

Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment

CAP 1966



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About this document

This document is published in response to the request made by Heathrow Airport Limited (“HAL”) in July 2020 for the CAA to change its approach to the calculation of HAL’s regulatory asset base (“RAB”) to take account of the actual and expected impact of the covid-19 pandemic on its revenues in 2020 and 2021. It provides our initial views on HAL’s request and proposes next steps for consultation.

The document sets out:

- the background to HAL’s request and the initial views of airlines in response to it;
- our approach to assessing HAL’s request;
- our initial assessment of HAL’s request; and
- proposals for our next steps and timetable for dealing with the issues raised by the request.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in chapters 1 to 3.

Please e-mail responses to economicregulation@caa.co.uk by no later than 5th November 2020. 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 Stewart Carter (stewart.carter@caa.co.uk).

Summary and introduction

Introduction

1. HAL¹ is subject to a price control that sets the maximum revenue (or “yield”) that it can recover from the per passenger airport charges it can levy on airlines. In setting the last main price control covering the period 2014 to 2018 (“Q6”),² we noted that we could reopen these arrangements to deal with exceptional circumstances (although we did not include in HAL’s licence a specific mechanism to reopen the price control, or any specific criteria by which any request for such reopening would be assessed).
2. The entire aviation sector has experienced a severe and unprecedented downturn in passenger demand and revenues as the spread of covid-19 developed into a pandemic. Passenger numbers fell 97% at Heathrow airport in April 2020 when compared to April 2019. While there has been a modest recovery in passenger numbers since then (in August 2020 passenger numbers were 82% lower than the previous year), it is clear that the sector is facing a severe and prolonged downturn, and the path of any further recovery is highly uncertain. The financial impact is being felt by all companies within the aviation sector, including airports, airlines and their suppliers, and these companies’ employees and investors.
3. Across the aviation sector companies and their investors have taken, and are continuing to take, significant and often difficult steps to support the liquidity of their businesses during these challenging times. HAL has taken steps to negotiate waivers on certain aspects of its debt financing arrangements, suspend dividends, reduce its operating costs (including cutting staff numbers and salaries) and reduce its capital expenditure programme.

¹ Definitions of terms and abbreviations used in this consultation as well as references to previous CAA consultations are set out in the glossary at Appendix B.

² The approach adopted for Q6 was subsequently extended to 2019 and then by a commercial deal between HAL and airlines for 2020 and 2021.

4. In addition to the steps set out above, on 27 July 2020 HAL made a request to the CAA for a significant upward adjustment to its regulatory asset base (“RAB”) from 2022 to help protect it from the consequences of the covid-19 pandemic. The RAB is a key parameter that we use in setting HAL’s price control. In broad terms, it represents the value of the investments that HAL has made in its regulated business that have not yet been recovered through aeronautical revenues. We use it as the basis for setting the allowances for regulatory depreciation and returns in HAL’s price controls. In simple terms, increasing HAL’s RAB at the start of 2022 would allow it to increase charges to airlines in future years.
5. HAL has said that making this RAB adjustment would be consistent with our primary duty to consumers, as it would allow for more spending in the short term and reduce HAL’s financing costs in the longer term (which would put downward pressure on its prices).
6. HAL has also shared its request with airlines and a number of airlines have made representations to the CAA and suggested that such an adjustment would not be in the interests of consumers and that we should reject HAL’s request.
7. This document sets out for consultation our initial assessment of HAL’s request, taking into account the evidence provided by HAL and the initial responses from airlines.

HAL’s request and the initial views of airlines

8. HAL has suggested that the impact of the covid-19 pandemic has created urgent short term and longer term issues for its business, including:
 - pressure to cut costs that could jeopardise not only the quality of service experienced by passengers and airlines, but also future investment in the airport; and
 - higher financing costs that could threaten HAL’s future financeability and the affordability of its charges.
9. To help deal with these difficulties, HAL has suggested that the CAA should make an adjustment to its RAB. HAL has proposed a mechanism that would compensate it for the majority of the revenue it expects to lose in 2020 and 2021

from the downturn in passenger traffic levels. HAL has estimated this lost revenue would be about £2.2 billion³ and its proposal would lead to an upward adjustment to the RAB to apply from 2022 of around £1.7 billion. HAL has said it would bear around £0.5 billion of the estimated revenue loss of £2.2 billion. This would increase airport charges by around £1.20 per passenger, or about 5% on the expected level of charges from 2022, and more in the longer term. HAL has also said that consumers would gain from the RAB adjustment as its cost of capital would be lower in the future and so, in its view, airport charges would be lower in the future than would otherwise be the case.

10. HAL has said that this intervention would help it to avoid the difficulties summarised in paragraph 8 above and would:
 - be consistent with the CAA's statutory duties (including to further the interests of consumers), the Q6 price control settlement and the approaches taken at both other European airports and in other sectors subject to economic regulation in the United Kingdom; and
 - also recognise the importance and value of an appropriately balanced approach to risk sharing.
11. HAL requested that we should take action quickly and commit to the RAB adjustment to help protect its quality of service, capital expenditure programmes and financeability, as well as to prevent significant increases in its cost of capital.
12. In contrast, airlines have objected to HAL's proposal and suggested that:
 - HAL has been too slow to introduce efficiency savings;
 - HAL should seek additional support from its shareholders given that its problems, in part, arise from the high level of gearing it has adopted;
 - the returns made by HAL's shareholders during the Q6 price control period have been excessive and no further assistance is warranted;

³ This is an estimate based on a forecast of passenger numbers during 2020 and 2021. HAL is proposing that the final amount is calculated based on actual passenger numbers in 2020 and 2021.

- HAL's comparisons with the adjustments made at other regulated airports for the impact of the covid-19 pandemic are misleading;
- regulatory intervention would be inconsistent with the Q6 regulatory framework, which was based on the assumption that HAL would be responsible for managing volume risks; and
- no other major airport (or airline) in the UK is seeking to compensate its shareholders for loss of revenue by increasing its prices to consumers and it would not be appropriate of the only airport subject to full price control regulation to be allowed to do so.

Our approach to assessing HAL's request

13. We have assessed HAL's request in accordance with our statutory duties. These include our primary duty to further the interests of consumers, where appropriate by promoting competition and our other duties, including to have regard to HAL's financeability. This has involved considering whether intervention is warranted given the regulatory settlement for the Q6 price control and the commercial deal between HAL and airlines for 2020 and 2021. It is very clear that the impact of the covid-19 pandemic has created exceptional circumstances, and we should consider whether the regulatory framework for HAL is fit for purpose as a result. We have already recognised that we will need to consider how the regulatory framework should change in response to these challenges, and are starting to address issues in our work on the review of HAL's H7 price control, which we expect to implement from January 2022.⁴
14. Nonetheless, in considering changes in respect of 2020 and 2021, we should recognise that the starting point for our assessment is a long standing system of economic regulation that allocates managing traffic risk to HAL in the period to December 2021, and that HAL accepted the continuation of these arrangements as part of a licence modification in 2019. We would need to be clear that any changes to this approach must be consistent with our statutory duties and

⁴ We provided a programme update in CAP 1914 (April 2020) and a policy update and consultation in CAP 1940 (June 2020).

supported by clear evidence. Careful thought and a strong justification would be needed to support adjusting the price control settlement mid-period, particularly where there is no predetermined threshold and/or mechanism within the licence to allow for such an adjustment.

15. Our assessment has mainly focused on whether urgent intervention is justified as we will, in any case, undertake a wider review of HAL's price control arrangements for the H7 period in 2021. We have considered:

- whether there is evidence of significant short term issues in relation to the incentives provided by the existing regulatory framework in respect of quality of service and investment for 2020, and particularly 2021;
- to what extent there is evidence of material financeability issues either now or to an increasing extent during the rest of 2021 and into 2022. In considering whether there is evidence of material financeability issues, we also consider whether there is evidence as to:
 - (i) whether financeability issues have been exacerbated by the decisions made by shareholders to increase and maintain the level of gearing of HAL beyond that we have assumed in setting HAL's price controls;
 - (ii) the role of shareholders and whether they should take further steps to help HAL deal with the difficulties it faces, and/or whether further regulatory intervention might be warranted; and
 - (iii) whether financeability issues (including the likely impact of regulatory action on HAL's cost of capital) should be dealt with now or at the H7 price control review. We recognise that financial markets and investor expectations regarding returns will have changed as a result of the impact of the covid-19 pandemic on aviation, but more evidence is likely to emerge over time that will allow us to better estimate the longer term impact of these factors robustly.
- where there are issues that might warrant regulatory intervention, whether an appropriate range of options has been assessed and whether there is evidence to support the identification of a proportionate and appropriate remedy. HAL's request focuses on one possible remedy for the issues that

it has identified, and does not consider or evaluate in detail alternative options; and

- whether there are other issues and measures we should consider to protect consumers better.

Our initial assessment of HAL's request

16. While HAL's request identifies a range of issues consistent with the assessment framework set out above (such as the incentives created by its regulatory framework and the financeability of its activities), the evidence that HAL has provided so far falls short of that required robustly to justify its claims that "urgent support/action is necessary" and that any such support should be in the form and of the scale in HAL's request (i.e. a £1.7 billion upward adjustment to HAL's RAB).
17. Firstly, we consider that, at this stage, HAL has not provided comprehensive evidence as to why existing regulatory arrangements are not sufficient to protect quality of service and investment. HAL's request does not set out what the additional requirements and service level impacts would be likely to be in 2020 and 2021 and why additional regulatory support is needed now. If further evidence is forthcoming that robustly demonstrates an urgent need for regulatory action to further the interests of consumers, we would consider an appropriate, targeted and proportionate response to address that need. It is also not clear that HAL has considered a range of possible options or that the remedy that HAL has put forward is an appropriate and proportionate approach to deal with any issues that warrant regulatory intervention.
18. Secondly, we do not consider that, at this stage, HAL has fully explored issues around financeability and whether shareholders should provide additional funds given their previous decisions to increase and maintain HAL's gearing significantly above the assumptions used in setting its price controls. On the cost of capital, HAL has not explained why it is better to deal with these issues now rather than at the next (H7) price control review, which will, by its very nature, need to consider the appropriate risk and reward package for HAL for the next control period, and how this relates to HAL's financeability and the affordability of its charges.