

Virgin Atlantic Airways Ltd: summary of hearing, 29 May 2007

VAA's business

1. Virgin Atlantic Airways Ltd (VAA) operated out of Heathrow, Gatwick and Manchester airports, with limited operations from Glasgow, using 37 large wide-bodied aircraft. Its business operations were largely run from Heathrow. Gatwick, Manchester and Glasgow were more leisure orientated. Eight jumbos were allocated to leisure traffic. It cooperated with a sister company, Virgin Holidays, the largest long-haul tour operator in the country.
2. After 23 years VAA still had only 3 per cent of the slots at Heathrow.

Airport charges

3. Airport charges were very significant, even though they represented less than 5 per cent of overall costs as the airline business was a fine margin one.

Relationship with BAA

4. VAA was closely involved with airport issues and the constructive engagement process. It did not think the new BAA management team was living up to its claim of being more customer-focused. It was critical of BAA's handling of the security implications of the terrorist threat, both on 10 August 2006 and subsequently. BAA's ownership of both Gatwick and Heathrow had had a detrimental effect on Gatwick as talent had been sucked from Gatwick to Heathrow. If Gatwick was under separate ownership, VAA did not believe a different owner of Gatwick would have signed up to an agreement not to develop the airport until 2019. The airline was also critical of the constant change of personnel at Gatwick, which had resulted in principles and priorities established in constructive engagement process being constantly revisited and revised.
5. For example, much of the useful options work undertaken in 2006 for development in the south and north Gatwick terminals was negated when that work was suddenly totally revisited in 2007 and the airlines were given only one option, not a number of options for different ranges. After pressing BAA, the Gatwick airlines were offered two options, but the thrust of the discussions had now shifted from a balanced investment across both terminals allowing north and south to compete to a bias towards the north terminal—a sensitive issue for VAA which operated out of the south terminal. Moreover, the cost of the projects had increased by circa £200 million to £300 million.
6. BAA was a monopolist in the provision of services to airlines and in management of airports and VAA and other airlines had limited negotiating power and therefore looked to the CAA to protect them, which it was sometimes reluctant to do.
7. VAA felt that the whole economic model of the way that BAA airports were rewarded and incentivized did not seem to work. It produced the wrong behaviour from both BAA and CAA. There were inefficiencies that the airlines had to pay for. There was a very unreliable environment at Heathrow. The model encouraged BAA to under-invest and to sweat its assets and ignored the day-to-day cost to the airline industry. Ultimately the passenger was paying a massive price for this inefficiency. Heathrow was inefficient because it was badly managed, because investment had been misdirected or had not been made at all so that there had been under-investment in

some areas and over-investment in others, and because the system was just overloaded. BAA's game was to keep it 100 per cent utilized at all times, with the consequence that every day the airlines suffered from delays. The directly attributable delays cost about £4 million a year, which were just being borne by the airport's customers. There were also significant unidentified costs, for example circling time, or the time spent by an aircraft waiting for a gate to become available, burning up fuel, time and resources.

8. There were also problems related to security and space. Many of the delays incurred by VAA were attributable to the time taken by passengers in BAA's central security search, and to get cargo through to the aircraft and for VAA to get its personnel through the staff gates. It was a daily occurrence for VAA to have planes waiting to get on to the piers because these had not been cleared. From an operational and ultimate cost perspective this was a deeply inefficient process but it was perceived by BAA to be efficient because the assets were being fully utilized and sweated. BAA was inefficient in both its capital structure and its use of manpower. Further it was not incentivized to arrange financing for investment at a lower cost than its already guaranteed margin.
9. The investment that had gone into T5 had been gifted to BA causing a massive competitive imbalance. Every other airline had paid the same charges as BA and all had paid in advance of this facility becoming operational.
10. VAA considered that competition between terminals under different ownership at JFK Airport had worked well. Such an environment improved service quality and reduced costs. By contrast there was no incentive on BAA to build efficiently as airlines funded developments in advance. Further, BAA was expanding its monopoly, eg operating as a retailer, providing security services while neglecting users' needs.
11. Constructive engagement between BAA and the airlines was flawed in some respects. CAA did not exercise any mediation role, especially in situations where airlines had six or seven different interests. BAA was therefore able to ignore some airlines and do 'sweetheart' deals with others, for example, when BAA reversed spending commitments to the south terminal which had a major overcrowding problem.
12. As to constructive engagement on capital expenditure, VAA did not think that the airlines had been given sufficient information in sufficient time in relation to the capital investment plans. VAA had not seen sufficient justification for some of the projects at Gatwick and thought that the proposed level of spending should be challenged. The airlines had reviewed needs during the constructive engagement process and had settled on £422 million including re-spacing of check-ins and a new baggage system as the best option to meet passenger growth requirements. BAA had then said that the 10 August 2006 security event had changed priorities and that £700 million was now needed for north terminal works. The AOC had responded by asking BAA for options related to levels of capacity in both terminals and BAA had provided two unsatisfactory options. The AOC was still seeking a full presentation of options about the use of the whole £700 million.

Traffic forecasts and methodology

13. Turning to traffic forecasts, VAA said that there was broad agreement on the traffic forecasts at Gatwick in January pre-Open Skies. There was no agreement at Heathrow. BAA had applied certain variable factors at Heathrow to suggest a structural down-turn in passenger figures and had changed its flow forecasts at Gatwick but there remained a difference of opinion between BAA and the airlines. In

general the airlines wanted earlier details and information and for BAA's calculations to be more transparent.

14. The Open Skies agreement at Heathrow would probably mean some currently inefficiently used slots being taken over by carriers with bigger aircraft, and thus it would lead to better aircraft utilization of the airport. Some carriers at Gatwick, eg those serving New York and Houston would probably move to Heathrow. The final effect might be marginally more efficient use of slot resources.

Capital expenditure

15. Asked about Capital expenditure (capex), VAA said that there was a need for strengthening the mechanisms, through constructive engagement, for encouraging timely investment programmes. Its own preference was to seek to improve capex's delivery by the use of more intelligent triggers. The airlines, and the CAA, needed to do more work on exactly what those triggers should be, quantifying them so that BAA was incentivized through the price cap to deliver the correct capex and to do so when the airline community needed it to be done. There should be more intelligent and more detailed triggers, agreed in advance, for example, increasing the number of gates at an airport or for building more security lines so that when the volume hit a particular threshold the capital investment kicked in. The service quality rebate scheme applying to BAA did not work sufficiently. There was no real incentive on BAA to take the right remedial action because if one of BAA's services failed to meet agreed targets, the rebate was too small to matter much to BAA so that by the time remedial action was taken the airlines and their passengers would have suffered considerable detriment. If cause and effect were more aligned, then it would be more likely that capital and opex spending would take place at the right time and more efficiently.
16. VAA undertook to provide a statement of its opinion on an external study of BAA's capital costs and BAA's responses to it. BAA's capital costs were too high. It regularly paid too much in the marketplace. When VAA undertook its modest capital projects it always drove a far better bargain in price, and provided better customer service, than BAA. BAA was presenting T5 as a great success, delivered on time and to budget, but that, of course, raised the question of whether the timing and the budget had been padded at the last budget review. Another example was the common user computer terminals at Gatwick. BAA had bought the PCs, so that different airlines could use the computers at the check-in stations. The airlines were being charged by BAA 21p per customer. The airline community had, however, found an alternative supplier and got the price down to 10.5p.

Risk

17. Discussing the handling of catastrophic risk for BAA and the airlines respectively, VAA took the view that BAA enjoyed a virtually risk-free environment. If there was a catastrophic event, customer demand would be restored or maintained only by the airlines lowering fares in order to sustain loads. However, while passengers would pay less to the airlines, the airlines would be paying the same per passenger in airport charges to BAA. Hence VAA did not think that the cost of capital should be adjusted more than marginally to take account of catastrophic risk factors.

Charges

18. VAA considered that BAA had become a takeover target at least partly because of the generosity of the previous quinquennial settlement (Q4) in which the airlines had

felt they were paying more in charges than they should have paid. It would be very concerned if the consequence of Ferrovial's takeover and its debt restructuring provisions were to be to require airlines to pay yet more in the forthcoming quinquennial settlement (Q5).

19. As a better model, VAA offered the airlines' experience with NATS. The airlines had part ownership in NATS and it was aligned with their interests and was delivering agreed goals for all of them.

Operating expenditure

20. On operating costs, VAA thought that it was reasonable to expect BAA to achieve a minimum efficiency saving of 3 to 4 per cent in Q5. There was plenty of room for efficiency. BAA's central security search operation featured over-manning, over-paying, poor practices, and a monopoly labour pool where manning was going up but unit rates of throughput were going down. VAA by contrast operated in a competitive market, outsourcing its security to a number of competitive providers.
21. VAA expressed dismay at the unilateral decision by BAA to move to a 95 per cent security clearance rate within an average of five minutes. This decision had been published without any consultation through constructive engagement with the airlines. Five minutes was not the obvious or only target; and it needed to be considered as part of a chain of services to different types of customers, not in isolation. The airlines had said that they expected BAA to pay for the change, but there had been no subsequent discussion and no data to settle the target and the costings.

Monitoring standards

22. VAA explained that it regularly monitored delays and their causes. There were often delays in non-passenger areas, not subject to service quality and service level agreements, such as security clearance for cargo, crew buses and crew, which meant that planes were not able to leave on time. These delays had often been caused by BAA switching staff from these facilities to passenger security which meant it had been able to push passengers through to meet its own targets successfully.
23. Quality Service Measures could be misleading. A new car park built by BAA for Terminal 3 was often gridlocked although apparently it met all its service quality targets.
24. VAA preferred to have Service Quality Rebates rather than not. It thought, however, that less reliance should be placed on manual surveys and much more placed on automatic computerized measures, for example to capture the service level of travelers and lifts. VAA would have more confidence if the CAA managed this monitoring function as a disinterested third party. Generally VAA believed that the CAA needed to be more proactive in learning from how other regulators had acted in monopoly situations.
25. On the at-risk amount in service quality to be paid by BAA, VAA thought that as a general principle the penalty should be set at a level consistent with the damage done to airlines and with the impact on customers, but certainly more than the current 3 per cent.