent changes, the highest air passenger tax in the world limits the competitiveness of the UK aviation sector and the UK's connectivity. In order to ensure that new capacity delivers the economic benefits set out, APD needs to be significantly reduced and abolished over the long run to ensure the UK can support and sustain links to emerging economies.
- Visas: A competitive visa regime is also important. VAA has always worked cooperatively with the Home Office and the Shadow team through regular meetings and working groups as VAA seek to achieve the same goal of increasing prosperity whilst protecting our borders. Over this Parliament, the Home Office has made extensive improvements in the visa application process for China, and increasingly in India. This is to be commended. VAA would welcome and encourage a similar focus on other key markets such as South Africa.

Slot Allocation and other competition issues

The Commission has until this point held the current slot allocation regime as a constant in its analysis. However, there is scope for further consideration as to whether this approach should be modified to ensure the fair and equitable distribution of additional slots that become available under new capacity.



As well as addressing future slot allocation, a key factor of being able to compete effectively is down to having equivalent facilities. VAA operates out of Terminal 3 (T3), while our main competitors enjoy the much more modern facilities in Terminals 5 and 2. Location of facilities is also important. It is critical for VAA to remain in the Central Terminal Area (CTA). The CTA offers good surface access and transfer connectivity to other terminals which is crucial to our business. A CTA position is also key to the efficiency of VAA's operation at its home base. In particular, we value the ability to access both runways for operational movements and our engineering hangar without needing to cross a live runway.

It is critical that airlines are able to compete on an equal footing and VAA will strongly oppose any proposed solutions which would further dilute our ability to compete effectively at LHR.

Airspace Configuration

Airspace also needs to play its role in ensuring that any expansion is achieved and delivered with minimal impact to communities and the environment. Future flight paths will play a key role in defining the extent of the impact for communities in the future. It is essential that such consultation is undertaken in collaboration with communities to ensure that the benefits are balanced for all. Therefore, at this stage it is extremely difficult to evaluate the potential impact on local communities under expansion without knowing the exact detail behind how airspace will be utilised.

Airline business models

VAA has concerns that the Airports Commission's assessment of airline business models is flawed. This will have fundamental implications both for how the benefits of new capacity and the competition benefits are assessed.

In the Airports Commission's assessments, VAA is defined as a home-based "legacy" carrier. This definition is both wrong and mis-leading. Whilst other carriers may deserve this label, VAA has never been a nationalised airline and therefore has never inherited a slot portfolio. When VAA was first founded 30 years ago, the traffic distribution rule meant we weren't allowed to operate from Heathrow. Since these restrictions were lifted in the early 1990s, VAA has had to grow its operations gradually, as and when we have been able to buy suitable slot pairings.

Having two home based long-haul carriers competing at the hub is a unique feature of the UK aviation market and has provided competitive benefits to passengers, particularly in the world's biggest aviation market, the trans-Atlantic, so we think it's essential that this is accurately reflected in the Commission's (and its consultants') assessments.

Q5. Do you have any comments on how the Commission has carried out its appraisal of specific topics (as defined by the Commission's 16 appraisal modules) including methodology and results?

Traffic forecasts

VAA believes there needs to be assurance over the forecasts. Sound business cases need to be made on all levels of traffic forecasts to ensure passengers are not bearing un-necessary risk from optimistic forecasts.

Demand risk needs to be allocated to the airport, as the party best able to manage this. This would create strong incentives for the airport to have realistic traffic forecasts and to take account of the effect of airport costs and other economic factors on demand.

The airport could, for example, reduce demand risks by reducing costs and/or by making sure that the development was likely to attract airlines, passengers and freight. This allocation of demand risk would therefore provide stronger incentives on the airport to meet passenger needs. It would also help promote competition because the airport would have to attract those customers that had a choice of whether to fly to the airport and whether to base aircraft there.

Economic assessments

VAA would welcome further detail on how this analysis has been carried out and in particular how the costs of the schemes have been fed through to their assumed economic benefit.

Cost and Commercial viability

VAA believes that commercial viability is an essential factor for the delivery, in the passenger interest, of any new capacity. Without commercial viability it is not feasible to allocate risks commensurate with rewards. However, it is not enough for a project simply to be viable for an airport's shareholders, as this can be achieved by an airport abusing its significant market power. It must also provide value for money to passengers, who will be required to fund the airport's project.

Perceived financing risks are likely to vary significantly between projects, according to the commercial viability of the scheme chosen. Airlines do not believe that airports would face real financing issues if a commercially viable option is selected, because the project would be attractive to airlines and passengers, to investors, and therefore to the CAA, significantly limiting risk of all kinds. Indeed, recent evidence has shown that regulated airports remain very attractive to investors as we do not see this changing¹. Airlines therefore do not believe a case has been made as to why pre-funding of airport capacity is necessary or in the passenger interest.

¹ <http://www.telegraph.co.uk/finance/newsbysector/transport/10397806/Ferrovial-sells-Heathrow-stake-to-UK-pension-fund-for-392m.html>

Q6. Do you have any comments on the Commission's sustainability assessments, including methodology and results?

VAA would like to comment on a number of the sub - factors which are applicable to all of the sustainability assessment for each of the schemes:

Local economy impacts

VAA highlights that both airports and airlines provide significant investment in local communities both from an economic standpoint through local employment, supporting local businesses, and via surface access links.

Both airports and airlines also operate valuable local community investment programmes, offering grants for local improvements and targeted assistance to people seeking employment, including apprenticeships and various skills development programmes in customer services, engineering, foreign languages etc.

It is vitally important that both direct and indirect benefits to local communities are fully taken into consideration in this assessment process to ensure a thorough evaluation takes place.

Noise

VAA considers it vitally important to play our part in minimising the impact we have on local communities, along with continuing to deliver the social and economic benefits we bring to these communities. It is for this reason that we have a robust programme in place through our first ever Aircraft Noise Management Strategy, a first for any airline, setting out clear commitments on tackling aircraft noise, published last year.

However, there are a number of factors that are beyond the control of airlines when considering the noise implications from expansion. These include land-use planning and airspace configuration. Both of these matters require a collaborative multi-stakeholder approach in order to maximise noise mitigation to the greatest extent. In both regards, support and clear policy guidance from Government is necessary in ensuring that the gains being made by industry in mitigating noise are not countered by external policies both now and in the future.

Mitigation and Night Flights

VAA has concerns with the suggestion that noise mitigation options may include changes to the current night flying regime. As reiterated in previous submissions, VAA currently only operates a limited number of night flights at Heathrow, and these flights are disproportionately intrinsic to the UK economy.

For various reasons, such flights cannot be rescheduled to later on during the daytime period due to restrictions and time-zone implications. Such flights are also particularly important if the UK want to maintain connections to emerging economies in the Far East. Therefore there is an intrinsic need to maintain the current status quo.

VAA is conscious of the need to balance the economic need for night flights against the needs of local communities, and believes that there is a balance to be achieved between the two. The utilisation of operational procedures and fleet investment should serve to further mitigate the negative externalities that can arise from such flights.



Insulation and mitigation schemes

VAA supports the ICAO 'balanced approach' on aircraft noise mitigation. If new incentives or benefit sharing schemes are developed for local communities, careful consideration is needed to ensure they do not create any unintended distortions. The same applies when evaluating the necessary insulation schemes to adopt with the proposed expansion plans. It is important that these are extensively evaluated through a cost/benefit assessment to ensure these provide an appropriate benefit to all parties, sharing the gains in noise reductions between local residents and industry.

VAA also notes that under expansion at other major international hubs, the associated noise mitigation schemes in place are supported by Government funding, and believe this is something that should be taken in to consideration here in the UK given the positive externalities that will accrue to both Government and the UK economy.

It is crucially important when consulting with local communities either through local engagement and outreach programmes, or airport consultative committees, that engagement takes place on as wide a platform as possible to ensure that a balance of views is taken into account. This is increasingly the case when evaluating additional capacity and the needs of those affected now, and in the future, need to be taken on board. It is also important to adopt this approach when evaluating mitigation schemes, along with ensuring there is an appropriate cost benefit assessment of any scheme adopted.

Air Quality

VAA is aware of the air quality implications both within the parameters of the airport boundary and in surrounding local communities, and acknowledges that this is a significant factor to be taken into consideration. We welcome the Commission's further work on this matter, and look forward to assessing the more detailed air quality modelling when made available.

Quality of Life

VAA notes the Quality of Life analysis that has been undertaken by the Commission with respect to expansion, and agrees that this should be seen as providing a commentary rather than a robust assessment.

A particular area of focus should be the impact that cultural and social interaction can have on both the local and national assessments. The increased social and cultural interactions and interchanges that will take place due to an increase in capacity should result in a positive impact in both respects for Quality of Life.

Q7. Do you have any comments on the Commission's business cases including methodologies and results?

VAA has not made a detailed assessment of the business cases at this stage. We would anticipate a period of intensive scrutiny, mandated by the CAA, once a decision has been made.

VAA believes that detailed scrutiny of costs by airlines as a proxy for air passengers, is needed before the costs of the schemes are finalised and the amount that can be passed through to passengers is agreed. Constructive engagement could be one way to do this if there is a mandate and appropriate forum for the scheme operators to share information with airlines, as representatives of passengers.

This engagement will also allow airlines and the airport to work together to ensure that the final proposals that are submitted for planning permission offer the optimal solution both operationally and from a passenger experience perspective.

There should therefore be a recognition in the final decision by the Airports Commission that their recommendation is not wedded to a specific cost and that further cost and scheme scrutiny work is required.

Q8. Do you have any other comments?

The remainder of this response focuses on some key topics where VAA has additional points to make:

Surface Access

VAA believes the Government should fund the majority of surface access requirements associated with expansion and welcomes the acknowledgement from the Airports Commission on this in the consultation document. Both road and rail infrastructure are fundamentally the responsibility of Government, and Government benefits directly from the revenues they generate from users.

All the schemes will generate significant economic benefits for both the local and national economy. It is therefore not clear why passengers should have to pay the costs for surface access expansions, outside the airport campus, that will have wider economic benefits.

VAA supports particular points raised around:

- Southern rail access should be included in the extended baseline in the Heathrow assessments.
- Proposals to review the widening of the M4 should be reviewed and carefully scrutinised as the current analysis does not fully take into consideration other modal shifts particularly to Crossrail.
- There is a need to fully incorporate the modal shift from private to public transport for the Heathrow assessments, particularly the additional indirect airport employees that have not been included in the analysis up until this point.

Strategic fit – airline competition

VAA has studied the papers produced by the OECD, published alongside the Airports Commission work, and has the following comments:

Airline Definitions

The importance of airline and market definitions is intrinsic to the viability of the economic assessments that take place during this process. With this in mind our view is that Virgin Atlantic should not be referred to as a legacy carrier.

Whilst other national carriers may have this label, VAA has never been a nationalised airline and did not inherit its slot portfolio from the state. When VAA was first founded 30 years ago, the traffic distribution rule meant that the airline was not permitted to operate from Heathrow. Since these restrictions were lifted in the early 1990s, VAA has had to grow its operations gradually, as and when we have been able to buy suitable slot pairings. Having two home based long-haul carriers competing at the hub is a unique feature of the UK aviation market and has provided competitive benefits to passengers, so we think it is essential that this is accurately reflected in the Commission's (and its consultants') assessments.

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Market Definition

Regardless of which option is finally chosen by the Airports Commission, VAA believes that the potential increase in capacity at either airport will not have an impact on the current market distinctions in place i.e. Heathrow will continue to remain the UK's only hub airport.

Heathrow Airport: We fly to the world's leading and emerging long-haul destinations from Heathrow. Heathrow is our airport of choice for these routes because it offers:

- Strong local demand from its catchment area, particularly for time sensitive business traffic;
- Significant additional demand from domestic connecting passengers and international transfer passengers;
- Interlining abilities with our joint venture partner Delta Air Lines and with our other airline partners; and
- Strong demand for cargo services.

Gatwick Airport: ✂

Therefore VAA's view is that Heathrow is not substitutable by Gatwick or other London airports for time-sensitive passenger and therefore increased services at Gatwick do not act as a competitive constraint on BA at Heathrow. This view is shared by the EU Commission (2012) who found that:

'easyJet generally operate from Gatwick, Luton and Stansted whereas IAG and bmi generally operate from Heathrow. It is therefore likely that EasyJet may generally represent a weaker substitute to IAG's flights from Heathrow for those routes on which bmi has operations from Heathrow. This seems particularly true for time sensitive passengers.'

Airline Scarcity Rents

Analysis of airline scarcity rents currently ignores the impact of high airport charges and APD on UK airline margins. These impose restrictions on the commercial flexibility of UK airlines, which are already obliged to offer a competitive price relative to indirect routes. This was picked up in PwC's 2013 report:

Whilst we agree that the benefits accrued to the users of aviation are likely to be highest when capacity is expanded at the airport with the largest excess demand, we would also expect there to be two additional changes in the market dynamics:

- An overall increase in demand in the market due to the increased connectivity and available destinations served; and
- An increase in airport charges associated, and therefore average cost of supply, with capacity expansion.

Our view is that these two additional changes in the market should be reflected prior to calculating the final economic rent due. ✂

Slot Allocation Regime

VAA recognises that slot allocation is likely to play an important role in which airlines can provide services following the introduction of new capacity. Over the years and under the currently slot allocation regime VAA has always strived to challenge the current market, and as a result has had to incrementally grow our operations due to the various restrictions that are in place. This is in contrast to our competitors with bases at other international airports who have been able to grow on a mostly unconstrained basis, and BA which has inherited a significant slot portfolio.

Appraisals by the Airports Commission have been made on the basis there will be no meaningful change to the current slot allocation guidelines. ✂

The UK, and specifically Heathrow, is unique in that there are two home base carriers operating and competing at the same airport. However, under the current slot allocation regime this would only serve to entrench BA monopoly position at the airport and further reduce competition. Therefore, we believe there should be a fair and equitable system in place which distributes any future slots via a mechanism that compensates the market constraints in place over past years. Such a mechanism should seek to provide some form of competitive equivalence to rebalance the distortions in the market up to this point.

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Effective airline competition is provided by carriers being able to compete on frequency and schedule as well as destinations.

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These are all concepts which we believe could be considered further under additional capacity, and would welcome involvement in further discussions around each of these issues.

Funding

Whilst the allowed profile of revenue recovery is an issue for the CAA, we thought it would be helpful for the Commission to understand VAA's key points and concerns.

VAA agrees with the CAA's view that risk should lie with those best able to manage that risk. However, VAA believes the draft policy does not always support this principle in practice and therefore disagree with the proposals around planning (category B) costs. The political risk around the planning process remains high. This is one of the reasons why it is only appropriate for runway costs to be recovered once any additional capacity is in use. As well as being the outcome in a competitive market, ahead of this there remains a risk that the Government of the day will not accept the results of the Commission and/or that planning permission may not be granted or may be delayed or subject to onerous conditions.

Airlines believe that the CAA's proposals on planning costs therefore warrant significant further consideration and disagree with the proposals as set out. The current plan could still leave users having substantially contributed towards capacity expansion that may never be realised. As airlines have previous outlined, this is not desirable, nor is it in the passenger interest. It is essential that the CAA learns from previous experiences at Heathrow and Stansted.

We are also concerned the CAA places too much weight on commercially negotiated outcomes, or contracts, delivering the best outcome for consumers. Whilst in well-functioning markets this is clearly true, the CAA has recently determined that both Heathrow and Gatwick hold Significant Market Power and therefore continue to need Licence based regulation. Given the ability of the airports to exert their monopoly power on their customers, airlines have concern that commercial deals may not lead to the best approach and the CAA should be considering other options.

Perceived financing risks are likely to vary significantly between projects, according to the commercial viability of the scheme chosen. We do not consider that airports would face real financing issues if a commercially viable option is selected, because the project would be attractive to airlines and passengers, to investors, and therefore to the CAA, significantly limiting risk of all kinds.

However, if a scheme is chosen that is not commercially viable, airlines do not consider that regulatory intervention, however innovative, is likely to reduce demand, regulation or financing risk sufficiently. We therefore do not believe a case has been made as to why pre-funding of airport capacity is necessary nor in the passengers interest. A better mechanism would be to smooth depreciation profiles over a much longer period to allow reasonable long-term returns.

Annex A: ✂