

H7 financial issues: CAP1876 response

IAG

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EXECUTIVE SUMMARY

Scope

On 13th January 2020, the CAA opened a new consultation (CAP1876) on the regulatory and financial issues for the economic regulation of Heathrow Airport Limited (HAL).² In December 2019, HAL shared its Initial Business Plan (IBP) with the CAA, and published a summary.³ IAG has retained CEPA to respond to the issues that CAP1876 discusses in relation to the cost of capital for Heathrow Airport Limited (HAL), it has also shared a copy of the IBP. In this report we consider:

- The appropriate approach to determining allowed return (WACC). We update our view of HAL's WACC based on the arrangements in place for the most recent regulatory determination (Q6) to determine an 'as is' range for H7, i.e. a range without allowing for expansion.
- Financeability in the context of expansion. Importantly, we assess whether the Q6 approach remains appropriate for H7, or whether the risks presented by expansion might justify different mechanisms for addressing risk – including consideration of some points raised by parties to the CMA RP3 appeal,⁴ which represent several different positions.
- The regulatory cycle, evolution of project risk and what this says about the early years of the programme.

Context

In coming months there will be additional decisions that have relevance for the H7 cost of capital, in particular, the CMA will publish its decision on the RP3 appeal by NERL in May (with provisional findings in mid-March),⁵ and four water companies have appealed Ofwat's recent determination. As a consequence, we update the market components of the WACC for new evidence, but we focus the analysis on HAL-specific parameters which are less likely to be affected by decisions elsewhere.

We also note that the position of the project has shifted in recent days following the Court of Appeal judgement. We consider that planning and political risk, which were already substantial, have increased and this undoubtedly impacts costs, including the cost of finance. In its plan HAL proposes an exceptionally long control period (15 years) and the CAA asks for views in CAP1876 on extending the term over which it gives certainty on aspect of the cost of capital. In the current circumstances we suggest that a shorter control than that proposed by HAL might better serve consumer interests. It would focus on the achievement of key milestones, e.g. the DCO, and place some risk with HAL that would force it to consider what it is willing to spend prior to planning permission being achieved. This potentially short regulatory period would focus on establishing a firm foundation for the project and on reducing programme risk. In response to CAP1871 IAG has already provided thoughts on an incentive mechanism that could be used in this period.

Baseline cost of capital range

Our analysis of the issues related to setting the cost of capital for expansion starts from an estimate of the 'as is' position i.e. the cost of capital without the capacity enhancement project. The results of this are set out in Table 1, alongside the estimates put forward by HAL. Please note that our estimates are based on market information to the

² CAA (Jan 2020) "*CAP1876: Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues*", available on caa.co.uk

³ Heathrow.com (Accessed February 2020) "[Economic regulation: H7 update](#)"

⁴ HAL (2019) "[Heathrow Airport Limited: Third party submission in the CMA RP3 redetermination](#)"

⁵ Gov.uk (Accessed February 2020) "[NATS En-route Limited \(NERL\) Price Determination](#)"

end of January 2020. We would expect the value of key parameters to be refreshed as the CAA approaches its final determination.

[Table 1: Comparison of CEPA initial roll-forward range and HAL IBP 2R cost of capital]

We consider that the above range provides useful context for the assessment of the cost of capital for capacity expansion. Our key conclusions comparing our range with HAL's range are:

- Heathrow's exposure to risk is low compared with other international airports.
- Heathrow is able to broadly match available cost of debt indices – despite high gearing.
- Having updated our analysis, we continue to support the CAA's position on market parameters.

We conclude that HAL's assessment of the 'as is' cost of capital is overstated prior to the issues of expansion being considered. HAL's figures do not provide an appropriate starting point from which to consider the change in risk that could arise out of expanding the airport.

Regulatory framework and financeability

As the expansion project is somewhat different from business as usual – it substantially changes the balance between steady state operation and capital investment – there is a case for ensuring the regulatory approach to financeability is clear before seeking to assess the allowed return. We suggest that the CAA considers financeability earlier in its decision-making process, and considers the target financing structure carefully.

Construction projects can proceed at a sub-A- rating (e.g. Thames Tideway Tunnel, TTT) though we acknowledge the logic of targeting a strong rating in order to facilitate access to diverse markets. However, the current notional gearing assumption of 60% is relatively debt-focused for a privately financed construction project and may be more appropriate for a steady-state network business than one that is expanding. An A- rating may require either significant de-risking or unwarranted cash flow adjustments to be feasible. As demonstrated in our analysis of the Q6 roll-forward, the regulatory regime for HAL warrants an equity return that is close to the overall market return, significantly lower than HAL has assumed. This presents a challenge to quantitative credit metrics under a relatively debt-focused financing approach.

Options for equity investors then are twofold:

- Manage weak metrics during the construction period. This may be reasonable – credit ratings are not only based on quantitative cash flows; they will draw on visibility of future returns.
- Invest sufficient equity to generate quantitative metrics consistent with an A- rating.

The CAA should consider both options carefully, noting that the latter helps minimise debt interest costs and is more consistent with the role of equity finance in a project such as this.

The CAA has specifically asked whether a stronger long-term commitment to the price control package would be required to support financeability. We consider that the perceived stability of economic regulation in the UK, combined with merit-based appeal rights for airports to an independent body, provide considerable comfort for investors that future decisions will be taken in a consistent manner. Credit rating agencies, for example, generally view the UK regulatory regime as credit positive. In this context a longer-term commitment on specific price control parameters from the CAA may add relatively little value. If such commitments would require longer-term forecasts or pre-judgement price control parameters they may even add to the risk of a mismatch between regulatory allowances, economic variables and the allocation of risk.

Allowed return

As demonstrated by the recent Court of Appeal ruling, material risks remain around the political process and Development Consent Order (DCO). While HAL's IBP treats the construction phase as a single homogenous

programme of work, in reality some components of work are riskier than others and the overall risk is front-end loaded. The CAA should not accept HAL's characterisation of risk as a fact.

The CAA suggests that it will roll forward the 'as-is' WACC and then make an adjustment because doing so is transparent and makes use of existing thinking and analysis. While we agree with this approach in principle, we would caution that it is more appropriate to think in terms of an adjustment, not an 'uplift' to the WACC. Thinking of an uplift prejudices the answer to the question of whether HAL's exposure to risk will increase, which is a function of the regulatory regime as well as any inherent volatility in cash flows.

Contemplation of the need for an adjustment should start from an appropriate base. Our Q6 roll-forward represents the WACC for a private airport with significant market power and a well-understood regulatory framework. Despite the size of the proposed expansion project it is not clear that the fundamental proposition for HAL's investors will be materially different from this. The evidence for individual parameters will of course continue to change. Irrespective of that, our Q6 roll-forward presents a view that is similar to that put forward by the CAA's own advisors, PwC. It also demonstrates the wide gap between HAL's proposals and the evidence.

Any adjustment should be grounded in an assessment of how risk exposure has changed, and should recognise that without a dramatic shift in the single till approach, exposure to volume risk or cost incentives HAL's risk exposure is likely to remain below that of typical private airports. The experience of TTT shows that risk exposure for large, complex projects can be tightly controlled. If required, an adjustment ought also to be computed within the common regulatory language of the capital asset pricing model (CAPM), not added arbitrarily as is the case in HAL's IBP.

Evidence from HAL's actual debt costs (at a gearing materially above notional) indicates standard cost of debt indices are sufficient to remunerate HAL's notional debt costs. Provided that the CAA sets a cost of debt allowance commensurate with the target credit rating, it should set a high bar for any adjustments to notional indices. Both the CAA and HAL have adopted an assumption of an A- credit rating; if retained, this should be reflected in the cost of debt benchmarks applied.

We do not comment on tax but are broadly supportive of the CAA's approach to provide a separate tax allowance based on transparent modelling of the notional entity.

1. INTRODUCTION

1.1. CONTEXT

On 13th January 2020, the CAA opened a new consultation (CAP1876) on the regulatory and financial issues for the economic regulation of Heathrow Airport Limited (HAL).⁶ In December 2019, HAL shared its Initial Business Plan (IBP) with the CAA, and published a summary⁷ – this provides some indication of what we can expect from HAL's response to CAP1876. The CAA notes that its CAP1876 consultation does not yet consider HAL's IBP, but that it will respond to the IBP in April.

In this report we consider:

- The appropriate approach to determining allowed return (WACC) as discussed in CAP1876 Section 2 – we update our view of HAL's WACC based on the arrangements in place for the most recent regulatory determination (Q6) to determine an 'as is' range for H7, i.e. a range without allowing for expansion.
- Financeability, in the context of expansion and as discussed in CAP1876 Section 3. Importantly, we assess whether the Q6 approach is appropriate for H7, or whether the risks presented by the expansion might justify different mechanisms for addressing risk – including consideration of some points raised by parties to the CMA RP3 appeal,⁸ which represent several different positions.
- The regulatory cycle and evolution of risk and what this says about the early years of the programme.

In coming months there will be additional decisions that have relevance for H7, but these will not be available in time for IAG responding to CAP1876. In particular, the CMA will publish its decision on the RP3 appeal by NERL in May (with provisional findings in mid-March),⁹ and four water companies have appealed Ofwat's determination for the upcoming price control period – although only one of these four raised finance as an important part of its grounds for appeal. As a consequence, we update the market components of the WACC for new evidence, but we focus on HAL-specific parameters.

1.2. APPROACH AND REPORT STRUCTURE

We have taken the following approach:

- In **Section 2** we discuss how the project to expand Heathrow Airport, and in particular, its key risks, may progress over time, how this impacts the regulatory cycle and the resulting implications for the cost of capital.
- In **Section 3** we calculate a current range for the cost of capital on an 'as is' basis – taking into account new data and broader thinking on the cost of capital.
- In **Section 4** we consider how the CAA might adapt its regulatory framework and approach to fit the context of capacity expansion.

⁶ CAA (Jan 2020) "*CAP1876: Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues*", available on caa.co.uk

⁷ Heathrow.com (Accessed February 2020) "[Economic regulation: H7 update](#)"

⁸ HAL (2019) "[Heathrow Airport Limited: Third party submission in the CMA RP3 redetermination](#)"

⁹ Gov.uk (Accessed February 2020) "[NATS En-route Limited \(NERL\) Price Determination](#)"

2. EXPANSION PHASING AND THE REGULATORY CYCLE

In its IBP, HAL says that the capacity constraint at Heathrow Airport has led to lower consumer choice. Through expansion it will remove the current supply constraint and this will permit airlines to offer new routes. We can see that there are strong arguments for progressing the expansion project rapidly. But, doing so results in a heavily front-end loaded programme of work. HAL illustrates this point clearly in its IBP, as shown in [Figure 2.1.

[Figure 2.1: redacted]

It goes on to say that:

[Redacted]

Arguably a benefit of substantial early work being undertaken by HAL within a stable regulatory environment is that it can be undertaken at all. The project is currently being pursued by HAL in a way that would be unacceptable to commercial organisations in other forms of transaction e.g. in a PFI type structure. In these alternative transaction structures bidders and lenders would not expend significant cost prior to the DCO being granted and before understanding any additional risks that might emerge from the DCO decision itself. They would also expect HAL to be in a position to quantify the risk of early works in some way that can be priced.

To the extent that the CAA is willing to support pre-DCO costs through remuneration within the regulatory regime, HAL is making progress when others would be unable or unwilling to do so. But there is a consequence; risk is being transferred via airlines to consumers without the guarantee of an expanded airport being delivered. It is not clear at this stage that the risk of significant delay or even the project being abandoned can be quantified since planning consent is not within any of the main parties' control. There is therefore a question as to whether pressing ahead at the pace HAL proposes can be justified. More broadly, the likely delay impact of the recent court ruling serves to illustrate the wider uncertainties facing the project as a whole.

With this background (and prior to the recent court ruling), HAL's IBP seeks an exceptionally long H7 control period (15 years) and the CAA indicates in CAP1876 that it might be willing to consider giving certainty over some aspects of the cost of capital for a longer period than would normally be the case. At the current time there may be stronger arguments for a control period not necessarily set in time but rather by achievement of key milestones; DCO consent being key.

In thinking about the length of control we would point out that, while the Heathrow Airport expansion is both large and complex, it is a portfolio of projects that are not homogenous in terms of risk. In the same way that the overall expansion plan is front-end loaded we would argue that the risk profile of its early component projects is similarly distributed. A standard length or even short control which focuses HAL's efforts on removing risk and establishing a more developed design for expansion may have substantial merit in terms of cost reduction and should be considered as an alternative to the longer control that the IBP suggests that HAL would prefer.

We would suggest that the cost of capital for the main construction phase of the project should not be set until the planning and wider political uncertainty that now surrounds the project has been removed and ideally not until some of the earliest risky components of the project have progressed to a point where their risk can be quantified and addressed objectively. This would likely adversely impact the timing of delivery of key assets but there would be upside in reducing risk and consequently the cost of borrowing for the main construction phase. In taking a view the CAA will need to consider whether value for money is best served by pressing ahead or by slower but more certain progress towards additional capacity. Current uncertainty underlines the need for the CAA to have good reason to depart from commercial norms in exercising its duty to protect the consumer interest. The recent court case perhaps provides the opportunity to take a step back and reflect on some of the assumptions that underpin HAL's IBP and the CAA's consultation.

In terms of financing for an initial pre- main construction control period, we would suggest that the CAA creates an incentive on HAL to consider how much it is willing to spend in a period of inherent uncertainty i.e. until the DCO is granted.

risk in relation to stranding or abandonment. IAG has put forward a proposal for remuneration in this period in its response to CAP1871 which deals with early costs. We do not comment on that further other than to reiterate that the commercial disciplines that exist in transactions outside of the regulated sector have relevance to considering how much cost might reasonably be incurred pre DCO and in the early preparatory phases of the project. Current uncertainty underlines the need for the CAA to have good reason to depart from commercial norms in exercising its duty to protect the consumer interest. The recent court case perhaps provides the opportunity to take a step back and reflect on some of the assumptions that underpin HAL's IBP and the CAA's consultation.

Post-DCO (and assuming that the issues raised by the recent court decision can be addressed), we consider that the risk of stranding substantially diminishes. At that point HAL would continue to benefit from the stable and relatively benign regulatory environment that it enjoys now. We tend to agree with the CAA's overall position that incentives for delivery in the main construction phase are required but should be proportionate to avoid a significant adverse impact on the cost of capital. Setting incentives (e.g. in terms of identification of delivery obligations or triggers for the incentive) will become more straightforward if the focus is on the main construction period and a firm design is in place.

3. ROLLING FORWARD THE Q6 COST OF CAPITAL

In this section we set out our view on the appropriate approach to determining allowed return (WACC) as discussed in CAP1876 Section 2. We update our view of HAL's WACC based on the arrangements in place for the most recent regulatory determination (Q6) to determine an 'as is' range for H7, i.e. a range without allowing for expansion. We agree with the CAA's broad approach to consider this 'as is' range as a starting point from which to assess any required adjustments to the cost of capital to reflect capacity expansion.

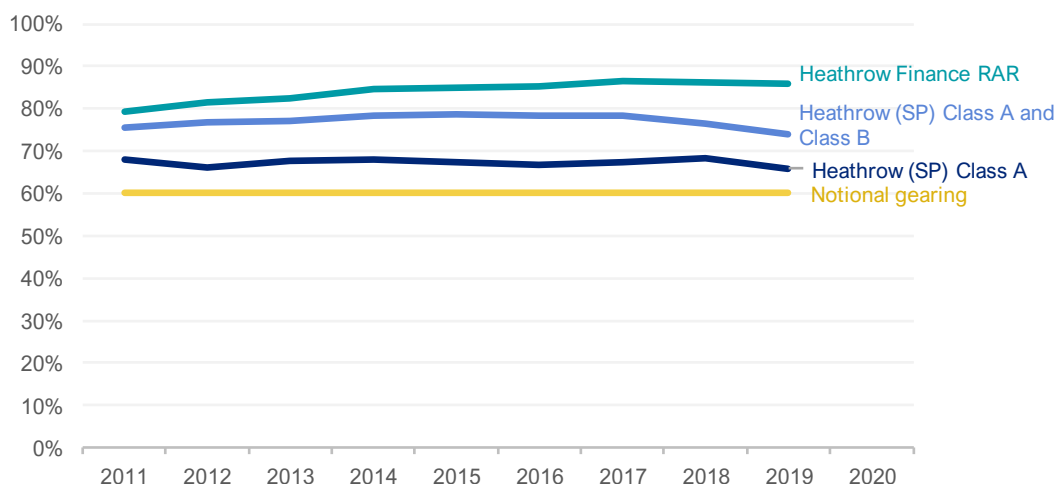
As RPI has been de-designated as a national statistic, our view is that the transition to CPI (or CPIH) indexation should take place from the start of the next price control. However, we have presented figures in this report relative to RPI inflation for ease of reference.

3.1. GEARING

The notional gearing assumption is an input into the cost of capital calculation in two places. Its primary function is to describe the relative proportions of debt and equity finance in the weighted average cost of capital. It is also used as an input in determining the cost of equity itself: the equity risk to which investors are exposed is a function of underlying business risk for the asset concerned (captured under the CAPM in the asset beta) and the financing risk introduced through debt finance (captured under the CAPM in the equity beta).

We have assumed a notional gearing level of 60% in relation to the Q6 roll-forward WACC, in line with the CAA's Q6 determination for HAL¹⁰ and HAL's IBP. For a mature regulated business operating in steady-state this level of gearing, while high relative to most corporates, is a common assumption on the part of regulators. In making this assumption we note that HAL's actual gearing is materially above that level – as shown in Figure 3.1.

Figure 3.1: HAL's gearing¹¹



Source: Heathrow Finance plc (2019) "September Investor Update" p.32

We have previously discussed in a report for the CAA and Ofwat that despite its high gearing, HAL has still been able to achieve a cost of debt at or even below A/BBB iBoxx index, a solid investment grade credit rating.¹² It is worth noting that there may be some read-across from HAL's chosen capital structure to its view of underlying

¹⁰ p35, CAA (Oct 2013) "CAP 1115 - Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014", available on caa.co.uk

¹¹ Please note that care may be needed when comparing the measures of gearing shown here to listed companies. For example, the market value of debt for HAL may include a premium to the nominal values used here.

¹² CEPA (2016) "Alternative approaches to setting the cost of debt for PR19 and H7"

business risk—other things being equal, highly geared financial structures require relatively low-risk, stable and predictable cash flows.

3.2. COST OF DEBT

As our focus is on rolling forward the proposed Q6 approach, in this report we consider the ‘as is’ cost of debt, rather than a cost of debt inclusive of expansion. We discuss principles around our approach to the cost of debt and then discuss the cost of embedded debt and cost of new debt separately. We consider in Section 4.2 whether changes in the composition of HAL’s debt portfolio during a period of capacity expansion would be likely to warrant an adjustment to the cost of debt approach.

3.2.1. Overall approach to the cost of debt

We consider that the cost of debt allowance should compensate for embedded debt and new debt. In setting allowances for the two components of the cost of debt:

- The focus should be on a notionally efficiently financed airports, with benchmark indices used rather than HAL’s actual interest costs.
- Non-financial iBoxx indices are most appropriate for estimating the cost of debt and are used by other regulators in Great Britain.
- Weight should be placed on iBoxx indices with broad A and broad BBB credit ratings.
- iBoxx indices with a tenor of 10-15yrs are appropriate to reflect HAL’s debt, noting the increasing tenor of the iBoxx 10yr+ indices.
- GBP iBoxx indices should be used as a benchmark unless HAL can demonstrate that non-GBP debt needed to be issued due to a saturation of the GBP market (rather than opportunistically considering issuances in other currencies based on market conditions).
- HAL’s actual debt costs and profile should not be used to set the allowance. Actual debt costs should be used to select appropriate benchmark indices and the trailing average approach. When considering actual debt costs, HAL’s gearing has been materially higher than notional gearing assumptions and this should be considered within any analysis.
- We also note that HAL issued bonds in 2008 that reflect incentivised re-financings.¹³ Care is required if those bonds are to be considered.
- Nominal yields should be deflated using market estimates of the cost of debt, covering the same time period as the tenor of debt to be issued. We use breakeven inflation to deflate nominal iBoxx indices.
- We estimate a real cost of debt relative to RPI inflation.

We discuss the cost of embedded debt and the cost of new debt separately. We then discuss the weight to be placed on both debt categories and appropriate debt issuance costs to arrive at a suitable range for the cost of debt.

Comparison of primary yields

The CEPA report for the CAA and Ofwat in 2016¹⁴ considered the cost of Heathrow’s actual bonds, relative to the iBoxx non-financial GBP A and BBB rated corporate indices on the day of issue. The analysis found that Heathrow

¹³ Please see British Airways (2013) ‘Economic Regulation at Heathrow Airport from April 2014. A Response to the CAA’s Final Proposals by British Airways. Technical Appendices.’ Available [here](#). p23-26.

¹⁴ CEPA (2016) [“Alternative approaches to setting the cost of debt for PR19 and H7. A report for Ofwat and the CAA”](#)

nominal GBP bonds, when adjusted for tenor, had outperformed the benchmark indices – as demonstrated in Table 3.1. This evidence is based on yields at issuance, so does not change over time. Heathrow Funding Ltd has not issued bonds fitting with this categorisation since the publication of the CEPA report.

Table 3.1: Estimated outperformance of Heathrow GBP nominal bonds, based on CEPA (2016)

Bond issuance date	Outperformance of benchmark indices
9 August 2016 ¹⁵	+23bps
12 June 2014	+81bps
31 October 2013	+22bps
3 December 2009	-80bps
15 February 2006	+18bps
27 November 2003	+35bps
30 January 2002	+82bps
10 December 2001	+48bps

Source: CEPA 2016 report for Ofwat and the CAA on the cost of debt

We consider that this supports the idea HAL can perform in-line or outperform the chosen benchmark indices, based on an ‘on the day’ comparison.

Comparison of secondary yields

The CEPA 2016 cost of debt report showed secondary yields on Heathrow bonds with an average time to maturity of 10-15yrs. In early 2016, the bonds were outperforming the iBoxx GBP A and BBB non-financial corporate 10-15yr index.

There is only one nominal GBP bond that would be included based on our criteria to conduct updated analysis. We compare the nominal yield on this Heathrow bond (a 6.45% coupon bond issued in 2014, maturity in 2031) to the nominal spot yield on the iBoxx GBP A/BBB indices of 10-15yr tenor. No adjustment is made for tenor, as the Heathrow bond has c.12yrs time to maturity over the period of comparison.

¹⁵ Note that this calculation had been based on the announcement date in the original report, as it had been published close to the date of release.