

Economic regulation of capacity expansion at Heathrow: policy update and consultation

CAP 1782



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About this document

This document follows on from the consultations that we published on the regulatory framework to support capacity expansion at Heathrow airport in January, June and December 2017 and April and October 2018. It consults further on the development of the regulatory framework and includes:

- our proposed approach to taking into account the financeability of Heathrow Airport Limited's (HAL's) activities over the period of capacity expansion;
- our latest thinking on the development of capital efficiency incentives;
- the proposed next steps for introducing a new licence condition to further promote economy and efficiency on the part of HAL; and
- further thinking on the issues that may be raised by alternative arrangements for delivering new capacity.

Views invited

We welcome views on the issues raised in this document and, in particular, those discussed in the executive summary and highlighted in chapters 1 to 4.

Please e-mail responses to economicregulation@caa.co.uk by no later than 24 May 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Rob Toal (Robert.Toal@caa.co.uk).

Update and summary

Introduction

1. In October 2016, the Government announced that its preferred option for the expansion of airport capacity in the south east of England was the Heathrow “Northwest runway”. The CAA has consistently stated that additional runway capacity in the south east of England will benefit air passengers and cargo owners. The timely delivery of more aviation capacity is required to prevent future consumers¹ experiencing higher airfares, reduced choice and lower service quality.
2. Over the course of 2017 and 2018, we issued a series of consultations on the core elements of the regulatory framework to support capacity expansion at Heathrow.² The most recent of these was issued in October 2018³ and set out:
 - an update on our approach to aligning the regulatory timetable with the overall timetable for the development of capacity expansion;
 - detailed consideration of a possible new licence condition to further promote economy and efficiency on the part of HAL;
 - details of our approach to addressing the issues that may be raised by alternative arrangements for delivering new capacity; and
 - an update on our surface access policy.
3. HAL has also continued its work on the wider programme, including engaging with airlines and developing its proposals for an overall masterplan for capacity expansion. We strongly welcome the recent focus that HAL has adopted in terms of developing its forecasts of masterplan capital expenditure broadly consistent

¹ In this consultation, the terms “consumers” and “users” are used interchangeably. See Appendix A.

² These documents are available on the H7+ page of [our website here](#) and include [CAP 1510](#) (“the January 2017 Consultation”), [CAP 1541](#) (“the June 2017 Consultation”), [CAP 1610](#) (“the December 2017 Consultation”) and [CAP 1658](#) (“the April 2018 Consultation”).

³ See [CAP 1722](#) (“the October 2018 Consultation”)

with its 2017 Westerly Option estimates. Nonetheless, there remain important issues to resolve, including in respect of the overall timetable and agreeing efficient levels of expenditure in the period before the Secretary of State (or designated government minister) decides on HAL's application for development consent. As we explain below, we will consider these issues further in our next consultation paper.

4. Our Section 16 report on airport/airline engagement in September 2018 also acknowledged HAL's work in support of the process that led to parliamentary approval of the Airports' National Policy Statement, its work on establishing a new engagement governance protocol with airlines, and its work to reflect the interest of consumers in its masterplanning processes.⁴
5. This document builds on our earlier consultations and the responses we received to them, and sits alongside our Section 16 work in monitoring and encouraging effective engagement between HAL and airlines on the development of plans for capacity expansion at Heathrow.

Main issues raised in this consultation

6. Chapter 1 of this document explains how we intend to assess the financeability of HAL's activities in setting the price control that will cover the period of capacity expansion. This will help to ensure that HAL can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed, which in turn should deliver benefits to consumers in terms of greater choice, less delay and lower fares. It will also allow us to set the price control in a way that provides the best opportunity for the lowest overall efficient costs of capacity expansion. This will involve developing incentives for HAL's management to deliver capacity expansion efficiently, while calibrating these incentives in a way that does not create undue risks for HAL or raise its financing costs in a way that would increase prices for consumers.

⁴ See our "[Section 16](#)" reports at:

7. In several previous consultations, we have discussed the possible introduction of prospective (“*ex ante*”) efficiency incentives for HAL’s capital expenditure. These could provide stronger efficiency incentives for HAL, as it would bear a predetermined share of any capital expenditure under- or over spend. Our current approach, by contrast, relies primarily on retrospective (“*ex post*”) reviews to investigate possible cases of inefficiency and, where there is sufficiently clear evidence, to decide whether to disallow any expenditure from HAL’s regulatory asset base (“RAB”), which is used to calculate its price control.
8. Chapter 2 discusses how strengthening the incentives on HAL for the efficient delivery of capital expenditure is particularly important in the context of capacity expansion. The capital programme that HAL is proposing is very large and it will be in the interests of consumers and airlines to incentivise HAL to deliver expansion in a way that is both efficient and affordable. As noted above, we will also need to ensure that our price control proposals are financeable so that capacity expansion can be delivered with efficient financing costs and, so, the lowest overall efficient costs. Given the risks associated with cost inflation in a complex infrastructure programme, we will need to calibrate any *ex ante* capital expenditure incentives in a way that is integrated with both our assessment of HAL’s financeability and the risk and reward package.
9. We build on our earlier consultations on these matters, which describe the key findings of a consultancy study that we commissioned to help understand how *ex ante* incentives might be implemented and set out our views on how we should take forward the development of these incentives.
10. Chapter 3 discusses a possible modification to HAL’s licence to further the interests of consumers by introducing a new condition promoting economy and efficiency in the operation, maintenance and timely development of Heathrow airport. It discusses the responses to our previous consultations on these matters, sets out an amended draft licence condition and suggests the next steps in our process, including a statutory consultation to modify HAL’s licence in the summer (alongside the modifications we will make to implement the arrangements for the interim period of 2020 to 2021).

11. Our approach to alternative delivery arrangements is discussed in chapter 4. We consider the responses we received on this issue to the October 2018 Consultation and assess the conclusions of the review by Arcadis of the proposals being developed by the Arora Group (“Arora”). Based on the evidence available, we consider its proposals are not sufficiently detailed at this stage for us reasonably to apply our initial tests to decide whether to progress work on developing the regulatory regime to accommodate these proposals. Nonetheless, we remain open to further engagement with Arora and other stakeholders on these matters and have published the Arcadis report alongside this consultation.

Other developments

The interim price review

12. The current regulatory controls on the charges and services that HAL offers to airlines are due to expire on 31 December 2019 and already include a one year extension to the previous Q6 price control.
13. In February 2019, we published a consultation⁵ on our initial proposals for the interim arrangements to apply after the end of the Q6 price control (in December 2019) for 2020 and 2021. We examined the commercial arrangements for this period that have been agreed by HAL and certain airlines, including our initial assessment of whether these provide appropriate protection for consumers.
14. Responses to this consultation are due by 23 April 2019 and we will issue a further update on these matters in July 2019.

Working paper on ring-fencing

15. In April 2019, we intend to publish a working paper setting out the options the CAA is considering for providing further assurance that HAL operates in a financially resilient manner and that risks to consumers arising from financial distress are appropriately mitigated. The paper will consider options for possible changes to the financial resilience and ring fencing provisions in HAL’s licence

⁵ [CAP1769](#)

that may be appropriate given the scale and challenges of the development of new capacity at Heathrow airport. It will develop further the thinking that we set out in the June 2017 and December 2017 Consultations.

Enhanced Engagement

16. Our work on capacity expansion at Heathrow has been conducted in the context not only of our regulatory oversight of HAL under the Civil Aviation Act 2012 ("CAA12"), but also a request from the Secretary of State under section 16 of the Civil Aviation Act 1982. That request asked us to review and advise on how well HAL is engaging with, and responding to, the airline community on its plans for capacity expansion at Heathrow and whether this engagement is appropriately reflecting the interests of consumers in line with the CAA's general duty under the CAA12. Our next update will be provided to DfT in April 2019.

Next steps

Category B and early Category C costs

17. We intend to publish a consultation on the regulatory treatment of HAL's Category B (planning) costs and early Category C (construction) costs in late April or early May 2019. This will build upon the issues identified in the April 2018 Consultation⁶ and the report of the IPCR⁷ into HAL's 2016 and 2017 planning costs.
18. This consultation paper will address issues around the information that has recently emerged from HAL that shows significant increases in its estimates of these costs.

Working papers on surface access

19. We will publish a working paper on our surface access policy in May 2019. This document will consider the responses we received on these issues to the

⁷ [IPCR report](#)

October 2018 Consultation and will set out our next steps with respect to surface access policy.

Workshops

20. We will also consider whether there might be advantages in holding workshops with key groups of stakeholders on issues such as the timetable for the development of the regulatory framework for HAL and the specification of incentives for cost efficiency.

Our duties

21. In developing this consultation, we have had full regard to our statutory duties under CAA12, which are set out more fully in Appendix A.

Structure of this document

22. The structure of this consultation document is as follows:
- chapter 1 explains how we intend to take into account the financeability of HAL's activities over the period of capacity expansion;
 - chapter 2 provides an update on our approach to developing capital efficiency incentives;
 - chapter 3 sets out the proposed next steps on a possible new licence condition to be included in HAL's licence to further promote economy and efficiency; and
 - chapter 4 describes our current thinking as to how we will approach alternative arrangements for delivering new capacity.

Chapter 1

Approach to Financeability

Introduction

1.1 HAL's next main price control will cover the period of capacity expansion and a very significant programme of capital expenditure. In setting this price control, we will consider the financeability of HAL's activities to help ensure it can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed. This will both facilitate capacity expansion (which should deliver benefits to consumers in terms of greater choice, less delay and lower fares) and allow us to set HAL's price control in a way that provides for the lowest overall efficient costs of capacity expansion. This will involve identifying a package of incentive and other arrangements that:

- will incentivise HAL's management to deliver capacity expansion efficiently;
- are consistent with financeability;⁸ and
- will not create undue risks for HAL that would inappropriately raise its financing costs and, so, prices to consumers.

1.2 In this chapter we:

- summarise the main issues on financeability raised by respondents to the April 2018 Consultation;
- explain how we will consider financeability throughout the price control process;
- present our latest thinking on gearing and capital structure;
- describe how we plan to test financeability in setting HAL's price control; and

⁸ This approach should also enable us to satisfy our duty under section 1(3)(a) CAA12 to have regard to the need to secure that HAL is able to finance its provision of airport operation services at Heathrow (often referred to as the "financeability duty").

- discuss how we might adjust our approach to incentive arrangements or our assumptions on financing costs if substantial concerns about its financeability were to emerge during the price control review.

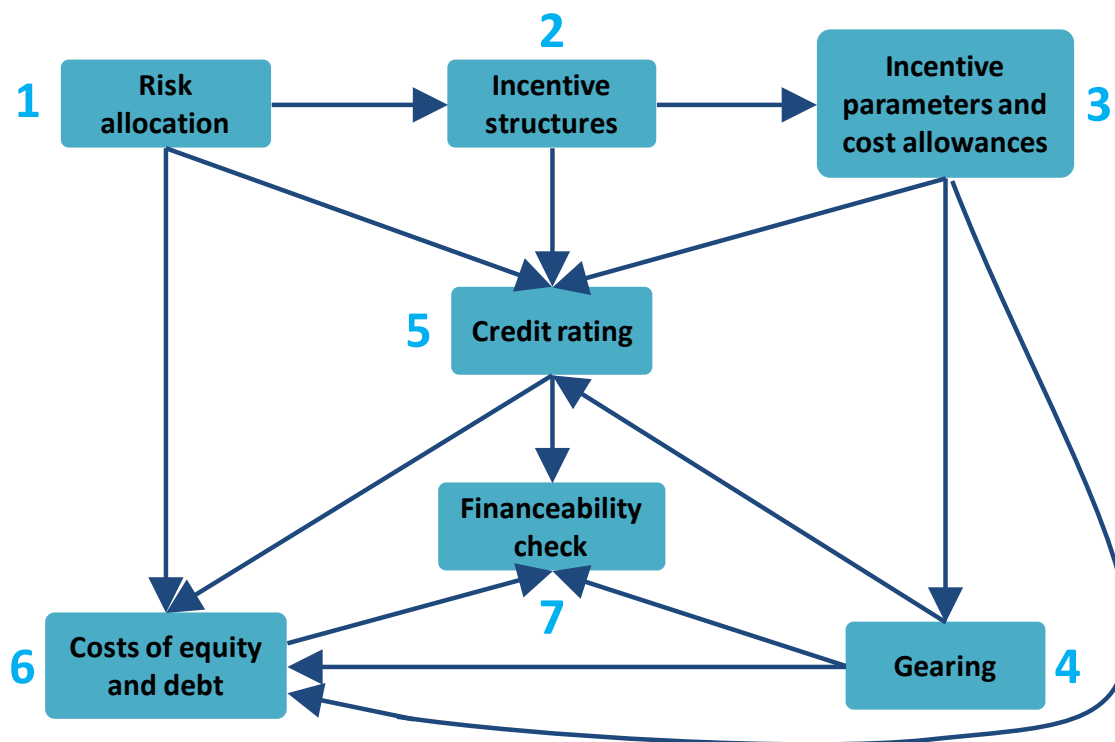
The April 2018 Consultation and respondents' views

- 1.3 The April 2018 Consultation described our approach to affordability and financeability. It discussed a range of financeability issues, including our assumptions on capital structures, and our approach to testing for debt financeability and the associated credit metrics.
- 1.4 In response, HAL highlighted the importance of the regulatory framework and the price control review in reasonably promoting its financeability, and noted that the CAA's decision making needs to be integrated. HAL referred by way of example to the CAA's work on:
- financial ring fencing, where it noted the risk that the CAA could inadvertently impose licence conditions that HAL is unable to comply with, such as in relation to credit ratings. It also noted Moody's downgrades of the outlook of several water companies as an example of the potential consequences of inappropriate changes to the regulatory ring fence licence conditions; and
 - incentives, financial resilience, financeability and the cost of capital, with HAL noting that these are areas where the CAA's decision making should be properly integrated.
- 1.5 HAL also:
- supported the use of the notional approach to assessing financeability and supported this being the primary basis for assessing financeability;
 - made recommendations on the specific credit metrics that the CAA should treat as core and secondary as part of the financeability assessment;
 - suggested that the CAA should explicitly target a specific investment credit rating for HAL as this would support capacity expansion; and
 - said we should also use this rating in our financeability assessment and any proposals for the cost of debt indexation.

- 1.6 Airlines focussed mostly on affordability. Nonetheless, there was some cautious support for a “twin track” approach to financeability assessment and acknowledgement that HAL’s actual financial structure is best determined by its management. There was also support for setting a price control consistent with HAL retaining access to costs effective investment grade financing.
- 1.7 Other respondents raised concerns about the financial viability of capacity expansion and the possible need for state support. They made various suggestions, including that gearing should be capped and that we should assess the incremental impact of expansion (relative to a two-runway future for HAL).

Incorporating financeability throughout the price control

- 1.8 We intend to take a holistic approach to financeability, which will build on the approach we set out to financeability in the April 2018 Consultation. Such an approach will be consistent with the views of respondents in so far as it:
- captures HAL’s comments about promoting capacity expansion, taking an integrated approach; and
 - supports airlines concerns about the importance of overall efficiency and affordability.
- 1.9 A key driver of HAL’s financeability during capacity expansion will be the delivery by HAL’s management of capacity expansion in a way that is efficient and represents value for money. This will be an important assumption underlying our assessment of HAL’s financeability and we will build on this to take account of a range of factors, as illustrated in Figure 1 below.

Figure 1: the financeability framework**Source: CAA**

- 1.10 This assessment will involve the consideration of the underlying risks associated with capacity expansion and how these are best managed and allocated: this helps inform the sort of incentives we should set for HAL and how investors will perceive the riskiness of HAL.
- 1.11 For instance, we understand that there will be risks associated with delivering the necessary infrastructure for capacity expansion on time and to budget. On the other hand, it is very important to consumers that capacity expansion is delivered in a way that is affordable. The efficient delivery of capital expenditure will be an important part of this. HAL's management can also exert significant influence on operating and capital efficiency. Taken together, these factors suggest careful consideration of the approach to capital expenditure incentives is required, and that a key consideration in developing and calibrating these incentives should be their impact on HAL's prospective credit rating, costs of debt and equity finance and, ultimately, its overall financeability.
- 1.12 As incentives are developed, the impacts of parameters and cost baselines can be reviewed and modified in the light of their expected impact on revenues, cash

flow, credit ratings, efficient capital structures and gearing levels, credit ratings and the cost of capital. We will take a consistent approach across these assessments, for example, adopting an approach to gearing⁹ which is consistent with the target credit rating,¹⁰ and calculating the costs of debt and equity to be consistent with that gearing and credit rating.

- 1.13 We will take an iterative approach to these matters so, if the checks indicate that HAL has significant headroom above key financeability constraints, we will consider whether more stretching incentives might be appropriate. On the other hand, if the financeability checks indicate difficulties with HAL supporting efficient financing arrangements, we will consider what are the most appropriate mitigating actions to take. In doing so, we will first assume that HAL's management has taken all reasonable steps to manage its financeability and taken appropriate mitigating the actions. If there continues to be an issue, we will revisit our decisions on incentives and/or consider other adjustments to support financeability.¹¹
- 1.14 This approach will build on the work we have undertaken in relation to NATS En Route plc and our draft RP3 performance plan published in February 2019.¹²

Capital structure and gearing

- 1.15 As part of our work in testing financeability and setting the cost of capital, we will need to make assumptions about HAL's capital structure, including its opening level of gearing at the start of the new price control and the range that it is reasonable for HAL's gearing to take over the period of the price control (and beyond). The April 2018 Consultation discussed the use of a "twin track" approach to capital structure and gearing levels:

⁹ See paragraph 1.15ff for further consideration of gearing.

¹⁰ See paragraph 1.28ff for further consideration of credit ratings.

¹¹ See paragraph 1.35ff for further description of our approach to financeability adjustments.

¹² See: [CAP 1758](#)

- “Capital Structure 1”: a level of gearing similar to the 60% (with a single class of debt) that the CAA (and other economic regulators) have used in the past as the basis for setting price controls and assessing financeability; and
- “Capital Structure 2”: a more leveraged structure with a higher level of gearing (and probably at least two classes of debt) that might be more consistent with the financing arrangements that HAL will adopt to support capacity expansion.

- 1.16 At this early stage of our process, considering these two capital approaches to capital structure will help us understand how sensitive our financeability assessment and approach to the cost of capital is to different assumptions on gearing. It also gives us the flexibility to consider arrangements that will be more consistent with the financing arrangements that HAL is likely to adopt in delivering capacity expansion.
- 1.17 In the April 2018 Consultation, we referred to Capital Structure 1 as a “notional” capital structure. In practice, both Capital Structures 1 and 2 will be based on assumptions and so could be regarded as “notional” structures, since the relative complexity of HAL’s financing arrangements and the potential for them to change over time means it will not be practical or desirable for us to precisely model HAL’s actual capital structure.
- 1.18 Our assumptions on capital structure will have an impact on our assessment of financeability and cost of capital. As the price control review progresses, it is likely that we will want to take a more focused approach and have a clear set of assumptions on capital structure. Nonetheless, it will remain the responsibility of HAL’s management to decide on its actual financial structure and ensure that its business is financeable.
- 1.19 At the last (Q6) price control review, our approach to capital structure and gearing was broadly based around Capital Structure 1, and assumed a 60% level of gearing in calculating the cost of capital and testing financeability. This approach is clear, simple, widely understood and consistent with regulatory precedent (including the approach we have adopted in our draft proposals for the RP3 performance plan). However, there are several reasons that suggest we

should reconsider this approach in the circumstances of HAL and capacity expansion:

- there is a significant gap between the notional and actual gearing levels: HAL's 2017 regulatory accounts show a class B gearing ratio of 78.4%.¹³ Given the ability of HAL to sustain relatively high levels of gearing, it is worth considering whether there would be advantages for consumers in assuming a higher level of gearing, and what the risks might be with such an approach; and
- it is not clear that the notional approach associated with Capital Structure 1 provides adequate assurance of financeability, particularly in the circumstances of capacity expansion. While we expect the efficient level of gearing to fall from the present levels, it is likely that HAL will seek to utilise significant amounts of investment grade debt financing to help fund the very large capital programmes that will be associated with capacity expansion. If the resulting capital structure is reasonable, and does not involve undue risks for consumers, it may be appropriate to test for financeability on similar levels of gearing.

1.20 We will consider these issues further and test what level of gearing HAL can reasonably sustain given the incentive arrangements that we will develop as part of the price control review.

1.21 There are two of our other workstreams that may have implications for HAL's gearing levels:

- in the April 2019 working paper on Financial Resilience and Ring Fencing, we will discuss issues around gearing caps; and
- alongside our work on the cost of capital, we are considering the use of gearing sharing mechanisms, although our initial view is that such mechanisms are unlikely to suit the circumstances of capacity expansion at Heathrow airport. We discuss these matters further in Appendix B.

¹³ Given HAL's current high level of gearing and the forthcoming expansion it is plausible that HAL's gearing might decrease over the H7 period without any regulatory intervention.

Financeability testing

- 1.22 In the April 2018 Consultation, we noted that capacity expansion will require significant amounts of new equity and debt finance, and that our financeability tests should cover both these sources of finance. We plan to say more about equity financeability in a further consultation in the autumn of 2019, alongside our developing thinking on estimating the cost of equity capital and ensuring that price control incentives are part of an appropriate risk and reward framework. Bearing this in mind, the discussion below largely focuses on debt financeability.
- 1.23 Our financeability testing will be a qualitative and quantitative assessment of relevant factors and an analysis of projected financial ratios to help assess whether the price control arrangements that we are developing are consistent with HAL financing its activities. This “financeability check” is a key part of the holistic approach to financeability illustrated in Figure 1 above. As well as considering the base assumptions used in calibrating the price control and setting incentives, it will also be important to consider reasonable downside scenarios, so that investors and consumers have assurance that the business will remain financeable in an appropriate range of circumstances. This should also keep HAL’s financing costs relatively low and support overall affordability.

Stress testing

- 1.24 The downside scenarios or stress tests we need to consider will involve analysing what would happen if the price control were set on a particular basis, but the assumptions with respect to costs or other variables turn out to be less favourable than assumed in setting the price control. For example, we might look at the impact of a macro economic downturn in which passenger volumes and non-aeronautical revenues fall.
- 1.25 We would assume that HAL’s management would effectively manage factors over which they can exert a reasonable degree of influence, so that the focus of the stress tests would be factors that are less controllable and have the potential to drive downsides. We would also expect that management would mitigate the financeability impact of less controllable factors, by, for example:

- deferring non-essential capital expenditure;
- reducing dividend payments;
- considering whether there are other steps to limit any increases in gearing, including, if appropriate, seeking additional equity finance; and
- maintaining prudent levels of liquidity.

1.26 Appendix C describes our initial thinking on possible scenarios that we would expect to use for our stress testing analysis. Our thinking on these matters is likely to evolve as the price review proceeds.

1.27 While the stress testing analysis will produce quantitative results, interpretation is likely to require a qualitative assessment and the stress tests may not provide a simple “pass/fail” assessment of the financeability of a potential price control settlement.

Credit ratings

1.28 We expect to use credit ratings in two ways as part of our financeability assessment:

- to check that HAL’s financial position in the base case (i.e. when all costs and revenues match up with the regulatory allowances) is consistent with a “reasonable investment grade” credit rating; and
- to assess that, in our downside scenario, post management mitigating actions, HAL’s financial position is still consistent with an investment grade credit rating (i.e. at least BBB- or equivalent).

1.29 In making assumptions as to what should constitute a reasonable investment grade rating, we will consider the advantages of higher investment grade debt (which is a very cost effective finance but would only be consistent with more stringent financeability checks) against lower investment grade debt (which would be somewhat more expensive, but would be consistent with less stringent financeability checks). As we have noted above, if we were to adopt Capital Structure 2, this could involve assessing multiple classes of debt.

- 1.30 In the Financial Resilience and Ring Fencing working paper, we will consider options for the possible introduction of a requirement to maintain an investment grade credit rating and we expect to carry out stress tests in a way consistent with any credit rating requirements in HAL's licence.
- 1.31 In response to the April 2018 Consultation, some respondents raised the issue of whether we should assess credit rating levels by reference to the threshold level for a credit rating (i.e. the lowest possible level for a given rating) or the point midway between downgrade and upgrade to a different rating. Our current thinking is that, when seeking to achieve a "reasonable investment grade" credit rating in the base case, we would plan to use mid-points, while the stress test would look to achieve at least the minimum level for investment grade.¹⁴

Credit metrics

- 1.32 Credit metrics are financial ratios which give insights into the financial position of a company and its credit rating. They are commonly used by credit rating agencies as well as being used in some lending agreements (including the debt which the Heathrow group issues to fund HAL).¹⁵
- 1.33 In the April 2018 Consultation, we listed the credit metrics that we would expect to consider as part of our financeability assessment. We also categorised the metrics between core and secondary to indicate those on which we expected to place greater reliance. Following further consideration, we no longer categorise metrics as core and secondary and instead describe the guiding principles to selecting credit metrics and how these principles apply to the metrics that we select.
- 1.34 Our guiding principle in selecting credit metrics is to identify metrics that will help us to assess whether HAL's financial position will be reasonably compatible with our assumptions on credit ratings. To the extent it is appropriate, we will look not

¹⁴ Our assessment would look at the underlying substance of the projected financial position. So, we might consider that isolated instances of metrics below threshold levels would not constitute a financeability concerns provided that the longer term position was healthy.

¹⁵ See the "[common terms agreement](#)" for HAL's financing platform: