

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

CAP 1966A



Published by the Civil Aviation Authority, 2020

Civil Aviation Authority,
Aviation House,
Beehive Ring Road,
Crawley,
West Sussex,
RH6 0YR.

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA

First published October 2020

Enquiries regarding the content of this publication should be addressed to: stewart.carter@caa.co.uk

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

Contents	3
Appendix A	4
Our duties	4
Appendix B	6
Glossary	6
Appendix C	10
Quality of Service and Investment Issues	10
Introduction	10
Summary of HAL's request	10
Our initial assessment	12
Appendix D	16
Financeability and Cost of Capital	16
Introduction	16
Summary of HAL's request	16
CAA's initial assessment	19
Appendix E	25
Historical Performance	25
Introduction	25
Summary of HAL's request	25
Airline views	26
Our initial assessment	26
Appendix F	30
Regulatory Precedent and Case Studies	30
Introduction	30
Summary of HAL's request	30
Airline views	32
Our initial assessment	32

Appendix A

Our duties

- A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
- A2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
- A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
- A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
- the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the Better Regulation principles.

- A6 In relation to the capacity expansion at Heathrow, these duties relate to the CAA's functions concerning the activities of HAL as the operator at Heathrow.
- A7 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.
- A8 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

Appendix B

Glossary

Acronym/term	Definition
ADP	Airport operator Groupe ADP, formerly Aéroports de Paris, based in Paris.
ADR	Airport operator ADR Group or Aeroporti di Roma, based in Rome.
Aena	Airport operator Aena SME, based in Spain.
AOC	Airline Operators' Committee (for Heathrow), a private company limited by guarantee.
AOS	Airport operation services, as defined in section 68 CAA12.
BA/IAG	British Airways plc/International Airlines Group (owner of British Airways).
Beta	A measure of the perceived riskiness of an investment relative to the equity market as a whole. Entities with a beta of less than one are considered less risky than the market as a whole, while a beta greater than one indicates that the investment is considered more risky than the market as a whole.
CAA ("us"/"we")	The Civil Aviation Authority.
CAA12	Civil Aviation Act 2012.
Capex	Capital expenditure.
CMA	The Competition and Markets Authority.
Commercial deal or Commercial Agreement	The Agreement entered into between HAL and airlines that applies in 2020 and 2021 and provides for: - a "fixed rebate" to all airlines currently operating from Heathrow totalling £260 million, split into two equal payments of £130 million for 2020 and 2021; - a further volume rebate if the number of passengers rises above certain thresholds in 2020 and 2021;

Acronym/term	Definition
	- if passenger numbers were to turn out significantly lower than expected, the commercial deal also provides for some downside protection for HAL (in these circumstances the fixed rebate to airlines would be reduced); and - default arrangements for any airlines that did not sign the commercial deal, so that those “non-signatory” airlines would receive an appropriate share of the fixed rebate but would not benefit from the volume rebate. Further details and discussion of the commercial deal are set out in CAP1852, “Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications”. See www.caa.co.uk/CAP1852.
Commercial revenues	Revenues HAL derives from services to passengers, such as retail, food and beverage, <i>bureaux de change</i> , advertising, car parking and car rental, or from services to airlines, check-in desks, office rental, airline lounges and warehousing.
Constructive engagement	The process for engagement between HAL and its airlines customers as part of the H7 price control process.
Consumers	As defined in CAA12, consumers are passengers and cargo owners, both now and in the future.
Delayed recovery	HAL’s scenario in its request with relatively rapid recovery in traffic.
Deprecation holiday	A period over which regulatory depreciation is included in aeronautical charges but not removed from the RAB.
ERA	Economic regulation agreement, for ADP.
<i>ex ante</i>	Based on forecasts/before an event.
<i>ex post</i>	Based on actuals/after the event.
Financing platform	The “whole business securitisation” funding arrangements used by HAL to raise debt finance. Details of the arrangements comprising HAL’s financing platform can be found at: https://www.heathrow.com/company/investor-centre/offering_related-documents .
Gearing	Ratio of a regulated company’s debt to its RAB.

Acronym/term	Definition
H7	The next HAL price control that we assume will be in place from 1 January 2022. If set for the usual five year period, this will run for the years 2022 to 2026.
H8	The next HAL price control period after H7. If H7 is set for the usual five year period, H8 will start from the year 2027.
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport.
Heathrow Finance Plc	A holding company of HAL, which owns and operates Heathrow airport.
IBP	HAL's "Initial Business Plan" for the expansion of Heathrow Airport. The IBP was provided to the CAA in December 2019 and was prepared in the expectation of a 3rd runway being built.
IDoK	Interim determination of the K factor, a regulatory tool used in the UK water sector.
iH7	Interim H7 price control. Runs from 1 January 2020 until 31 December 2021.
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport.
NERL	NATS En Route plc.
Opex	Operational expenditure.
ORCs	Other Regulated Charges.
PCM	Price Control Model.
Q4 or Q4 price control	The "Q4" price control was the price control for the period from 2003 to 2008. See for example CAA decision document covering Q5 price control here .
Q5 or Q5 price control	The "Q5" price control is the price control for the period from 2008 to 2014. See for example CAA decision document covering Q5 price control here .
Q6 or Q6 price control	The "Q6" price control is the price control for the period from April 2014 to end of December 2018, the approach to which

Acronym/term	Definition
	has subsequently been successively extended to cover 2019-2021. For the Q6 final decision, see www.caa.co.uk/cap1138 .
QoS	HAL's quality of service, which is regulated through the SQRB scheme in its licence granted under CAA12.
RAB	Regulatory Asset Base.
Spread (also "bond spread")	The difference between the yield on a corporate bond and the yield on a risk-free security such as a government bond.
SQRB	Service quality rebates and bonuses, a scheme of incentives within HAL's current price control in its licence granted under CAA12.
Star Alliance	An airline alliance with 26 member airlines.
TRS	Traffic risk sharing mechanism.
United	United Airlines.
VAA/Virgin	Virgin Atlantic Airways.
WACC	Weighted Average Cost of Capital.
WTP	Willingness to pay survey.

Appendix C

Quality of Service and Investment Issues

Introduction

- C.1 In its request for a RAB adjustment, HAL highlighted a number of actions taken within its business to limit its monthly cash outflow.
- C.2 However, despite these measures, HAL stated that, without regulatory intervention, further actions would be needed to reduce costs and investment so that it can maintain acceptable liquidity. HAL suggested that these actions could be expected to have a detrimental impact on the quality of service (“QoS”) received by consumers, as well as an impact on its ability to invest in Heathrow airport.
- C.3 In this Appendix, we summarise the parts of HAL’s request that relate to QoS and investment issues, and provide our initial assessment of the evidence that HAL has provided.

Summary of HAL’s request

- C.4 In its request, HAL stated that it has *“mitigated the impact to the extent possible”* of the large drop in passenger numbers, *“to protect the business and conserve cash”*, by undertaking *“decisive actions”*.
- C.5 HAL provided the following examples of actions it has undertaken to save cash totalling around £80 million per month:
- consolidating operations onto one runway and temporarily closing terminals 3 and 4 and areas of Terminals 2 and 5;
 - cutting its capex programme for 2020 from £1.9 billion to £445 million (over £250 million of which had already been spent when the impact of covid-19 pandemic started to be felt);
 - implementing temporary pay reductions of between 10 and 25% for all colleagues;

- undertaking a company-wide reorganisation, making over 500 head office staff and 880 front line staff redundant to date; and
- furloughing over 50% of its staff.

C.6 However, despite these measures, HAL stated that without regulatory intervention, it will have to take further steps to reduce costs and investment so that acceptable liquidity can be maintained. HAL also indicated its view that these cost reductions would be likely to be asymmetric, in that it will not be able to reverse them quickly as demand at the airport recovers, and that this will potentially impair QoS in those circumstances.

C.7 HAL provided the following list of potential actions relating to QoS and investment:

- **Further permanent headcount reductions:** HAL stated that this would be likely to have a significant impact on QoS and costs as the airport returns to more normal operations. It stated that it might need to constrain passenger throughput in future or that the re-hiring of staff to meet demand increases would result in additional costs and delay. HAL suggested that service standards would fall for an extended period and provided examples of longer queuing times and reduced on time departures to illustrate this point.¹

HAL noted that the same dynamic would be seen in most, if not all, of HAL's costs, such as maintenance, customer service, access, resilience and information, with similar long term asymmetric effects. It also stated that regulatory intervention will enable it to avoid taking such cost reduction decisions and meet new covid-19 health related requirements more effectively, increasing consumer confidence in safe travel and helping to re-establish its route network.

- **Investment will continue to be drastically curtailed including into H7:** HAL stated that investment can currently only be made on safety

¹ HAL attempted to quantify the impact of these QoS reductions using the illustrative examples of on time departures falling from 80% to 60% (the recent levels at Gatwick) and a 5 minute increase in security queue time. It calculated this would result in a loss of consumer welfare of £570 million and £150 million respectively. This calculation utilised the results of their Willingness to Pay ("WTP") Survey set out in HAL's ^{IBP}

critical items and to complete works already underway where pausing work would be extremely uneconomical. It expected this to result in a backlog of maintenance capex needed in future years which could be detrimental to future service if it could not be funded.

Further, HAL suggested that the current lower utilisation of the airport provided an opportunity for it to undertake capital maintenance projects more efficiently and effectively, for example, because it would not be required to undertake work in short windows during the night. HAL stated that a RAB based recovery mechanism would allow greater investment during 2021.

- **HAL will not be able to provide its partners with the support they need to help with their recovery:** HAL stated that the recovery of the airport will depend on a large number of partners at the airport, including the airlines, retailers, ground handlers and others. It also stated that an appropriate recovery mechanism would place it in a better position to be able to help these partners with their recovery and ensure consumers receive the service experience they desire throughout their airport journey.

Our initial assessment

- C.8 We recognise that HAL has seen a very significant fall in its revenues as a result of the impact of the covid-19 pandemic and that there is uncertainty about the recovery in passenger traffic. If the recovery is relatively slow, this could put significant strain on HAL's financeability and its ability to invest.
- C.9 HAL has set out a number of actions which it considers it would need to undertake in the absence of a RAB based adjustment in order to preserve cash. While we agree these actions would be likely to drive some detrimental impact on the services that consumers receive, we have a number of concerns with the quality of the supporting analysis and evidence provided by HAL in support of its request. These concerns are principally that:
- the issues that HAL has raised about reduced quality of service and levels of investment seem to be primarily caused by issues around a lack of