

# Gearing Sharing Mechanisms

Report on gearing sharing mechanisms and application to LHR

23 April 2019 | Version 1.0

**Reliance restricted**

23 April 2019

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CAA House, 45-49 Kingsway  
London, WC2B 6TE

Dear Dan,

**Gearing Sharing mechanisms and application to LHR**

In accordance with our engagement agreement to provide expert financial advice under the terms and conditions of the Pan-Regulators' Framework Agreement for Economic, Financial and Related Consultancy Services with the Civil Aviation Authority (CAA), reference number 2587 (the "Engagement Agreement"), we have prepared a high level assessment of some of the possible mechanisms to share the benefits of additional gearing, with a particular focus on Ofwat's new proposed mechanism.

This assessment was prepared based on your instructions outlined in Section 1: Order form for Contract C (Contract 2587), which was an extension of the Order form dated 28 April 2017. The assessment has been prepared solely for the purpose of assisting you in reviewing the Ofwat publication "Putting the sector back in balance" and in considering whether a Gearing Sharing mechanism (ie. a mechanism to share financial returns in excess of regulatory settlement, solely due to higher gearing levels) might be appropriate for LHR (Heathrow airport). It should not be relied upon for any other purpose. Because others may seek to use it for different purposes, this document should not be quoted, referred to or shown to any other parties unless so required by court order or a regulatory authority, without our prior consent in writing. In carrying out our work and preparing our document, we do not seek to provide any legal services to you and have worked solely on your instructions.

Our assessment exclusively relies on publicly available information. We did not seek to review or verify any of this source data and information. Our scope did not include any consultation process with Heathrow Airport Limited, existing equity holders and lenders, credit rating agencies, airlines or any other stakeholders.

Our assessment may not have fully considered issues relevant to any third parties. Any use such third parties may choose to make of our paper is entirely at their own risk, and we shall have no responsibility whatsoever in relation to any such use. Whilst the CAA may use this paper in accordance with the term and conditions set out in the Engagement Agreement, we assume no responsibility or liability whatsoever to any third party in respect of the contents of our deliverable.

Please note that this assessment is high level and reflects our findings to date based on publicly available information and on discussions with you. We stress that a more detailed review may reveal additional considerations that this assessment has not.

Yours faithfully,

**Ernst & Young LLP**

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### Executive Summary

#### Background and Context

- ▶ In 2018, Ofwat launched a consultation to – in its words - put the water sector back in balance and rebuild trust therein. The consultation was concluded with the recommendation that company's outperformance of equity returns solely as a result of gearing levels materially above the regulator's assumptions (i.e., notional gearing) should be shared with customers.
- ▶ In its Q6 regulatory settlement for Heathrow airport (LHR), the Civil Aviation Authority (CAA) has assumed a notional gearing ratio of 60%. However, the actual gearing at the HoldCo level for LHR has been closer to c. 85%. As a result, the CAA would like to understand whether LHR might be generating returns in excess of regulatory settlement, solely due to higher gearing levels.

#### Scope of Work

- ▶ In the context of CAA considering whether a Gearing Sharing mechanism (ie. a mechanism to share financial returns in excess of regulatory settlement, solely due to higher gearing levels) might be appropriate for LHR, the CAA have commissioned EY to:
  - ▶ review Ofwat's "Putting the sector back in balance" publication, summarise key proposals therein (with a focus on the gearing sharing mechanism) and the market responses to Ofwat's proposal.
  - ▶ explore other regulatory frameworks, both in the UK and abroad, in respect of their approaches to gearing and the cost of capital.
  - ▶ consider LHR's current capital structure and historical levels of gearing along with the potential effects of a hypothetical Gearing Sharing mechanism on LHR.
  - ▶ develop a number of options/alternatives through which a gearing sharing mechanism could work for LHR, if CAA were minded to consider this.

#### Limitations of our assessment

- ▶ Our scope of work does not include an assessment of the relative merits and/or demerits of Gearing Sharing mechanisms, nor is our work aimed to endorse or criticise the concept of Gearing Sharing. It seeks to provide an illustrative analytical tool for CAA to consider the mechanism in the context of LHR.
- ▶ The analysis herein uses the Q6 regulatory settlement numbers to carry out illustrative quantitative analysis to demonstrate the potential impact of a Gearing Sharing mechanism. This analysis is illustrative in nature and is aimed at understanding the scale of the impact that a gearing sharing mechanism may have.
- ▶ Whilst the gearing sharing options discussed in this report include potential changes to the Cost of Capital, we do not assume any adjustment to the risk allocation arrangement between HAL and the end users (customers).
- ▶ In theory, the options presented could be introduced on a temporary or a permanent basis. HAL may vary its gearing levels as a response to the changes. Our illustrative examples do not account for any potential response by HAL.
- ▶ The quantitative analysis conducted is illustrative in nature.

#### LHR 3<sup>rd</sup> Runway (R3) implications

- ▶ Our illustrative financial analysis has been undertaken based on the Q6 regulatory settlement numbers and does not take into account potential changes to the capital structure as a result of the R3 development.
- ▶ The R3 development requires a significant capital undertaking. The material change in the risk profile of HAL could require a change in capital structure and possible deleveraging. This aspect was considered in our Equity Financeability Report to the CAA dated 23/10/2017. Therefore:
  - ▶ Any outcomes as a result of implementing a gearing sharing mechanism may only be realised in the short-term.
  - ▶ CAA must also consider the potential impact of changes in regulation on R3 financeability, in giving due consideration to Gearing Sharing.

## Dashboard

### Executive Summary

A brief summary of each section of our report is set out below:

#### Section 1: Review of Ofwat's 'back in balance' publications

- ▶ Ofwat is introducing a gearing sharing mechanism where water companies' actual gearing exceeds the notional level, on the basis that a higher gearing results in additional benefits to shareholders and places the customer at risk.
- ▶ Responses to the Ofwat proposal have been mixed. Certain water companies (with lower gearing) have been supportive. Companies with higher gearing and their investors have been critical of the proposal citing that (i) the proposal contravenes traditional corporate finance theory that the capital structure is irrelevant for the Cost of Capital (CoC), (ii) the stable return profile supports additional debt over and above notional gearing levels (iii) there is no credible evidence that customers have borne additional risks from higher gearing and (iv) a mechanism is already in place to share the benefit of a greater tax shield with customers.

#### Section 2: Other regulatory frameworks

- ▶ Ofwat's approach of targeting perceived benefits from greater gearing stands in contrast to Ofgem's approach which is broadly capital structure agnostic (provided the financeability of the business is not put at risk).
- ▶ In a few select examples we considered across Europe, setting a notional gearing level remains the most prevalent manner of setting the cost of capital. Significant differences in the assumed nominal gearing levels exist. There are however regulators who use the actual gearing level and actual cost of debt.

#### Section 3: LHR financial structure

- ▶ HAL's debt (Class A & B) is rated investment grade (A- & BBB). Ensuring that minimum rating covenants are not breached and HAL can maintain an investment grade rating (despite any changes to the allowed cost of capital) will be key to maintaining the financeability of HAL in light of R3.
- ▶ Our review of historical data finds a cost of debt broadly consistent with the assumptions of the Q6 regulatory settlement, with a gearing level (c.85%) in excess of the notional level (60%).

We have concluded in our previous report to the CAA dated 23/10/2017 that it is

likely that HAL's gearing will reduce to maintain an investment grade credit rating for R3 financing.

#### Section 4: Options

- ▶ Financial Outperformance, as discussed in this report, in the context of a Gearing Sharing mechanism can occur due to one or all of the following:
  - ▶ Gains made by additional tax-shield resulting solely from actual leverage being higher than that considered in the regulatory settlement,
  - ▶ Gains made due to an outturn cost of debt being lower than that considered in the regulatory settlement, and
  - ▶ Higher equity returns realised solely from a higher level of leverage than the notional gearing considered in the regulatory settlement.
- ▶ A number of options (including a Gearing Sharing Mechanism) are available to a Regulator to address the issue of Financial Outperformance. This report does not purport to discuss all such options – rather the objective of this report is develop a limited number of the potential options of implementing Gearing Sharing mechanism, should CAA chose to do so, based on the Ofwat example.
- ▶ The potential options for implementing a Gearing Sharing mechanism for LHR have been developed using the following two regulatory levers:
  - ▶ Periodicity (ie. adjustments at the end of every year or after the control period)
  - ▶ Adjustments to the Passengers Charges by either offsetting the prior period Financial Outperformance or by adjusting the Cost of Capital
- ▶ Due to annual options being difficult to actually implement in practice, the options considered in this report are (Annual options, 1a, 2a and 3a have not been considered for any further development):
  - ▶ Option 1b: True-up – Adjustment to regulated passenger charge (offset of prior CP financial outperformance)
  - ▶ Option 2b. Adjustment to the cost of capital (control period reset)
  - ▶ Option 3b. True-up – Adjustment to regulated passenger charge (offset of prior CP financial outperformance) plus adjustment to the cost of capital (control period reset)

## Dashboard

### Executive Summary

A short summary of each option is provided below:

1. Option 1b: True-up – Adjustment to regulated passenger charge (offset of prior CP financial outperformance)

The mechanism is formulaic and therefore easy to operate. In this structure, HAL shares Financial Equity Outperformance, solely, as a result of higher gearing levels. This could encourage deleveraging and greater financial resilience. In this report, Ofwat's formula has been used to calculate the Financial Outperformance ie.

*Sharing rate  $\times$  (Notional Cost of Equity – Actual Cost of Debt)  $\times$  (Actual Gearing – Reference Gearing)*, where Reference Gearing will be the gearing assumed at the previous regulatory settlement.

The disadvantage with a True-up is that the change might encourage a sub-optimal capital structure and be negatively received by investors (i.e., inconsistent with regulatory precedent, retrospective nature, etc.)

2. Option 2b: Adjustment to the cost of capital (control period reset)

A potential approach to account for the incremental benefit of additional gearing is to reset the cost of capital. In this option, a revised CoC is calculated using the outturn gearing level (instead of using the notional gearing level), actual cost of debt and implied cost of equity (based on a notional unlevered return on equity), all from the previous Control Period (CP).

This mechanism fits into the existing regulatory framework, except for a charge that HAL's cost of capital reflects its actual gearing. This option does not explicitly encourage deleveraging although that is likely to be an indirect consequence of this mechanism.

3. Option 3b: True-up – Adjustment to regulated passenger charge (offset of prior CP financial outperformance) and Adjustment to the cost of capital (Control Period reset)

This option is essentially the amalgamation of the mechanics of the above two

options, in effect (i) adjusting the passenger charges by offsetting the Financial Outperformance realised in the previous Control Period, driven by the difference in the Gearing assumed in the previous regulatory settlement and the outturn actual gearing, (ii) adjusting the passenger charges by resetting the Cost of Capital for the next period, based on actual outturn gearing in the previous control period. On the basis of illustrative calculations, this option will result in larger impact to HAL's revenue (relative to the other two options discussed above).

#### Periodicity

HAL's existing regulatory framework operates over 5 year settlement periods. Keeping the adjustment in line with the 5 year window reduces the administrative burden. Alternatively, annual adjustments are possible where a formulaic approach can be pre-agreed. The adjustment would benefit from being more real-time. However, the annual options have not been discussed in any further details in this report.

- Based on the illustrative analysis carried out, methods 1 & 2 reduces HAL's passenger charges and in turn its adjusted EBITDA by c. 3-5% per illustrative calculations. In contrast, for method 3 the decrease in adjusted EBITDA is c9% as per the illustrative analysis.
- The CAA needs to consider whether any change will be perceived by investors as a "regulatory" policy change/intervention in the UK and hence it should consider the consequences in greater depth. Further, as set out earlier, our report excludes any potential implications to LHR capital structure arising from R3 financing. As a result, our analysis should be considered highly illustrative, with a view to illustrate impact of the Ofwat mechanism on LHR in a very narrow context.

In making its decision on whether to implement any mechanism similar to Gearing Sharing, CAA should appropriately consider any impact on R3 financeability.

# 1

## Review of Ofwat's 'back in balance' publications

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## 1 Review of Ofwat's 'back in balance' publications

### Key objectives of the consultation, feedback and proposals 1 & 2

#### Key objectives of the consultation and proposals

- ▶ According to Ofwat:
  - ▶ The consultation (initiated in April 2018) was driven primarily by concerns around behaviour of water companies, which it saw as eroding trust in the industry.
  - ▶ The industry has seen an increasing trend of high levels of dividend payments and performance-related payments, as well as potentially risky financial structures.
  - ▶ The proposals are aimed at ensuring the industry is delivering the best outcomes for consumers through:
    - ▶ encouraging individual utilities to take account of customer interests
    - ▶ improving incentives for utilities to be more transparent in demonstrating that their dividend policy and performance-related executive pay takes account of customer delivery
    - ▶ assessments of financial resilience and improvements as needed, lowering risk to consumers
  - ▶ the proposals do not aim to set dividend policy, capital structure or executive pay, and aims to provide flexibility to utilities to select a preferred approach that meets Ofwat's objectives.

#### Feedback on the consultation process

- ▶ Water companies and other stakeholders commented on many aspects of Ofwat's proposals.
- ▶ Some of these responses are summarised on the right and overleaf.

#### Proposal 1: Dividend policy (not being considered in this report)

##### Ofwat proposal

- ▶ Companies have to set out their dividend yield in their annual reports, demonstrating that the level of dividends is justified relative to customer delivery in the year.
- ▶ A base nominal dividend yield of 5% is suggested as a reasonable benchmark with which to compare. Ofwat state that this is not a control nor cap on dividends, but simply a comparison tool to measure the level of dividends.

##### Market response

- ▶ 26 out of 32 respondents to Ofwat's consultation were supportive of Ofwat's proposals. However, there were concerns regarding:
  1. a regulatory intervention to control dividends may reduce the industry's attractiveness for long-term investors .
  2. a regulatory intervention to control dividends, over and above Company Law, which already sets out specific requirements with which companies must comply may be considered onerous by the long-term investors.
  3. Dividend policy has to be seen in the wider context of the business

#### Proposal 2: Performance-related executive pay (not being considered in this report)

##### Ofwat proposal

- ▶ Companies must demonstrate that there is a substantial link between executive-pay and stretching performance delivery, by reference to the business plan, as opposed to a singular link to financial performance.

##### Market response

- ▶ There were concerns by some respondents that there would be unintended consequences such as an increase in base pay to offset any reduction in performance-related pay.

# 1 Review of Ofwat's 'back in balance' publications

## Proposal 3 and response

### Proposal 3: Gearing sharing mechanism (being considered for this report)

#### Ofwat proposal

- ▶ Ofwat's view is that no benefit is currently being passed to customers from high gearing, although customers implicitly accepted higher risks (such as the risk of financial failure and an inability to adapt to regulatory requirements).
- ▶ For Ofwat, this implies that:
  - ▶ Equity holders earn 'super-normal' returns that are disproportionate to an appropriate risk arising from higher gearing.
  - ▶ Higher gearing implies a lower WACC, whilst water companies are paid charges based on a higher WACC derived from a notional capital structure with lower gearing. The financial benefit accrues to shareholders at the expense of customers.
- ▶ Ofwat's intention is to share benefits with customers where gearing is significantly higher than the notional level. Ofwat's stated intention is not to influence changes to each company's capital structure.
  - ▶ The company remains best placed to determine the financial structure and therefore no gearing cap or change to notional gearing percentage is being proposed.
- ▶ Ofwat have proposed a formula to calculate the share of customer as follows: Gearing difference<sup>1</sup> x financial outperformance difference<sup>2</sup> x sharing rate<sup>3</sup>
  - ▶ This will only apply for companies with a gearing >10% higher than notional gearing level (i.e., applies from 70%) This percentage was increased by 5% as a result of consultation process.
  - ▶ Companies are given the flexibility to propose an alternate mechanism.
  - ▶ Quantitative analysis by Ofwat suggests that £200mn-£350mn of benefits can be transferred to customers through this mechanism against total revenue across the industry of £5.8bn (2015).

<sup>1</sup> Gearing difference = actual gearing – 65% [Reference point]

<sup>2</sup> Financial outperformance difference = notional cost of equity (Re) – actual cost of debt (Rd)

### Response to Ofwat consultation<sup>4</sup>

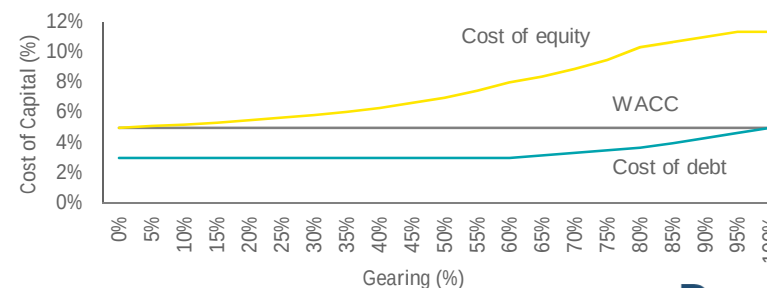
We have reviewed market commentary regarding the proposal; the documentation reviewed comprises of the following publications:

- ▶ A report by KPMG commissioned by a consortium of private investors (or owners of water utilities) in response to the Ofwat consultation, published on 17 May 2018,
- ▶ A sample of consultation responses from water companies with higher gearing (Thames Water, South East Water & Yorkshire Water), some with lower gearing (South West Water, United Utilities and Wessex Water) and six from water company investors; and,
- ▶ Varied market commentary

We summarise the key arguments made in the responses below.

#### Benefits gained by higher leverage are in accordance to traditional finance theory

- ▶ Modigliani-Miller's (MM) Capital Structure Irrelevance Proposition asserts that in the absence of taxes and bankruptcy costs, a company's WACC is determined by the underlying risk of the business. And further, under the assumptions made by MM, an increase in debt results in greater risk to equity holders, thus increasing the cost of equity.



<sup>3</sup> Sharing rate = 50%

<sup>4</sup> Ofwat consultation responses from Utilities and KPMG: Commentary on the Ofwat consultation Putting the sector back in balance

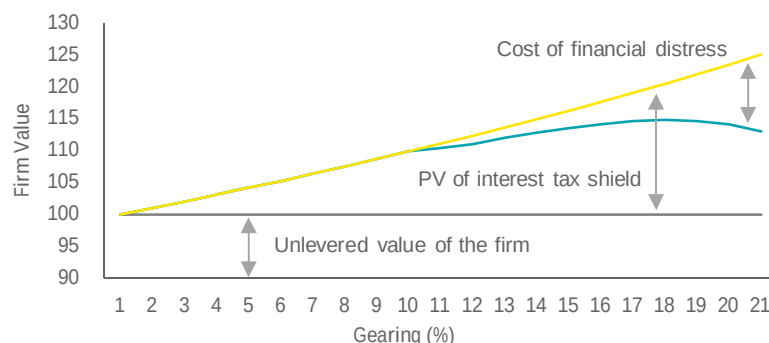
## 1 Review of Ofwat's 'back in balance' publications

### Proposal 3 and response (cont'd)

#### Response to Ofwat consultation (cont'd)

- Several responses assert that Ofwat's proposal would be a significant departure from regulatory precedent since, in their view, all UK regulators to date recognise the MM principle.

#### Tax shield and costs of financial distress



- Consultation responses also stated that increased leverage lowers the WACC through interest deductible payments and that Ofwat already has a mechanism in place for sharing the increased tax deductions (tax shield) where water companies are leveraged above the notional gearing level.
- South East Water and Yorkshire Water assert that the gearing sharing mechanism could incentivise companies to de-lever, lowering the tax shield benefit be passed to customers.

- Ofwat's 'back in balance' publication states that high levels of gearing decreases financial resilience, potentially imposing the costs of financial distress on customers. Some consultation respondents commented on this issue:

- United Utilities suggests that enhanced gearing results in additional income for investors, with little benefit to customers. Further higher gearing increases susceptibility to shocks. Similarly, Wessex Water states that elevated gearing is not in the interest of customers and may be 'too high' at some companies.
- A joint Ofgem & Ofwat paper (2006) clarifies that financial distress costs due to decisions on financial structure should be borne by capital providers<sup>2</sup>.
- KPMG's research suggests that higher gearing to date has not correlated to poorer operational performance or reduced investment.

#### Observed gearing in the market

- Consultation responses include market evidence that gearing structures of 70-80%+ are sustainable in infrastructure segments with stable cash-flows and limited demand-side risk.

#### Commentary regarding the regulatory regime

- Consultation responses from water investors and highly geared water companies also critique the proposal in regards to the following :
  1. Unjustified - no demonstrated market failure by Ofwat to redress
  2. Retrospective – negatively impacts companies for their historic financing decisions
  3. Asymmetric – penalises companies for leverage above the notional level with no benefit to companies with gearing lower than the notional gearing
  4. Perfunctory consultation period of three weeks - insufficient for such a fundamental change to the regulatory regime

<sup>1</sup> Modigliani-Miller capital structure theory (with taxes) assumes transactional cost of buying and selling securities as well as bankruptcy costs of nil. The trade-off theory, an extension to MM, considers the cost of financial distress associated with greater debt (Kraus and Litzenberger 1973).

<sup>2</sup> Ofwat & Ofgem – 'Financing Networks: A discussion paper'

## 1 Review of Ofwat's 'back in balance' publications

### Proposal 3 and response (cont'd)

#### Response to Ofwat consultation (cont'd)

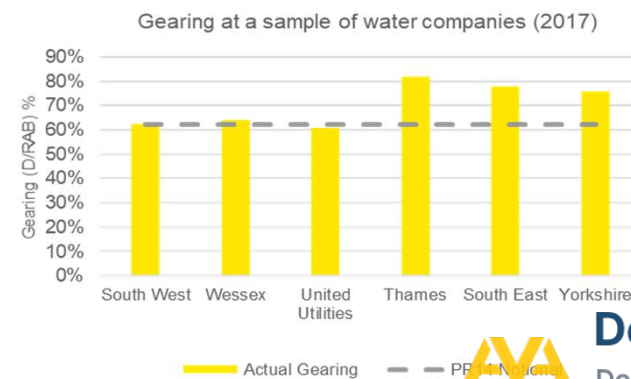
- ▶ Investors cite the UK's open, consultative and stable regulatory regime to date as drivers of investment in the water sector. The gearing sharing proposal is cited as being a significant departure from the status quo where capital structure decisions are the preserve of the board.
- ▶ The consultation responses of two Canadian pension funds noted, in regards to the proposal's effect on the attractiveness of the UK's water sector:
  1. OMERS (c. 32% in Thames Water): 'it risks the investability of the sector'
  2. BCI (c. 9% in Thames Water): 'the sharing of financing outperformance could undermine our ability to continue with our investment in the UK water sector'.
- ▶ A recent FT article discusses the UK's 'negative and hostile political and regulatory environment' for infrastructure. The article cites the difficulties encountered by Yorkshire Water's owners in selling their stakes in conjunction with Ofwat's 'tough new regime'.<sup>1</sup>
- ▶ In terms of credit rating impacts, the gearing sharing mechanism in conjunction with a tougher regulatory stance by Ofwat appears to drive Moody's negative outlook for the water sector (see 22 May 2018 announcement<sup>2</sup>):  
*'We see moves by Ofwat to discourage gearing above the regulator's notional capital structure and the proposed further oversight of equity distributions as departures from long-standing regulatory practice', says Stefanie Voelz, a VP-Senior Credit Officer at Moody's.*  
*'We also see heightened risk of future political interference in the design of the regulatory framework and are changing our assessment of the stability and predictability of the UK water regulatory regime under our methodology to Aa from Aaa. To reflect the increasing business risk we have also tightened our generic ratio guidance for the sector,' continues Ms Voelz.*
- ▶ In short, it appears the proposal (and its manner of implementation) is having impacts on the perception of regulatory risk and the appeal of UK water assets.

<sup>1</sup> FT – Infrastructure investors put 'blanket ban' on UK assets (2019)

<sup>2</sup> Moody's changes outlook to negative on ratings of 4 UK water groups (22 May 2018)

#### Commentary by water companies

- ▶ We have reviewed the consultation responses of a representative sample of six water companies (i.e. 3 with lower gearing and 3 with higher gearing) shown below.
- ▶ The proposal is critiqued by water companies with higher leverage (e.g., Thames Water, South East Water & Yorkshire Water).
- ▶ The response amongst companies with lower gearing levels is more varied. United Utilities and Wessex Water are broadly supportive of the proposal but stress the need to increase the reference point in the gearing sharing formula to 68% and 70% respectively
- ▶ South West Water is supportive of sharing 100% of gains (that "sit outside of the regulatory framework") made by companies with the customers. It stresses that the proposed mechanism may incentivise the wrong behaviour (ie. incentivise shareholders either to retain a higher level of gearing or perversely incentivise lower geared company to increase gearing).



## 1 Review of Ofwat's 'back in balance' publications

### Responses continued & key takeaways for CAA

#### Response to Ofwat consultation (cont'd)

##### Other relevant points of commentary:

- ▶ Respondents who are against the proposal cite that the lenders and financing agreements impose strict discipline on management teams, making leveraged companies more efficient to the benefit of shareholders.
- ▶ Examples of potential perverse incentives are stressed by respondents in both camps; examples of these are included below:
  1. Achieving a higher actual cost of debt to reduce the spread between the cost of debt and equity
  2. Scenarios where debt is paid down in favour of higher pension deficits to escape the definition of debt, etc.

##### Other Ofwat proposals

Along with its proposals for dividend policy, executive pay and gearing sharing proposals, Ofwat considered a range of other proposals which could impact the capital structure and cost of capital. These included:

- ▶ Cost of debt sharing mechanism: companies can propose a voluntary mechanism to share the benefits of the actual cost of embedded debt versus the notional cost of debt. New debt will be index linked to reduce market pricing risk.
- ▶ Changes to the Initial Assessment of Business Plans: include additional wording to specify the need for directors to demonstrate attempts to take into account a fair balance between customers and investors (including outperformance sharing, dividend policies and any performance related element of executive pay).
- ▶ Financial resilience tests: companies are required to perform a minimum suite of scenarios set out by Ofwat, as well as any additional, company specific scenarios to improve the current significant inconsistencies in the level of detail provided by companies. This may impact the sustainable levels of gearing.

- ▶ The mechanism proposed by Ofwat is seen by some respondents to Ofwat's consultation as penal in nature to companies with high-levels of leverage because the spread between the notional cost of equity and actual cost of debt is expected to be positive and relatively large.
  - ▶ There is a risk, it may result in deleveraging among companies potentially leading to a sub-optimal capital structure.
- ▶ Ofwat has provisions for targeting the increased debt tax shield as a result of an increased gearing, however, CAA's Q6 settlement does not currently contain provisions to capture the increased tax shield arising from higher gearing than the notional gearing assumption.
- ▶ Ofwat's proposed gearing sharing mechanism seeks to partially reduce the risk of financial distress (associated with higher leverage). This may have some relevance for LHR as:
  - ▶ Should CAA pursue a Gearing Sharing mechanism, further work could consider the likelihood of financial distress at various gearing levels along with expected costs in the event financial distress imposed on passengers/taxpayers. We recognise that assessing the likelihood of financial distress at HAL specifically is difficult. An option could be to use the credit ratings on HAL's most junior bonds to inform the probability of distress. As an example, S&P assesses a c.0.5% probability of default on infrastructure debt rated BB.<sup>1</sup>
  - ▶ Furthermore, LHR is an asset of national importance. Thus it is very likely that interventions would be necessary to keep LHR operational in the event of HAL insolvency.

## 1 Review of Ofwat's 'back in balance' publications

### Other proposals & R3 considerations

- ▶ Should CAA decide to implement any Gearing Sharing mechanism, the mechanism, implementation and communication of any changes to the CAA's determination of HAL's regulatory cost of capital should be carefully considered.
  - ▶ Ofwat's formula is considered penal by several investors in the water sector, though it has the support of certain companies. In contrast to Ofwat, CAA's price control framework affects only HAL. This allows the CAA to implement a mechanism which is bespoke to HAL
  - ▶ As discussed in Section 3 of the report, HAL's average debt maturity is 12 years and its equity investors have long investment horizons. The perception of regulatory risk is enhanced where regulatory changes are sudden (i.e., deviate too far from the ex-ante expectations of investors) or worse yet, where changes are retrospective. So, CAA needs to consider a phased implementation of any major changes.
  - ▶ Ofwat was criticised for not having evidence of the perceived market failure which it was attempting to redress. The CAA should, if possible, explain the market failure it is seeking to address and clearly explain how its proposals would address that failure.

An in-depth consideration of these factors is outside the scope of this report.

### Runway 3 impacts

#### Background

- ▶ The construction of a new runway at Heathrow Airport ('Runway 3'/'R3') will require significant capital investment (i.e., c. £25bn over c. 8 years), thus increasing the RAB by c. 150% and boosting aircraft movement by c.50%.
- ▶ R3 will therefore magnify any changes implemented in respect of gearing sharing due to (i) higher passenger volumes and (ii) a higher RAB. Hence, setting an appropriate cost of capital becomes even more critical.

#### R3 financeability

- ▶ Any short-term benefits in the form of reduced passenger charges should be balanced with R3's financeability given the need for significant capital investment.

- ▶ R3 will introduce a level of development risk and demand risk (due to the scale of new capacity). The increased risk may translate into a higher cost of capital. The mechanism introduced should not preclude capital providers from earning a sufficient return that is commensurate with the risk of R3.
- ▶ The willingness of existing shareholders to continue investing in HAL amidst a changing risk profile is unclear, though shareholders have expressed a high degree of commitment. To ensure R3 financeability, HAL should continue to be perceived as an attractive and investable asset. As with debt, this will depend on both expected cash flows over the next regulatory period and beyond, which are directly influenced by investors' views on HAL's regulatory regime.
- ▶ A large part of R3 will be financed through debt issuance which is expected to test the debt markets, even with an investment grade rating. In putting forth any proposal, CAA should be cognisant of the potential impact of such a proposal on HAL's ability to raise investment grade debt.

Key considerations in maintaining an investment grade credit rating are as follows:

1. Whether any changes in expected cash flows arising from the Gearing Sharing mechanism could affect key debt ratios; and,
2. Rating agencies' perception on the stability of HAL's regulatory environment.

- ▶ Notwithstanding the gearing sharing, deleveraging may be required to maintain the investment grade credit rating as R3 is developed. This deleveraging may limit the impact of any regulatory gearing sharing mechanism.
- ▶ Deleveraging in conjunction with R3 development could be encouraged through other regulatory changes. For instance, HAL could be allowed to earn a return on incurred CAPEX that has not been completed, which could encourage profits to be retained to finance a greater share of R3.

An in-depth consideration of R3 impacts is outside the scope of this report.

# 2

## Other regulatory frameworks

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## 2 Other regulatory frameworks

### Introduction

#### Introduction

- ▶ In the context of CAA potentially adopting a Gearing Sharing mechanism for LHR, we have explored a number of other regulatory frameworks, both in the UK and abroad, in respect of their approaches to gearing and the cost of capital.
- ▶ We have explored whether other regulators have similar mechanisms to deal with higher gearing, including sharing mechanisms, gearing caps, or financeability requirements. We look at:
  - ▶ GB energy networks (Ofgem)
  - ▶ Other European energy regulators, with short case studies on Germany and Belgium
  - ▶ Australian regulators, both energy and water
  - ▶ The gearing cap CAA implemented for NERL
  - ▶ The Thames Tideway Tunnel
- ▶ We have set out brief thoughts on how each of these might be applicable to CAA in its regulation of LHR