

Economic regulation of Heathrow Airport Limited: working paper on financial resilience and ring fencing

CAP1832



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About this document

Views invited

This working paper focusses on options the CAA is considering to provide further assurance that Heathrow Airport Limited (“HAL”) operates in a financially resilient manner and that risks to consumers arising from financial distress are appropriately mitigated while not cutting across the financing arrangements that HAL already has in place to support its regulated business. It considers options for possible changes to the financial resilience and ring fencing provisions in HAL’s licence that may be appropriate, in particular, given the scale and challenges of the development of new capacity at Heathrow airport. It develops further the thinking we set out in our consultations on the regulatory framework to support capacity expansion at Heathrow in June and December 2017.

We welcome views on all the issues raised in this working paper.

Please e-mail responses to economicregulation@caa.co.uk by no later than 11 October 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 James Wynn-Evans (economicregulation@caa.co.uk).

Executive summary

Introduction

1. In addition to our main consultation papers on developing the regulatory framework and price control arrangements for HAL, we are publishing working papers to address further issues and detailed aspects of the regulatory arrangements. The first such paper discussed the cost of capital and incentives.¹
2. Our consultations on the regulatory framework to support capacity expansion at Heathrow in June and December 2017 set out our initial thinking on financial resilience and ring fencing.² As indicated in the October 2018 Consultation, this working paper develops that thinking in the light of stakeholders' views and the further work we have undertaken.

Our approach to financial resilience

3. Consumers can suffer detriment when service providers experience financial difficulties, including because financial distress can cause disruption to services and investment. The importance of the services provided by HAL emphasises the significance of its financial health to consumers.
4. There are existing conditions in HAL's licence that relate to financial resilience. HAL has also successfully financed the redevelopment of Terminal 2 and created strong arrangements to facilitate its access to the UK and international debt markets to support the financing of its regulated business, which we refer to

¹ See CAP1674, Economic regulation of capacity expansion at Heathrow: working paper on the cost of capital and incentives www.caa.co.uk/CAP1674

² See:

- CAP 1541: Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow ("the June 2017 Consultation") www.caa.co.uk/CAP1541;
- CAP 1610: Economic regulation of capacity expansion at Heathrow: Policy update and consultation ("the December 2017 Consultation") www.caa.co.uk/CAP1610; and
- CAP 1722: Economic regulation of capacity expansion at Heathrow: policy update and consultation ("the October 2018 Consultation") www.caa.co.uk/CAP1722.

in this working paper as its “financing platform”.³ The size of the investment required to deliver capacity expansion (the development of a third runway and the associated infrastructure at Heathrow) will, however, bring new challenges for HAL to manage.⁴ Given this, and the impact of corporate financial distress on construction projects that we have seen elsewhere,⁵ we consider it is appropriate to consider whether we should seek to strengthen further the licence protections that relate to financial resilience, while taking full account of HAL’s circumstances and respecting its financing platform.

5. We consider that it is appropriate to progress our work on this issue at this stage of the development of the regulatory regime to support capacity expansion (and to do so transparently) through this working paper. While we have not reached a firm view as to whether (and if so what) changes to the regulatory regime are required to further the interests of consumers, it is important that investors and other stakeholders have early sight of the protections that we are considering. Addressing these issues at this stage will also allow any changes we propose to be taken account of appropriately in setting HAL’s cost of capital. Nonetheless, we have no evidence to suggest that the changes envisaged in this working paper will lead to an increase in HAL’s cost of capital.
6. Our approach seeks to recognise the continuing success of HAL in using its existing debt platform to raise new finance and that financial distress is a low probability but potentially high impact event. As we noted in the December 2017 Consultation, the financing arrangements used by HAL creates benefits for consumers in enabling it to raise large quantities of debt finance. We also note that bondholders and consumers have a common interest in HAL remaining financially robust.

³ Details of the arrangements comprising HAL’s financing platform can be found at: https://www.heathrow.com/company/investor-centre/offering_related-documents

⁴ While we observe that the conditions in HAL’s licence dealing with financial resilience and ring fencing do not necessarily reflect practice in other sectors, this is understandable given the different circumstances of each sector. We do not consider that these differences of themselves justify changes to HAL’s licence. Further detail on the CAA’s approach to comparisons with other sectors is set out in chapter 1 at footnote 16 to paragraph 1.25.

⁵ See, for example, the disruption to the construction of Midland Met Hospital after the collapse of Carillion.

7. To the extent that our proposals promote HAL's financial resilience and help it to avoid experiencing financial distress, they will be in the interests of both bondholders and consumers. At the same time, we need to recognise that, if HAL were to experience financial distress, the interests of bondholders (who are primarily interested in the repayment of their loans) and consumers (who will be interested, for example, in continuity of service and the longer term benefits of expansion) may diverge. Significant adverse impacts on consumers could arise from this. Bearing these factors in mind, we are considering appropriate, targeted and proportionate options that address this potential tension in the interests of consumers without cutting across HAL's financing platform.
8. Our aim is to protect consumers from the disruption that financial distress could cause by:
 - reducing the likelihood that HAL does not have sufficient resources to operate its business; and
 - mitigating the impact of financial distress should it occur, including through the provision of information to the CAA.
9. In this context, we must:
 - recognise the impact and importance of HAL's existing financing arrangements, while avoiding actions that would cut across those arrangements (such as restrictions on the ability of HAL to make payments to satisfy its obligations under the financing platform);
 - seek appropriate protection for consumers against the risks of financial distress; and
 - not undermine HAL's ability to deliver capacity expansion by making it difficult or more expensive for it to raise finance.
10. That said, and for the reasons outlined above, we do not consider that it would be appropriate for the CAA essentially to delegate the entirety of its financial resilience policy in relation to HAL to bondholders or other lenders to HAL's corporate group. This would be the case if we were to rely solely on the mechanisms set out in HAL's financing platform. Our view is, therefore, that we should continue to develop options for promoting HAL's financial resilience that

could work to enhance the protection given to consumers from the consequences of financial distress should it occur. These options will be designed to work in conjunction with, or alongside, rather than cutting across, the existing provisions of HAL's financing platform.⁶

11. The further analysis that we have conducted, together with our assessment of stakeholders' responses to the December 2017 Consultation, indicate that the additional steps summarised in Table 1 are worthy of further consideration.

Table 1: summary of key developments discussed in this working paper

Proposal	Description	New or existing condition?
Sufficiency of resources.	Enhance the existing sufficiency of resources obligation to (i) provide greater granularity over the nature of sufficient resources (including cash, liquidity and operational resources) and (ii) cover operation of the airport in accordance with the licence.	Builds on existing obligation and ensures consistency within the licence.
Obligation to maintain credit rating.	HAL to have and maintain an investment grade credit rating. Create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the investment grade credit rating is lost.	New provisions.
Sufficiency of resources certification.	Enhance the existing certification of sufficiency of resources, to clarify that HAL's board is expressly expected to consider each of: (i) operational; and (ii) financial resources robustly. Bolster supporting evidence required. Create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the certificate given is not "clean".	Builds on existing certificate and evidence requirements. New provision for trigger.

⁶ We also note that some debt finance is issued further up HAL's corporate structure. The aim of our proposals is also to avoid adverse impacts on this financing, as discussed in chapter 3.

Targeted curtailment of HAL's ability to make dividend and other payments.	New rules creating a targeted restriction on HAL's ability to pass funds to its shareholders and make other payments in the event that the triggers apply (subject to carve outs to avoid undesirable consequences and any inappropriate negative impacts on bondholders).	New provision.
Ultimate controller obligation.	Clarify HAL's existing obligation to make clearer that: (i) the undertaking should be provided by the top holding company in HAL's corporate group, not its shareholders; and (ii) group companies are expected to provide information for CAA. Require HAL to remind ultimate controller of its obligations annually.	Refine and clarify drafting of existing obligation. New provision for annual reminder.
Information provision.	Require provision of information in line with information provided to bondholders under HAL's financing platform. More onerous obligations to apply in the event of financial distress.	New provision.

12. We do not consider that the options of placing a gearing cap on HAL or a restriction on HAL's ability to dispose of assets which were discussed in the December 2017 Consultation should be considered further as part of this review. We are not considering options other than those set out above.
13. The structure of this working paper is as follows:
- chapter 1 summarises the issues raised in the December 2017 Consultation, stakeholders' responses and our latest thinking on our approach to financial resilience; and
 - chapters 2 and 3 build on the analysis set out in the December 2017 Consultation and set out more detail on the options summarised in Table 1.

Next steps

14. We invite comments from stakeholders on the issues raised in this working paper by 11 October 2019. Having considered them, we intend to produce a further working paper on the issues covered here later this year.
15. Our work on financial resilience and ring fencing sits alongside the development of the price control arrangements to cover the expansion of Heathrow. As such, it complements the discussion of the use of credit ratings in the assessment of the financeability of capacity expansion at Heathrow set out in the March 2019 Consultation.⁷ In this context, we note that our approach to setting HAL's price control should itself support financial resilience by being balanced so that risks are identified and HAL is rewarded appropriately for the risks that it takes. Nonetheless, such an approach does not necessarily eliminate the need for financial resilience licence conditions in the interests of consumers.
16. As noted above, we are still developing our policy in this area and have not decided whether (and if so what) changes to the regulatory regime are required to further the interests of consumers. However, should the CAA consider that any changes to HAL's licence were required to reflect the outcome of our work on financial resilience and ring fencing, these would be implemented as part of the full "H7" price control. Prior to that, the text of any required licence modifications would be consulted on in advance of the statutory consultation to implement the H7 price control.

Our duties

17. In developing this consultation, we have had full regard to our statutory duties under the Civil Aviation Act 2012 ("CAA12"), which are set out more fully in Appendix A.

⁷ See chapter 1 of CAP 1782: Economic regulation of capacity at Heathrow: policy update and consultation ("the March 2019 Consultation"): <http://www.caa.co.uk/CAP1782>

Chapter 1

The December 2017 Consultation

Introduction

- 1.1 This chapter summarises the issues discussed in the December 2017 Consultation, stakeholders' responses to them and summarises our latest thinking on these matters.

The December 2017 Consultation

- 1.2 The December 2017 Consultation set out our early thinking on possible developments to HAL's licence to protect consumers from the risks that they may face from HAL experiencing financial distress. The December 2017 Consultation built on the recommendations of a KPMG report on financial resilience⁸ and reviews of both HAL's financing platform and the approaches taken by economic regulators.⁹
- 1.3 The December 2017 Consultation:
- noted the rules in HAL's financing platform and their focus on protecting bondholders rather than consumers;
 - made it clear that any changes we introduce must have clear benefits and not impose undue costs on HAL and consumers (so, for example, must not precipitate a refinancing of HAL by cutting across the arrangements in HAL's existing financing platform);

⁸ This report recommended that the CAA explore the use of debt indexation, gearing caps, credit ratings and cash balance obligations. See:

<http://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=8452>

⁹ We reviewed the approaches taken by Ofwat, Ofgem, ORR and the CAA (in relation to its economic regulation of NATS (En Route) plc ("NERL") under the Transport Act 2000). See: <https://www.caa.co.uk/Commercial-industry/Airspace/Air-traffic-control/Air-navigation-services/NATS-En-Route-plc-NERL-Licence/>

- proposed that any changes should be designed to ensure that HAL has sufficient resources to operate its business and be financially resilient, while mitigating the risks and consequences of financial distress;
- noted the advantages of promoting stakeholder confidence in the long-term stability of regulatory arrangements;
- explained that HAL's board should retain primary accountability for financial stability; and
- said that financial resilience conditions should be consistent with other regulatory policy objectives and implemented in a timely way.

1.4 We also identified a “long list” of potential measures for further consideration.^{10,11}

Stakeholder views

- 1.5 The common thread of those stakeholders' responses that addressed financial resilience was to support rigorous cost-benefit analysis of any changes.
- 1.6 HAL's response was based on the premise that the best way to ensure that it is financially resilient is for the regulatory framework to compensate it appropriately for the risks it faces. While it welcomed the CAA's desire not to cut across its financing platform, it took the view that any duplication of the rules in the financing platform would be redundant and therefore costly. It said that the CAA should look at its financing platform and the licence together as a package to avoid the risk of diverging regulatory and financing obligations and/or obligations with an adverse effect on its financing arrangements.

¹⁰ These were (i) limited additional restrictions on the disposal of assets; (ii) a new obligation to maintain a corporate credit rating (iii) stronger sufficiency of resources obligations; (iv) enhanced compliance certification; (v) enhanced ultimate controller obligations; (vi) enhanced information provision; and (vii) cash/dividend lock up provisions.

¹¹ The December 2017 Consultation also observed that the protections in HAL's licence are less extensive than in other economic regulation regimes. See footnote 16 to paragraph 1.25 for our views on the relevance of the approaches used in other sectors to our analysis.