

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

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Contents

Contents	3
About this document	5
Summary and introduction	6
Introduction	6
The October 2020 Consultation	7
Responses to the October 2020 Consultation	8
Identifying a framework to assess the case for intervention	9
Developing the assessment framework	10
Identifying policy options	11
Preferred approach	13
Next steps and views invited	14
Our duties	15
Structure of this document	15
Chapter 1	16
Assessing the case for regulatory intervention	16
Introduction	16
Re-opening the Q6 price control	17
Assessment framework and objectives	21
Chapter 2	25
Assessing the options for regulatory intervention	25
Introduction	25
Option to commit now to making no intervention	26
Packages of intervention options	27
Discussion of intervention options	29
Objective 1: Protect consumers by avoiding undue increases in the cost of equity finance	30
Objective 2: Protecting consumers from the consequences of HAL experiencing difficulties with raising debt	34
Objective 3: Promoting affordable charges in H7	39

Objective 4: Protect efficient investment and service levels	41
Summary of preferred options and timing of intervention	44
Chapter 3	46
Next steps and timetable	46
Introduction	46
Next steps on any early intervention ahead of H7	47
Next steps on any intervention as part of the H7 price control review	48
Views invited	49

About this document

In October 2020, we published a consultation¹ document 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 impact of the covid-19 pandemic.

This update and consultation document provides our latest views on HAL’s request and our developing thinking on whether HAL’s price control framework should be changed in response to the circumstances created by the covid-19 pandemic. In particular the document sets out:

- our framework for identifying and assessing options for intervention;
- the assessment of options, including HAL’s proposal for a RAB adjustment, in the light of this framework and the views of HAL and airlines in response to the October 2020; and
- our next steps and timetable for dealing with these matters.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in the summary.

Please e-mail responses to economicregulation@caa.co.uk by no later than 12 noon on 5th March 2021. Given the short timetable for next steps on decisions for interventions ahead of the H7 price control, we do not expect to be able to take account of late responses.

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).

¹ See Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment (CAP1966) (the “October 2020 Consultation”): www.caa.co.uk/CAP1966

Summary and introduction

Introduction

1. This update and consultation document follows on from the October 2020 Consultation on HAL's request for an adjustment to its regulatory asset base ("RAB") to help deal with the circumstances created by the covid-19 pandemic.
2. The entire aviation sector has experienced a severe and unprecedented downturn in passenger demand and revenues as a result of the covid-19 pandemic. Passenger numbers fell dramatically at Heathrow airport in the spring of 2020 and were 83% lower at Heathrow airport in December 2020 compared with December 2019. The path of recovery is highly uncertain. The financial impact is being felt by all companies within the aviation sector, including airports, airlines and their suppliers, as well as 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 sought and obtained waivers on certain aspects of its debt financing arrangements, suspended dividend payments, reduced its operating costs (including cutting staff numbers and salaries), reduced its capital expenditure programme, and has obtained additional liquidity, including by raising new debt finance and making a capital injection from the wider group to support the regulated operating company.
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 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 fully recovered through airport charges. We use it as the basis for setting the allowances for regulatory depreciation and returns in HAL's price controls. In simple terms, and all else equal, increasing HAL's RAB at the start of 2022 would allow it to increase charges to airlines in future years above the level that

they otherwise would have been at. In HAL's July 2020 request, the RAB adjustment was expected to increase charges by about £1.20 per passenger, or about 5%, from 2022.

5. In setting the last main price control covering the period 2014 to 2018 ("Q6"),² we said that we could reopen these arrangements to deal with exceptional circumstances. Bearing this context in mind, HAL has said that making this RAB adjustment would be consistent with our primary duty to consumers, as it would allow HAL to make additional investments and improve services to consumers in the short term and reduce HAL's financing costs in the longer term. HAL considers this would put downward pressure, or limit upward pressure, on its prices compared with HAL's investors bearing these risks.

The October 2020 Consultation

6. We 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.
7. We considered a wide range of issues, including 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, which did not include any further provisions for exceptional events.
8. Our assessment mainly focused on whether urgent intervention is justified as we will, in any case, undertake a wider review of HAL's price control arrangements in 2021 for the H7 price review period (which we plan to apply from 2022), including considering any adjustment for the impact of covid-19 in 2020 and 2021. We also considered whether the proposed adjustment appeared to be proportionate. We concluded that the evidence that HAL had provided at that time fell short of that required robustly to justify its claims that "urgent

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.

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 £1.8 billion upward adjustment to HAL’s RAB).

9. In addition, we noted that:

- if, in response to the consultation, HAL provided further evidence of short term difficulties, including in relation to its incentives to invest or financeability, we would assess this evidence carefully; and
- if circumstances turned out to be particularly difficult, there could be very significant pressure on HAL’s financeability and continued ability to provide investment and reasonable levels of service. If these difficulties looked likely to emerge, it would be important for us to adopt a suitable process that would allow us not only to consult stakeholders, but also to be able to react quickly to protect consumers’ interests and consider what changes to the regulatory framework might be appropriate either in 2021 or as part of the H7 price review.

10. We also noted that airlines objected strongly to HAL’s proposal and suggested that:

- HAL has been too slow to introduce efficiency savings and 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; and
- 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.

Responses to the October 2020 Consultation

11. HAL has provided further information in support of its proposals for a RAB adjustment. It said that:

- investors had a clear expectation that the price control would be reopened in the event of exceptional circumstances;

- not making a substantial adjustment would undermine regulatory consistency, increase the cost of capital and harm financeability;
- as a result of lower traffic forecasts since its original submission, using the same approach means its proposed RAB adjustment has increased from £1.8 billion to around £2.8 billion;
- its charges in H7 would be lower if the RAB adjustment were made (by around £7 per passenger) due to the lower cost of capital and because it would allow HAL to reprofile the recovery of regulatory depreciation;
- with the RAB adjustment, HAL expected consumers to benefit from better services and greater capacity in 2021-22 and beyond (for example through quicker reopening of terminals) as it would allow it to increase capex by £218 million and opex by £9 million; and
- CAA has wrongly treated the RAB adjustment as a balance sheet issue and other regulators have been quicker to respond than CAA, where HAL contends it is mainly an issue of aligning the balance of risk and reward with the Q6 price control.

12. The airlines and other respondents opposed the RAB adjustment and have suggested it is not appropriate or in the interests of consumers, including for the reasons summarised in paragraph 9 above.

Identifying a framework to assess the case for intervention

13. Since the October 2020 Consultation, we have further developed our own approach to considering the issues around the impact of covid-19 and appropriate intervention. We have assessed three broad approaches to guiding the development of possible regulatory interventions:
- a) focusing on compensating HAL for the impact of the exceptional circumstances and the reduction in passengers/revenues on its price control activities;
 - b) using a framework based on our statutory duties to assess the broad range of issues raised by the covid-19 pandemic and considering the most appropriate package of options to address those issues; and

- c) relying broadly on the allocation of risks that was made in setting the Q6 price control, noting that HAL was remunerated at the market average cost of equity and was paid an additional premium in the form of a “shock adjustment” to the traffic forecast to manage volume risk.
14. While it is very clear that the impact of the covid-19 pandemic on the aviation sector generally, and Heathrow airport in particular, represent exceptional circumstances, this does not, in itself, constitute an automatic reason to focus only on compensating HAL for the reduction in passenger numbers. Therefore, we have concluded that approach (a) as summarised above would be too narrow and would not properly reflect our broader statutory duties, including to protect consumers.
15. By contrast, approach (c) with its focus on the approach to risk allocation that was used to set the Q6 price control appears to give relatively little weight to the genuinely exceptional circumstances created by the covid-19 pandemic and the wide-ranging impacts associated with the present very difficult circumstances.
16. We have adopted approach (b) as it has a focus on our primary duty to further the interests of consumers and allows for consideration of a broad range of issues and possible ways of intervening, not just focused on RAB adjustments. It is also consistent with what we said at the Q6 price control review that the price control could be reopened in exceptional circumstances and we would consider such a request in the light of our statutory duties and the circumstances prevailing at the time.

Developing the assessment framework

17. At the centre of our assessment framework is our primary duty to further the interests of consumers.³ In performing this duty, we must have regard to the matters set out in our “secondary duties”.
18. The most important of our secondary duties in the current circumstances appear to us to include the need to:

³ Consumers include both passengers and cargo owners.

- secure that reasonable demands for airport services are met;
- promote economy and efficiency on the part of HAL;
- secure that HAL is able to finance its regulated activities; and
- have regard to the principles of “better regulation” set out in CAA12.

19. Consideration of how best to address these duties has led us to focus on the following key objectives in deciding how best to deal with the challenges created by the covid-19 pandemic for consumers and HAL:

- we should seek to protect consumers from any undue increases in the estimates of the cost of equity finance that we use in setting HAL’s price control, since such increases would tend to increase prices to consumers at the next price control review and make the funding of investment much more difficult;
- in a similar vein, we should seek to protect consumers by ensuring that the regulatory framework is consistent with HAL being able to raise efficient, investment-grade debt finance;
- we should have regard to the overall affordability of HAL’s regulated charges, both now and in the future; and
- the regulatory framework should also support efficient investment and appropriate levels and quality of consumer service, both in the short and longer-term.

Identifying policy options

20. Since the October 2020 Consultation, we have seen further reductions in the short term traffic forecasts for Heathrow airport as a result of the covid-19 pandemic and additional travel restrictions. With traffic recovery continuing to be highly uncertain and potentially more gradual than previously expected, we are seeing further challenges to HAL’s financial performance.⁴ We have also

⁴ From HAL’s investor reports, the passenger forecast for 2021 has reduced between June and December 2020 from 63 million to 37 million. All else equal, this reduces HAL’s cash flows and increases HAL’s gearing, though we note it has taken steps to offset or mitigate some of these impacts. (Source: Heathrow (SP) Limited and Heathrow Finance plc Investor Report, June 2020 and December 2020.)

received HAL's revised business plan (RBP), which sets out its views on the importance of the RAB adjustment to supporting affordable levels of charges and supporting its financeability from 2022.

21. As a result of the continuing significant impact of the covid-19 pandemic and the importance of the RAB adjustment to HAL's future plans, we have not considered a "no intervention" option. At a minimum to protect the interests of consumers, we need to consider how best to address the objectives above as part of the H7 price review. In addition, it is important we should consider interventions ahead of the H7 price review and take action where this is justified by clear benefits for consumers.
22. With the objectives from paragraph 19 in mind, we have identified the following broad packages of possible policy measures and interventions.

Package 1: No intervention before H7, but consider interventions at H7

Package 1 would involve no immediate regulatory intervention, but we would consider the key issues around HAL's cost of capital, the appropriate profile of charges and the incentives for investment and quality of service later in 2021, as part of the H7 price control review. This would include consideration of whether some adjustment for lost revenues in 2020 and 2021 would further the interests of consumers. We would consider these issues in the round as part of our work to develop new price control arrangements for HAL.

Package 2 – Targeted intervention now and consider further intervention at H7

Package 2 allows both for consideration of issues at the H7 price review and for more immediate regulatory intervention now, ahead of the H7 price control review.

The triggers for the more immediate interventions could include:

- HAL's financeability, because of the very significant pressure on its financial position and the potential for issues with HAL's financeability to create difficulties for consumers, for instance because of possible disruption to investment or quality of service, but recognising the important role of shareholders in taking appropriate actions to support the business;

- the impact on HAL's cost of capital (if there are clear advantages in taking regulatory action ahead of the H7 price review) consistent with appropriately managing risks and avoiding undue increases in the cost of finance that would feed through to higher prices for consumers; and/or
- other shorter term issues linked to ensuring HAL maintains an appropriate level of investment and quality of service.

It is important to note that there are significant challenges with calculating the size and scale of any intervention of this type, ahead of considering the appropriate intervention as part of the H7 price review under package 1.

Package 3 – Application of H7 traffic risk-sharing approach to 2020-2021

This package would also involve considering immediate interventions consistent with package 2, but would go further in that we would also commit now to introduce a reconciliation for 2020 and 2021 on the same basis as any forward-looking risk sharing arrangements for passenger traffic that are introduced for the H7 price review. We are currently developing options for such risk sharing for further consultation as part of the H7 price review. This mechanism will be important to manage risks given the high uncertainty around the speed of traffic recovery and it will link with other parts of the price control, such as the cost of capital.

Package 4 – HAL's proposed risk-sharing arrangements for 2020-2021

This package would involve introducing the RAB adjustment as suggested by HAL, which would involve committing now to a substantial adjustment to compensate HAL for the regulatory depreciation it has not been able to recover in 2020 and 2021, with an additional adjustment to be made later and based on the shortfall in revenue that HAL experiences over both 2020 and 2021.

Preferred approach

23. In this document we have narrowed down the options, to provide greater certainty on our next steps. On balance, we consider that package 1 and package 2 would be appropriate to consider further in deciding how we should respond to the issues raised by covid-19 and the objectives we set out above.

We are seeking views from stakeholders on our approach, with the intention of reaching final decisions on these matters in March 2021.

24. Package 1 has a number of advantages, as many of the issues that we have identified for consideration would be best considered in the round as part of the H7 price review. This reflects the important links between any RAB adjustment, the cost of capital, future charges and HAL's financeability. These should be assessed in the round to make sure that charges remain affordable and HAL faces a reasonable risk and reward package in H7.
25. Package 2 builds on this by allowing us to act now if there are issues which are more urgent that we should deal with as soon as practicable. We consider that in principle there are reasonable arguments why an earlier intervention in 2021 may provide benefits to consumers, such as through higher investment and service quality, although we recognise that there are challenges in identifying how any such intervention should be calculated. We are consulting further on whether these issues should be addressed in 2021 and, if so, how these might be best addressed and any regulatory interventions calibrated.
26. Both packages 3 and 4 would involve us committing now to the principle of a potentially large adjustment to HAL's RAB. Neither of these approaches, when looked at in the round, appears to focus sufficiently at this time on furthering the interests of consumers, which is our primary statutory duty nor to be proportionate in the light of that primary duty. We consider that appropriate calibration of package 1 or package 2 could seek to resolve the issues that the present circumstances raise for the interests of consumers and would likely provide a more considered and proportionate way of addressing these issues.

Next steps and views invited

27. Views are invited on the matters discussed in this consultation by 12 noon on 5th March 2021. Key issues for consultation include:
 - whether we have identified an appropriate framework to assess the case for regulatory intervention in HAL's price control arrangements, given the exceptional circumstances created by the impact of the covid-19 pandemic;

- the detail of our preferred framework and whether we have considered an appropriate range of regulatory interventions for assessment;
- our assessment that package 1 and package 2 represent the best way forward. This means that we would consider the issues and appropriate intervention in the round as part of the H7 price review, while considering (for decision around end of March 2021) whether we should make an intervention ahead of the H7 price review; and
- the case for the early interventions (i.e. ahead of the H7 price control review), which we are considering under our package 2 of regulatory interventions, and how any such interventions should be calibrated to further the interests of consumers.

28. We will consider the views of respondents and any further evidence that is provided and intend to issue a further statement of these matters around the end of March 2021.

Our duties

29. 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.

Structure of this document

30. The structure of this consultation document is as follows:
- chapter 1 sets out the updated framework for assessing the issues raised by HAL’s submission and created by the impact of the covid-19 pandemic;
 - chapter 2 sets out the potential packages of options for intervention, our current assessment of these packages, and our preferred packages and options;
 - chapter 3 sets out next steps, including the further statement we intend to make around the end of March 2021 and analysis to support our decisions at the H7 price review; and
 - the appendices cover further information on the details of our assessment of HAL’s proposal.