



Direct Tel No: 01293 747075  
Direct Fax No: 01293 747073  
e-mail: Nigel.Milton@fly.virgin.com

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Julie Hawes  
Airports Inquiries Coordinator  
Competition Commission  
Victoria House  
Southampton Row  
LONDON  
WC1B 4AD

BY E-MAIL: Julie.hawes@cc.gsi.gov.uk

Dear Ms Hawes

#### HEATHROW AND GATWICK QUINQUENNIAL REVIEW

Thank you for your letter of 4 April inviting representations to the Competition Commission on the CAA's recommendations on the price control review for Heathrow and Gatwick Airports. Virgin Atlantic welcomes the opportunity to provide its views on this subject. Virgin Atlantic has 37 aircraft based at Heathrow and Gatwick, processing four and a half million passengers through these two airports in 2006. Consequently the price control regime that will be imposed between 2008 and 2013 is of significant interest.

Virgin Atlantic responded in some detail to the CAA's initial proposals for Heathrow and Gatwick that were published in December 2006. For your convenience, I enclose a copy of Virgin Atlantic's submission titled "Rewarding Failure" that was sent to the CAA in February 2007. In essence this document details Virgin Atlantic's frustration with the results of the CAA's previous price control in the fourth quinquennium, and sets out our disappointment with the CAA's proposed approach to the regulation of Heathrow and Gatwick during the fifth quinquennium.

It is not my intention to repeat all of the points made in this earlier submission in this letter, but to focus on the elements in the CAA's recommendations that differ from those in their initial proposals.

It should be stated from the outset that the CAA's recommendations are disappointing, and the CAA do not appear to have paid sufficient attention to the outputs of Constructive Engagement or to have heeded airport user responses to its initial proposals, when developing its recommendations to the Competition Commission.

#### Ownership Structure

Through provisions in the Regulatory Policy Statement, Virgin Atlantic welcomes the CAA's proposals to prevent the greater financial risks, resulting from the recent change in ownership and financial structure of BAA, being transferred onto users. Virgin Atlantic particularly welcomes the CAA's proposal for ex ante financial incentives for the delivery of investment programmes, and the proposal to make retrospective adjustments in

**Virgin Atlantic Airways Ltd**  
The Office  
Manor Royal  
Crawley RH10 9NU

T 01293 562 345  
F 01293 561 721  
Telex 877077

[www.virginatlantic.com](http://www.virginatlantic.com)



subsequent price control periods to account for disparities between projected and actual capital expenditures as a result of financial causes. However, Virgin Atlantic invites the Competition Commission to undertake a full assessment to understand if these proposals go far enough to protect users from changed financial structures and how such mechanisms may be invoked to sufficiently protect users as intended.

### Capital Investment Delivery

Virgin Atlantic welcomes the CAA's attempts to incentivise timely capital investment through a combination of measures. Virgin Atlantic agrees that the CAA's proposed methods and the consistency of their application, are necessary to foster an environment whereby BAA are incentivised to undertake timely capital investment but believe that the CAA should be encouraged to go further in providing regulatory protection for the progress made during the Constructive Engagement process. Virgin Atlantic supports mechanisms to ensure that capital investment projects are developed in conjunction with the community through appropriate consultation, and that capital investment projects are delivered according to appropriate timescales. Through Constructive Engagement, Virgin Atlantic has welcomed the development of a 'tracking and trigger' approach to capital investment projects. Such developments intend to encourage timely investment programmes that are jointly agreed by the community. However, these mechanisms need to be strengthened to ensure the effective management and delivery of capital investment projects and programmes. Virgin Atlantic would welcome the Competition Commission's views on how this might be achieved to ensure the delivery of capital investments to the benefit of airports users and passengers.

It is Virgin Atlantic's belief that the cost of capital proposed in the CAA's initial proposals document was excessive. This belief remains given that the estimated cost of capital has remained unchanged from the CAA's initial proposals. The CAA itself recognises that its 'analysis remains necessarily provisional'<sup>1</sup> and has recommended that it expects to revise its current estimates in light of recommendations and supporting evidence from the Competition Commission, amongst other information. Virgin Atlantic looks forward to the Competition Commission's informed guidance on this issue.

### Service Quality

#### Measures & Rebates

Virgin Atlantic welcomes the CAA's proposal to increase the number of measures covered in the service quality regime. Virgin Atlantic believes that by increasing the range and scope of elements within the scheme, it would go some way to improving the overall level of service received by our customers. The CAA's proposals to increase the maximum penalty charge from 3% to 4.5% of airport charges is welcomed by Virgin Atlantic and represents a movement in the right direction. However, this still falls considerably short of Virgin Atlantic's position that 10% of airport charges should be at risk.

#### Bonuses

A significant step change from its initial proposals is the CAA's concept of incremental bonuses for the airport in situations in which passenger service delivery exceeds the agreed standards. Virgin Atlantic strongly opposes the proposal that BAA should be

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<sup>1</sup> Airports Price Control Review CAA Recommendations to the Competition Commission for Heathrow and Gatwick Airports [March 2007], para. 11.53.



incentivised to exceed the standard that is agreed with airlines and rejects outright the view that such a proposal "complements"<sup>2</sup> penalties for poor service delivery.

Service level standards are agreed between the airport and the airlines as a result of discussion and negotiation to achieve the optimal balance between quality service delivery for passengers and provision at an economically efficient rate. Airport users pay for an agreed service level at this equilibrium. Virgin Atlantic questions why airport users should be required to pay a premium when the airport operator chooses to go beyond this agreed equilibrium? To impose a system that would encourage airports to go beyond the agreed level is perverse and would lead to inefficient and sub optimal resource allocation patterns.

In addition to this, Virgin Atlantic believes a bonus scheme might lead to a scenario where the airport operator is encouraged to 'trade off' different elements of the service quality scheme against each other, in an attempt to maximise financial returns. Such behaviour would undermine the integrity of the service quality regime thus leading to an inevitable failure to improve overall service standards for the passenger. Virgin Atlantic invites the Competition Commission to investigate, and reject, the CAA's proposal of introducing a bonus-based incentive mechanism to improving service quality standards.

### Constructive Engagement

Virgin Atlantic recognises the potential benefits of Constructive Engagement and has invested considerable time and resource in the Constructive Engagement process. This process has had several successes but we are concerned that the CAA may be over-reliant on it as a panacea to every controversial or disputed issue. To work effectively, Constructive Engagement must be undertaken by both sides in a positive and transparent manner. In Virgin Atlantic's view, this has not always been the case.

Virgin Atlantic was dismayed by BAA's public announcement [March 2007] of a new security queue standard level to process passengers through central search within five minutes for 95% of the time. In its initial proposals the CAA 'looked to the airports and airlines to consider the precise calibration of the financial incentives and whether there would be merit in tightening the standard for security queuing at central search'<sup>3</sup>. BAA has so far failed to share details of the costs of various options with the airline community. Contrary to BAA's assertions, Virgin Atlantic believes that there does not need to be a trade-off between standards and costs. BAA should be able to improve service delivery and standards, for which the airlines have already paid, while maintaining or even reducing costs. Virgin Atlantic was very disappointed that BAA publicly announced a new security queue standard level, which we believe has undermined the spirit of Constructive Engagement. In addition, Virgin Atlantic is keen to understand the sensitivity of reduced central search queuing times (when agreed) to retail incomes and its influence on the overall price control mechanism due to its impact within the single till arrangement. Virgin Atlantic would welcome the Competition Commission's views on these matters.

### Operating Costs

Virgin Atlantic welcomes the downward revision to projections of operating costs, reflecting further scrutiny by the CAA of a number of cost elements. In its recommendations, the CAA suggest that BAA's Heathrow operational cost allowance

<sup>2</sup> Airports Price Control Review CAA Recommendations to the Competition Commission for Heathrow and Gatwick Airports [March 2007], Executive Summary, para. 6.

<sup>3</sup> Airports Price Control Review CAA Recommendations to the Competition Commission for Heathrow and Gatwick Airports [March 2007], para. 5.14.



should be reduced by a further 3% (i.e. £21m) and at Gatwick by a further 1% (i.e. £0.5m) from the CAA's initial proposals.

However we are disappointed that the CAA have continued to ignore the operational efficiency gains of between 1 and 7% identified by the various consultants' studies they commissioned, and instead have retained the 1% proposal. Virgin Atlantic would welcome further scrutiny and guidance from the Competition Commission on the operational efficiency gains that BAA can be expected to achieve during the next price control period.

### Price Cap Ranges

Virgin Atlantic understands that the CAA has not at this stage reached a firm view on what the price control should be. However we note with great disappointment, at Heathrow in particular, that an indicative price range significantly in excess of RPI has been recommended. Virgin Atlantic believes that the CAA has again been far too generous to BAA. At a time when airlines face intense competition and modest profitability, we had hoped that the regulator would have sought to apply tighter controls on the monopoly powers of BAA. It is our hope that the Competition Commission will recommend a significantly reduced price control range as a result of its own investigations.

I trust that you find this submission useful. Please feel free to contact me if you require any further explanations or evidence.

Kind regards,

pp A. Kwaszenko.

Nigel Milton  
Manager, Government & International Relations