

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

CAP 2140



Published by the Civil Aviation Authority, 2021

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 April 2021

Second edition 4 May 2021

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/CAP2140

Contents

Contents	3
About this document	5
Summary and introduction	6
Introduction	6
The February 2021 Consultation	8
Responses to the February 2021 Consultation	8
Framework to assess the case for intervention	10
Assessing packages for intervention	10
Our decision and implementation	11
Additional protections for consumers	13
Approach to the H7 price control review	13
Our duties	14
Structure of this document	14
Chapter 1	16
Process for our decision	16
Introduction	16
Overall process	16
Responses to February 2021 Consultation	17
Chapter 2	21
Assessment framework	21
Introduction	21
Our updated assessment framework	21
Our views on responses to the February 2021 Consultation	23
Chapter 3	26
Assessment of packages	26
Introduction	26
The February 2021 Consultation and responses	26
Our assessment of the intervention options	27

Decision on our preferred option	39
Chapter 4	41
Details on intervention and next steps	41
Introduction	41
Details on early intervention	41
Approach to H7 price control review	47
Appendix A	49
Our duties	49
Appendix B	51
Glossary	51
Appendix C	55
Responses to points raised by stakeholders	55
Introduction	55
Comments on process	55
Form and magnitude of covid-19 related intervention	62
Analysis of Q6, iH7 and HAL's current financial situation	82

About this document

On 27 July 2020, HAL sent us a request that we should make an adjustment to its regulatory asset base (“RAB”) to address the shortfall in the revenue it expected to recover in 2020 and 2021 due to the severe impact of the covid-19 pandemic on its business. Since then, HAL has made a series of further representations to us in support of its request.

This document sets out the CAA’s response to HAL’s request and its further representations. It provides our decision on the regulatory intervention package which we will apply ahead of making our proposals for the next (“H7”) price review. It follows on from our October 2020 and February 2021 Consultations on these matters.

In particular, this document sets out:

- the process which we have followed in reaching our decision, including our consideration of stakeholders’ consultation responses;
- an updated and final assessment framework, based on our statutory duties including the “better regulation principles” which we must have regard to under the Civil Aviation Act 2012 (“CAA12”);
- our assessment of the different options for regulatory intervention using that assessment framework; and
- details of the early intervention we have decided to take and our proposed next steps.

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. On 27 July 2020, HAL sent us a request that we should make an adjustment to its regulatory asset base (“RAB”) to reflect the shortfall in the revenue it expects to recover in 2020 and 2021 due to the severe impact of the covid-19 pandemic on its business. HAL has since made a series of further representations to us on these matters. This document sets out the CAA’s response to HAL’s request and those representations. It provides our decision on the regulatory intervention package which we will apply ahead of making our proposals for the next (“H7”) price control review. It follows on from our October 2020¹ and February 2021² Consultations on HAL’s request.
2. In reaching a view on:
 - whether an early intervention is required;
 - what form of intervention would be most suitable; and
 - the scale of that intervention,
 we have followed a robust evidence-led process. We have considered the views of, and information and evidence provided by, stakeholders, received in response to the October 2020 and February 2021 Consultations. We have also considered further representations from HAL and airlines, such as on service quality and investment. We have then conducted our own analysis and assessment, including examining the impact of early interventions on charges and on HAL’s financeability.
3. Having considered this evidence and our duties³ in CAA12, we have decided that the best way for us to further the interests of consumers (our primary duty under CAA12) in response to the issues raised by HAL’s request is by making a targeted and focused regulatory intervention ahead of the H7 price review. In

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

² See Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment (CAP2098) (the “February 2021 Consultation”): www.caa.co.uk/CAP2098

³ In this context, our duties include not only our “primary” duties to further the interests of consumers, where appropriate by promoting competition in the provision of airport operation services that is set out in sections 1(1) and 1(2) CAA12, but also our “secondary duties” in relation to:

- the matters that we are required to “have regard to” (consider) in performing those duties set out in section 1(3) and 1(4) CAA12; and
- the duty in section 1(5) CAA12 to carry out our functions in the way we think best where there are conflicts between the interests of different classes of consumer, or between the interests of consumers in the different matters set out in section 1(1) CAA12.

contrast, we consider that either not intervening now or making an adjustment of the scale proposed by HAL (£800 million RAB adjustment in 2021, with a total RAB adjustment of around £2.6 billion) would not meet our duties.

4. We have decided that a regulatory intervention, in the form of a RAB adjustment of £300 million (in 2018 prices), is a transparent and proportionate intervention that is needed now to further the interests of consumers. We have reached this decision having had regard to the need to:
 - secure that all reasonable demands for airport operation services at Heathrow airport are met. We consider that this intervention will do this by incentivising additional investment by HAL during 2021 that would further the interests of consumers. We expect HAL to be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic;
 - secure that an efficiently (or “notionally”) financed company, which is consistent with our approach we use to assessing HAL’s financeability in setting price controls, can finance its licenced activities at Heathrow airport. This should avoid a higher cost of debt finance for HAL that could increase charges to consumers in the future. We consider that this intervention will do this by providing a strong signal that the regulatory framework is consistent with enabling a notionally financed company to continue to access cost effective investment grade debt finance. Nevertheless, we recognise that HAL faces significant financial risks if traffic recovery is slower than expected, even with this adjustment to its RAB; and
 - if evidence were to emerge of HAL failing to deliver on quality of service then we will take steps to further protect the interests of consumers by conducting a review of these matters (and we would seek to protect consumers from the costs of any such failures). This should help further incentivise HAL in delivering an appropriate level of investment and quality service to consumers.
5. In addition to the targeted and focused RAB adjustment we will consider the wider issues HAL has raised on issues such as regulatory depreciation and the cost of capital at the H7 price control review. We have also set out our intention to introduce new arrangements for traffic or revenue risk sharing as part of the H7 price control review. By reducing the risks that HAL faces for the current and next price control period, we expect consumers to benefit from a lower cost of capital in H7 and future price control periods than it would be otherwise.
6. The approach we have decided to adopt does not require any immediate modifications to be made to the price control conditions in HAL’s licence and will not have any impact on airport charges in 2021. As such, it will protect consumers from increased airport charges at a time when passenger numbers

remain depressed. This decision will, however, be reflected in the modifications we make to HAL's licence to implement the H7 price control, which we anticipate will come into effect in 2022.

The February 2021 Consultation

7. The February 2021 Consultation provided our updated thinking on HAL's request, taking in to account new and updated evidence, including the responses which we received to the October 2020 Consultation, and our own updated analysis. It included:
 - our framework for identifying and assessing options for intervention;
 - our assessment of a range of options (which included HAL's proposal for a RAB adjustment) in the light of our assessment framework; our own updated analysis; and the views of HAL and airlines in response to the October 2020 Consultation; and
 - next steps and the timetable for dealing with these matters.
8. The February 2021 Consultation discussed four different packages of options for regulatory intervention:
 - Package 1: no intervention before H7, but consider interventions at H7;
 - Package 2: targeted intervention now and consider further intervention at H7;
 - Package 3: application of a traffic risk sharing approach to be adopted for H7 retrospectively to 2020-2021; and
 - Package 4: HAL's proposed risk-sharing arrangements for 2020-2021.
9. We said that Package 1 and Package 2 would be appropriate to consider further in deciding how we should respond to the issues raised by the impact of the covid-19 pandemic and our statutory duties under CAA12.

Responses to the February 2021 Consultation

10. We received a large number of responses to the February 2021 Consultation from a range of individuals and organisations, including over 30 airlines. The majority of these respondents supported the development and use of a framework for assessing the need, and options, for intervention based on our statutory duties under CAA12. However, several respondents questioned whether we had properly reflected certain aspects of our statutory duties in the assessment framework.
11. In its response, HAL continued to argue for a substantial RAB adjustment, with a preferred adjustment based on the allowed depreciation provided for in 2020 in the current ("iH7") price control (£800 million in 2018 prices). It provided more

evidence and analysis to support this position. HAL was also seeking a clear commitment now to Package 3 or Package 4, which would mean that the mechanism to manage traffic risks in the H7 period is applied retrospectively to 2020 and 2021. Applying its proposed traffic risk sharing mechanism, HAL estimated that the total RAB adjustment would be £2.6 billion (in 2018 prices), based on traffic forecasts in its H7 revised business plan (“RBP”).

12. HAL said that the CAA’s preferred Packages 1 and 2 set out in the February 2021 Consultation would be insufficient to ensure that it would be able to finance the provision of airport operation services as required by our statutory duties. It also said that:
 - a substantial RAB adjustment was needed immediately to maintain the confidence of investors and credit rating agencies; and
 - not making an early adjustment would constrain and delay investment which it said would be needed to protect services at the airport, provide benefits to consumers and re-open capacity in a timely way.
13. Most airlines continued to argue that there should be no regulatory intervention. However, some noted that, of our proposed options, they could support Package 1 from the February 2021 Consultation. This was dependant on the calibration of any intervention and subject to evidence to suggest that it would lead to a lower cost of capital for HAL at the H7 price control review. No airlines supported early intervention (Package 2) or the RAB adjustments under Packages 3 and 4, which they considered to be inconsistent with our statutory duties.
14. Airlines said that HAL’s recent debt investor updates have:
 - signalled that there is no immediate danger of HAL breaching the covenants in its financing platform; and
 - shown that HAL has sufficient liquidity to continue in operation even under severe downside traffic scenarios.
15. Furthermore, airlines considered that HAL has a sufficient capital plan in place without any intervention by the CAA to allow it to:
 - reopen Terminal 4 when demand requires;
 - maintain service quality to consumers; and
 - carry out essential maintenance activity.
16. Other respondents expressed mixed views. Some opposed regulatory intervention, while Heathrow Airport Transport Forum (“HATF”) and Heathrow Strategic Planning Group (“HSPG”) jointly supported a RAB adjustment that was earmarked to support investment in environmental protection projects. MAG opposed regulatory intervention and noted that the type of support HAL is requesting is not available for any other airport in the UK.

Framework to assess the case for intervention

17. We have retained key elements of the assessment framework set out in the February 2021 Consultation because it reflects the need for us to make a decision that furthers the interests of consumers (our primary duty under CAA12) and having regard to matters we are required to by our secondary duties. It allows us to discharge our obligation to decide how best to further the interests of consumers where there are conflicts between the interests of present and future consumers and/or between consumers' interests in the range, availability, continuity, cost and quality of the airport operation services.
18. We have made certain changes to the assessment framework to reflect stakeholders' comments that we consider results in a better alignment with our duties. In particular, we have made changes to stress the importance of promoting economy and efficiency on the part of HAL, including efficient investment and service quality levels, and affordable charges. Furthermore, we have considered two new separate matters:
 - the impact of our approach on competition. This is to reflect the requirement in our duties under CAA12 that "where appropriate" we must further the interests of consumers by carrying out our functions in a manner that we consider will promote competition in the provision of airport operation services); and
 - to have regard to the "better regulation principles" set out in CAA12.
19. So, having considered our duties, the final assessment framework we used to take our decision on how we should further the interests of consumers has six key objectives as follows:
 - to protect efficient investment and service quality levels;
 - to promote economy and efficiency, including affordable charges;
 - to protect consumers by avoiding undue increases in the cost of equity finance;
 - to protect consumers from the consequences of HAL experiencing difficulties with raising debt, including by avoiding undue or inefficient increases in the cost of debt finance;
 - to continue to promote competition; and
 - have regard to the "better regulation principles" set out in CAA12, including proportionality and consistency.

Assessing packages for intervention

20. We have re-assessed the four packages of options for regulatory intervention set out in the February 2021 Consultation and summarised in paragraph 8 above.

We have done this using our updated assessment framework, our own updated analysis and in the light of the views and further evidence received from stakeholders in response to the February 2021 Consultation.

21. While HAL provided more evidence and analysis to support its position, we do not consider that its arguments have become substantially more persuasive that we should take action in the short term on the scale that HAL has proposed. We remain of the view that a number of the most important issues that HAL has raised are best considered as part of the H7 price review, where we can more clearly assess the impact on forward-looking charges, financeability and investment. These include broad issues around the protection of regulatory depreciation, the impact on the cost of capital, and the overall balance of risk and reward with traffic risk sharing.
22. Having thoroughly considered all the packages, our conclusion is to confirm our position set out in our February 2021 Consultation that we should focus on Packages 1 and 2. While Package 1 would largely meet our objectives to meet our statutory duties, adopting it could create some short term risks for consumers from:
 - lower service quality; and
 - a higher cost of debt finance for HAL (that could increase HAL's cost of capital and, so, charges to consumers in the future).

We consider that Package 2 could reasonably mitigate these risks and be calibrated in a way that avoids any undue increase in airport charges.

Our decision and implementation

23. Our decision is that we should respond to HAL's request by making an early regulatory intervention ahead of the H7 price review in line with Package 2. We will consider whether any further intervention is required as part of the H7 price control review.
24. We consider that an early regulatory intervention, in the form of a RAB adjustment, ahead of the H7 price review (in line with Package 2) is the best way to further in the interests of consumers in response to the impact of the covid-19 pandemic having regard to our secondary duties. We consider that such an intervention will further the interests of consumers, particularly by:
 - signalling to HAL the importance of maintaining appropriate investment and service quality levels ahead of the start of H7;
 - providing stronger incentives and financial capacity for HAL to be proactive in planning for potentially higher than expected traffic levels from the summer of 2021; and

- facilitating HAL in being able to continue to access investment grade debt to finance its activities, particularly if traffic forecasts are instead lower than currently forecast.
25. In considering HAL's financial position we have focused on the notional company, consistent with our wider approach to regulation of HAL and the approaches typically adopted by other economic regulators. The risks associated with HAL's actual financing structure are a matter for its shareholders and should not be passed on to consumers.
26. As noted above, an adjustment to the RAB would not require modifications to be made to the price control conditions in HAL's licence that apply during 2021. As such, it will not affect HAL's charges during the current price control in 2021, ahead of the H7 price control review. Furthermore, the impact on HAL's charges from 2022 will be lower than if the intervention were to be made to HAL's allowed revenues. This is because a RAB adjustment will mean that the costs of this intervention will be recovered over several price control periods. Finally, the RAB is well understood by investors and credit rating agencies, so that this approach should bring benefits to consumers from lower financing costs for HAL, without increasing charges to consumers in the short term.
27. We have therefore decided that an early RAB adjustment of £300 million is proportionate. We consider that an intervention of this scale is more appropriate than HAL's proposed RAB adjustment ahead of H7 which, in its latest response, was around £800 million in 2021 and a commitment for a total adjustment of around £2.6 billion (in 2018 prices).
28. As we explain further in chapter 4, our projections show that a RAB adjustment of £300 million will reduce HAL's notional gearing below an important threshold used to assess consistency with strong investment grade finance and should provide an important signal that the regulatory framework is consistent with enabling the notional company to continue to access cost effective debt finance. This intervention should also provide HAL with additional financial flexibility and incentives to carry out appropriate further investment, including the £218 million of capex that HAL set out to maintain service quality across a full range of demand scenarios and provide necessary capacity during 2021.
29. HAL's actual financing structure has a level of gearing above that of the notionally financed company we use in setting the price control. It has long been a principle of economic regulation that HAL's shareholders, rather than consumers, should bear the risks as well as the benefits associated with adopting its own financing structure. While it remains the position that actual financing choices are a matter for the company, we note that a RAB adjustment of £300 million would have a "spill over" effect of also providing a degree of support for the actual company. However, to the extent that any further support

might be required ahead of the H7 price control review, it would be for HAL's shareholders to support its actual financial structure.

30. We estimate that a RAB adjustment of £300 million would increase consumer charges from 2022 onwards by only around £0.30 per passenger (around 1.5%) and that there would be no impact on charges in 2021. On this basis, we are content that a £300 million RAB adjustment would not:
- have an undue or disproportionate impact on prices in H7 and beyond to the detriment of consumers; or
 - unduly constrain our discretion to calibrate appropriately any interventions at the H7 price control review to achieve affordability and financeability in the interests of consumers.
31. We consider it is reasonable to expect the benefits to consumers from a lower cost of capital and greater service quality in H7 to outweigh these costs from the RAB adjustment. On cost of capital alone, the increase in the per passenger charge of £0.30 per passenger could be offset by a reduction in the H7 cost of capital by around 10bps compared to what it would otherwise have been.

Additional protections for consumers

32. As noted above, if evidence were to emerge of HAL failing to deliver on an appropriate quality of service in 2021, we will conduct a review of these matters. This would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in a timely way and maintained service quality. In the event that such a review were to show that HAL had not responded appropriately, including in respect of service levels where this is within HAL's control, we would look to introduce additional protections around service quality in H7 and we would consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue. The existing Service Quality Rebates and Bonus scheme provides metrics that can help to give an early indication of any issues with service quality.

Approach to the H7 price control review

33. To provide additional clarity on our approach for the H7 price control review, we summarise in this decision our latest thinking on how we will assess the case for additional interventions to further the interests of consumers. We will consider:
- the need to protect efficient investment and expenditure that HAL incurs in 2021 to maintain or improve the quality of service for consumers and to provide the necessary capacity for consumers in a timely way;
 - how traffic risks are allocated in future. For the H7 period, we intend to introduce a form of traffic or revenue risk sharing which will reduce the level

of risk that HAL bears from variations in traffic levels. This could reduce the likelihood that HAL will under-recover depreciation in the future. It would also reduce future uncertainty and benefit consumers during H7 by reducing the cost of capital compared with what it would be otherwise;

- how best to estimate the range for the cost of capital taking account of the overall risk and reward package created by the price control framework and how to choose a point estimate from this range;
- making sure that any interventions are consistent with the risk-reward balance in the overall price control package, affordability and financeability; and
- further considering HAL's arguments that it should fully recover regulatory depreciation to protect its RAB.

34. On this final point, the work we have undertaken does not currently provide a clear case for a RAB adjustment that would provide the full recovery of regulatory depreciation from 2020 and 2021. The Q6 price control for HAL was set on the basis that HAL would recover regulatory depreciation and a reasonable allowed return on a forward looking basis, and that it would also bear traffic risks. This does not constitute a guarantee that HAL would recover regulatory depreciation irrespective of what happens to traffic levels during the regulatory period.
35. Nevertheless, this is an important issue that merits additional consideration, including assessing the impact of the treatment of regulatory depreciation on HAL's cost of capital and, if we were to make allowances for the recovery of historical depreciation, whether these should be adjusted to take account of outperformance by HAL earlier in the Q6 period. As regulatory depreciation from 2020 and 2021 was £1.6 billion (in 2018 prices), there would need to be a clear case that such an adjustment would further the interests of consumers, having regard to the other matters required by our secondary duties. We summarise our current analysis of these matters in Appendix C.

Our duties

36. In taking this decision, we have had full regard to our statutory duties under the CAA12, which are set out more fully in Appendix A.

Structure of this document

37. The structure of this decision document is as follows:
- chapter 1 describes the process which we have followed in reaching our decision including our consideration of stakeholders' consultation responses;

- chapter 2 provides an updated assessment framework, in accordance with our statutory duties including the better regulation principles which we must have regard to under CAA12;
- chapter 3 sets out our assessment of the different options for regulatory intervention using that assessment framework; and
- chapter 4 provides details of the early intervention and our next steps.

Chapter 1

Process for our decision

Introduction

1.1 This chapter:

- describes the overall process that we have adopted to support our decision making on HAL's request for a RAB adjustment; and
- summarises the responses we received to the February 2021 Consultation on HAL's request for a RAB adjustment, our assessment framework and the four packages of options that we assessed using this framework.

Overall process

- 1.2 On 27 July 2020, HAL sent us a request that we should make an adjustment to its regulatory asset base ("RAB") to address the shortfall in the revenue it expects to recover in 2020 and 2021 due to the severe impact of the covid-19 pandemic on its business. As such, this request sought to "reopen" the approach adopted by the CAA in the Q6 price control, as extended and now operating in the form of the "iH7" price control.
- 1.3 In our decision on setting the Q6 price control, we noted that we would consider requests to reopen the price control in exceptional circumstances and would do so in the light of our duties and the circumstances prevailing at the time.⁴ The CAA did not:
- set any expectation as to how it would deal with any reopening request (other than it would do so in the light of its statutory duties); or
 - commit to adjust the price control if HAL faced a risk over and above a set threshold identified from the Q6 settlement.
- 1.4 Bearing the above in mind, we have needed to develop an assessment framework based on our statutory duties to help us properly address HAL's request and consider representations from other parties. We have used this framework to help assess the detailed information that HAL has provided in

⁴ Specifically, in the final proposals for Q6 (CAP1138), the CAA explicitly stated (at paragraph A12) that:
"HAL may request that its price control be reopened at any time. The CAA would consider such a request in the light of its statutory duties under the circumstances prevailing at the time."

support of its request, and the representations we have received from other stakeholders on these matters.

1.5 As part of our approach, we have developed the following approach to governance:

- considered in detail the evidence and arguments put forward by HAL in its request of 27 July 2020;
- issued two consultations, in October 2020 and February 2021, giving extensive information to allow stakeholders to respond effectively with their views on the issues raised by HAL's request and how we should approach addressing them;
- considered in detail the responses that we received from stakeholders to those consultations;
- developed and revised our framework for the assessment of HAL's request;
- conducted our own assessment of the evidence presented by HAL and other stakeholders, including through (i) seeking additional information directly from HAL and (ii) conducting our own analysis and assessing evidence provided by both stakeholders and third parties, including credit ratings agencies, investors and other regulators as well as information available from public sources; and
- engaged directly with both HAL and airline representatives to give them an opportunity to express their views to us, both at a working level and to CAA board members.

1.6 As a result, the decision made by the CAA has been taken after:

- careful development of the assessment framework for addressing HAL's request; and
- detailed assessment of the individual issues raised by HAL through thorough consideration of the evidence provided by HAL, other stakeholders and the CAA's own inquiries; and
- extensive discussion and consideration of the issues by the CAA's Board.

Responses to February 2021 Consultation

1.7 In October 2020, we consulted on our initial assessment of HAL's request, and in February 2021 we consulted on an updated framework and assessment of options for intervention. We received a large number of responses to that latter consultation. We provide a summary of these responses below and respond to the main points raised in chapter 2 (on assessment framework), chapter 3 (assessment of packages) and Appendix C (responses to points raised by stakeholders).

HAL's response to the February 2020 Consultation

1.8 HAL continued to argue for a substantial RAB adjustment. HAL said that the CAA should:

- make a substantial RAB adjustment; and
- set out a clear commitment to apply its proposals for a H7 traffic risk sharing mechanism to 2020 and 2021.

It calculated a total RAB adjustment of £2.6 billion would be appropriate. This has reduced slightly from its previous response to the October 2020 Consultation (from £2.8 billion to £2.6 billion) due to an increase in the share of “downside risk” that HAL proposed to take (from 5% to 14%), based on opex savings compared with its revenue losses. This approach excluded revenues and costs from the “Other Regulated Charges” as defined in its Licence.

1.9 HAL considered that the CAA's preferred Packages 1 and 2 from the February 2021 Consultation would be insufficient to ensure that it is able to finance its provision of airport operation services at Heathrow and, so, in its view would be inconsistent with our statutory duties.

1.10 It said that a substantial RAB adjustment is needed immediately. HAL outlined five approaches for calibrating the scale of such an intervention ahead of H7. All of these approaches are based on bringing forward part of the total adjustment. HAL has specified a preferred adjustment based on the level of depreciation allowed in 2020 in the Q6/iH7 price control of £800 million (in 2018 prices). It is also seeking a clear commitment that the CAA should apply its proposed traffic risk sharing mechanism for the H7 price control retrospectively to 2020 and 2021 (as in Package 3).

1.11 HAL's response focuses on challenging the assessment we set out in the February 2021 Consultation of which options would be in the best long term interests of consumers. It stated that its proposed RAB adjustment would reduce H7 charges by £8.50 per passenger due to the impact it would have in facilitating a lower WACC and reprofiling of regulatory depreciation as part of the H7 price control settlement.

1.12 It suggested that we have:

- misinterpreted our statutory duties by giving insufficient weight to HAL's actual financial position rather than the notional basis used to set its price control; and
- given insufficient focus to equity financeability.

Furthermore, it has said that we have not fully engaged with the evidence that HAL has provided, or properly grasped the scale of HAL's financial challenges.

- 1.13 HAL said that delaying intervention until we set the H7 price control will undermine the expectations and confidence of investors and credit rating agencies. It considers that a failure to take sufficient action now would lead to difficulties:
- obtaining a covenant waiver from creditors in 2021, which could cause issues for its financeability; and
 - accessing new debt finance and liquidity facilities on reasonable terms
- This would increase costs to consumers and reduce financial resilience.
- 1.14 HAL also argued that if the CAA does not make an early adjustment to its RAB, this will constrain and delay its ability to make the investments that it states are needed to protect services at the airport, provide benefits to consumers and re-open capacity when it is needed.
- 1.15 It said that, as there is a clear case for intervention at the H7 price control review, then there would be no incremental costs associated with an immediate intervention, because it would simply involve bringing forward future action. On this basis the CAA should act immediately.

Airlines' responses

- 1.16 We received over 30 responses from airlines. Most airlines argued that there should be no regulatory intervention. However, some say that, of our proposed options, they could support Package 1 from the February 2021 Consultation, depending on the calibration of the intervention and evidence that it will lead to a lower WACC at H7.
- 1.17 No airlines supported early intervention (Package 2) or the RAB adjustments under Packages 3 and 4, which they considered to be contrary to our statutory duties. They stated that there is no case for urgent intervention because:
- the CAA has no obligation to reopen the Q6 price control and, if it did reopen it, no obligation to make a particular intervention;
 - early intervention would be contrary to our primary duty to protect consumers;
 - HAL's recent debt investor updates have signalled that there is no immediate danger of a covenant breach and show that it has sufficient liquidity even under severe downside traffic scenarios;
 - in Q6, all traffic risk was allocated to HAL. To amend this now would be damaging to regulatory commitments;
 - HAL has paid significant dividends to its shareholders during Q6 and those shareholders should inject new equity to remedy any financeability issues;

- HAL has a sufficient capital plan in place to reopen Terminal 4 when it is required, to maintain service quality to consumers and to carry out essential maintenance activities; and
- there is only around three months until the CAA needs to make its initial proposals for H7, so there is very little timing benefit in an early intervention.

1.18 Some airline responses provided comments on our framework for assessing options for intervention. They said that this framework could be better aligned with our statutory duties. Some airlines also disagreed with our conclusion that intervention would not affect competition and suggested that a substantial RAB adjustment would be anti-competitive.

Other stakeholder responses

- 1.19 Heathrow Hub Ltd said the CAA should not intervene and argued that shareholders should inject equity. They also:
- raised issues on the “value of time” and “willingness to pay” calculations that HAL has used to seek to demonstrate the benefits to users of investments in the near term;
 - estimated that HAL has over-distributed dividends compared with market benchmarks; and
 - considered that a RAB adjustment that seeks to secure HAL's financial sustainability would maintain or increase HAL's market power and would appear to be anti-competitive.
- 1.20 Heathrow Airport Transport Forum (“HATF”) and Heathrow Strategic Planning Group (“HSPG”) jointly supported a RAB adjustment that is earmarked to support investment in environmental protection projects. HSPG was concerned that the CAA did not consider its duty to ensure that their decisions do not have an adverse impact on the environment and considered an adjustment could bring benefits from acceleration of investment.
- 1.21 MAG said that the CAA should not intervene and noted that the type of support HAL is requesting is not available to any other airport. It considered that a RAB adjustment could have a material impact on airport competition in the UK. It requested that we consider the long term impact on competition and market structure when providing sizeable financial support to HAL, particularly at a time when other UK airports are experiencing significant financial pressures.
- 1.22 The two individuals who responded to our consultation said the CAA should not intervene. They raised concerns that consumers should not “bail out” HAL or support its high gearing, and that we should consider investment needed for climate change projects and future requirements.

Chapter 2

Assessment framework

Introduction

- 2.1 This chapter discusses our assessment framework for different options. The assessment framework in the February 2021 Consultation was based on our statutory duties under CAA12. This chapter provides an update to this framework and discusses our response to the representations we have received from stakeholders on these matters.

Our updated assessment framework

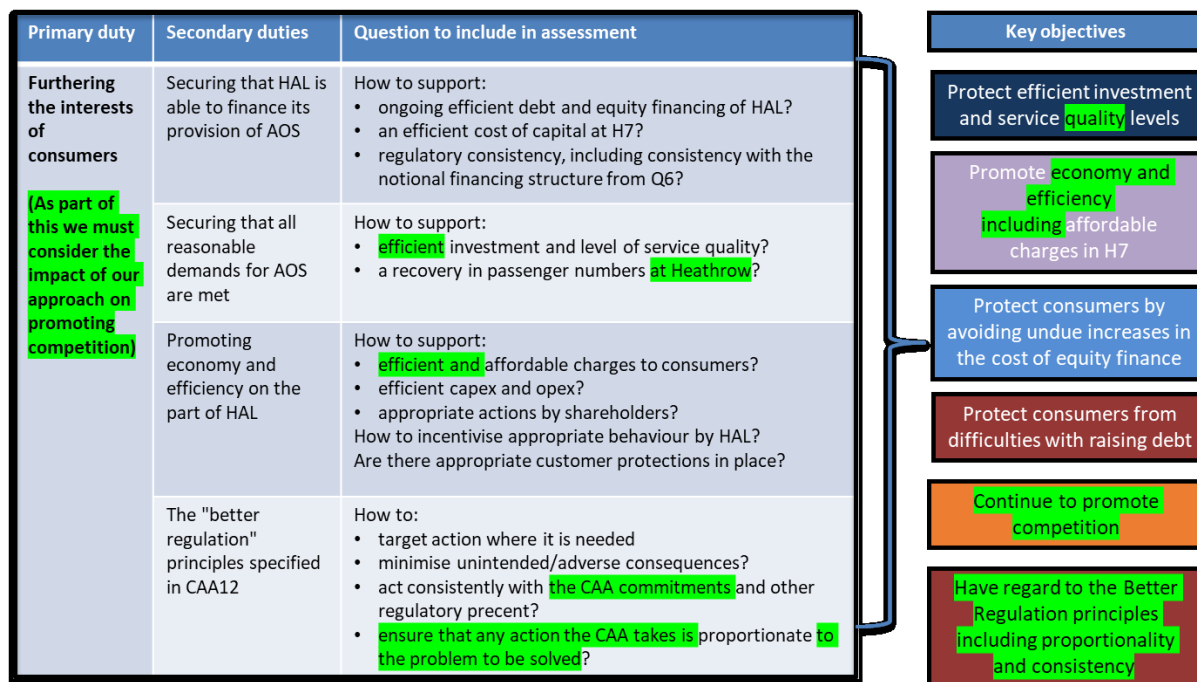
- 2.2 Respondents to the February 2021 Consultation generally supported an assessment framework based on our statutory duties. However, several respondents questioned whether certain aspects of our duties had been properly reflected in the proposed assessment framework. We consider these comments, and how we have addressed them, in more detail in the section below.
- 2.3 The CAA has a broad discretion on how to respond to HAL's request. However, its decision must be based on its primary duty to further the interests of consumers, having regard to the matters required by CAA12. Bearing the above in mind, we have retained key elements of the assessment framework set out in the February 2021 Consultation as it already:
- reflects the need for us to make a decision that furthers the interests of consumers;
 - has regard to matters we are required to "have regard to" (consider) by our secondary duties; and
 - requires us to decide how best to further the interest of consumers where there are conflicts between the interests of different classes of consumer, or between the interests of consumers in the different matters set out in section 1(1) CAA12.
- 2.4 Nonetheless, we have made certain changes to the assessment framework to reflect the feedback and comments which we received from stakeholders. Changes to that framework since the February 2021 Consultation can be summarised as us having:
- emphasised that, in applying our primary statutory duty to further the interest of consumers, we must consider the impact of our approach

on competition so that we can determine the “appropriateness” of promoting competition. So, we have included this as a new, separate objective;

- stressed the importance of promoting economy and efficiency, including efficient investment and service quality levels, and affordable charges. We have made some changes to our assessment framework to reflect this; and
 - emphasised the importance of the “better regulation principles”⁵ by including a new, separate objective that we must have regard to them, and by making some changes to the way we describe those principles.
- 2.5 We also want to clarify that the objective of protecting consumers from difficulties with raising debt focuses on avoiding undue or inefficient increases in the cost of debt finance to which consideration of the notional efficient company (as discussed further below) is relevant.
- 2.6 In finalising our assessment framework, having considered the representations made by stakeholders, we did not include an additional objective on mitigating the environmental effects of the airport. We consider that, in the context of HAL’s request, this is adequately captured by the objective of protecting efficient investment because, where appropriate, this will include projects that deliver environmental benefits.
- 2.7 The assessment framework is set out below. It seeks to enable the CAA to further the interests of consumers, having regard to the matters required by CAA12, taking account of the individual “secondary duties” including the “better regulation principles”, and comparing the weight of the evidence.

⁵ For the purposes of this decision, we refer to the principles in section 1(4) CAA12 that we must have regard to in carrying out our functions by virtue of section 1(3)(g) CAA12 as the “better regulation principles”.

Figure 1 – Updated assessment framework (changes since February 2021 Consultation are highlighted in green)



2.8 In assessing the policy options in chapter 3, we have sought to consider each of the packages against each of the six objectives set out in Figure 1 above. We consider that this approach allows us to identify the packages which are best aligned with our primary statutory duties, having regard to our secondary duties, including the “better regulation principles”.

Our views on responses to the February 2021 Consultation

HAL

2.9 HAL broadly supported our objectives for assessing policy options and considered that they are appropriate and consistent. However, it pointed out that the CAA has no duties in respect of the recovery of the aviation sector more widely and that we should consider the key strategic nature of Heathrow airport to the UK. Furthermore, HAL considered that our objectives and framework do not properly address CAA's duties to secure that HAL is able to finance its provision of airport operation services at Heathrow; to promote economy and efficiency; or to have regard to the better regulation principles.

2.10 We consider that regulatory actions that support recovery of aviation at Heathrow airport are consistent with:

- our primary duty to further the interests of consumers in the range and availability of airport operation services; and

- our consideration of the matters required by a number of our secondary duties, particularly that of securing that reasonable demands for airport operation services are met.

Therefore, we have clarified our wording in the assessment framework to say that we will consider how to “support a recovery in passenger numbers at Heathrow” because that is in the interests of consumers. We do not consider that separate consideration of Heathrow’s position as a hub airport adds to this analysis. Furthermore, we have made changes to emphasise the importance of economy and efficiency and we have included a new objective on the better regulation principles.

- 2.11 On HAL’s comments on financeability, we consider that an approach that focuses on the financing of an efficient (or notional) company is consistent with our primary and secondary duties. We note that interventions made to support the notionally efficient company will, in general, have a spill over effect in supporting HAL’s actual financial structure. We also note that such an approach is consistent with that adopted by other economic regulators. It is appropriate that there is a high hurdle for placing further weight on actual company financing given this would weaken incentives on HAL to manage the financial stability of the company and transfers the risks of its financing to consumers. We address this point in further detail in chapter 3 and Appendix C.

BA

- 2.12 BA said that the CAA is right to focus on its statutory duties but should take into account its duty to promote airport competition. BA proposed new objectives based on our statutory duties including promoting competition, regulatory commitments and incentivising efficiency.
- 2.13 In our updated assessment framework, we have emphasised that, in applying our primary statutory duty to further the interests of consumers, we must consider the impact of our approach on competition and we have included this as a new, separate objective. Furthermore, as noted above, we have made some changes to emphasise the importance of economy and efficiency and we have included a new, separate objective on the better regulation principles.

AOC/LACC

- 2.14 AOC/LACC considered that there is no case for reopening the Q6 settlement and making an intervention. However, if we do keep our assessment framework, we should include our statutory duties that relate to efficiency and competition, which should be equally important as ensuring that the notional company is financeable.

- 2.15 In our updated framework, as noted above, we have made some changes to emphasise the importance of economy and efficiency and we have included a new, separate objective on continuing to promote competition.

Other responses on promoting competition

- 2.16 In the February 2021 Consultation, we carried out an initial assessment of possible policy options against our duty to promote competition “where appropriate”. We concluded that interventions of the scale that we were considering will not have a significant impact on competition in the provision of airport operation services. As such, those interventions would neither promote nor harm competition.
- 2.17 However, in their responses to the February 2021 Consultation, airlines, Heathrow Hub and MAG disagreed with our assessment that the competition impacts of intervention would be minimal. They stated that we should take account of the impacts of intervention, which could maintain or increase HAL’s market power.
- 2.18 As noted above, in our updated assessment framework, we have included a new, separate key objective which states that any interventions which we make should be consistent with our duty to continue to promote competition. We give this new objective explicit consideration in chapter 3 when we assess the range of possible packages which form our policy options for intervention.

Chapter 3

Assessment of packages

Introduction

- 3.1 This chapter sets out our assessment of the different options for regulatory intervention based on the framework outlined in chapter 2, and in the light of views and further evidence provided by stakeholders in response to the February 2021 Consultation.

The February 2021 Consultation and responses

- 3.2 In the February 2021 Consultation, we rejected an approach that would have involved both no immediate intervention and no further consideration of these issues at the H7 price control review. We note that HAL and other stakeholders have interpreted this as us ruling out a “do nothing” or “no intervention” option.⁶
- 3.3 We then set out four main packages of intervention options:
- Package 1: no intervention before H7, but consider interventions at H7;
 - Package 2: targeted intervention now and consider further intervention at H7;
 - Package 3: application of H7 traffic risk sharing approach to 2020-2021; and
 - Package 4: HAL’s proposed risk-sharing arrangements for 2020-2021.
- 3.4 We concluded that Packages 1 and 2 had the potential to further the interests of consumers in a proportionate way. We identified significant concerns over Packages 3 and 4, including that the costs to consumers could be significantly higher, without necessarily providing clear additional benefits to consumers over those provided by Packages 1 and 2.
- 3.5 In its response, HAL set out an updated option, that is a variation on its earlier options. It considered that the CAA should:

⁶ For example: S&P, Heathrow Funding Class A ‘BBB+’ and Class B ‘BBB-’ ratings taken off CreditWatch Negative and affirmed; outlook negative, 4 March 2021; and Fitch, Fitch affirms Heathrow Funding and Heathrow Finance Notes, outlook negative, 30 March 2021.

- make a substantial early adjustment to the RAB to reflect unrecovered but allowed depreciation in 2020 (£800 million in 2018 prices);
 - commit to protect allowed regulatory depreciation; and
 - calibrate the full adjustment as part of the H7 price review based on its proposals for TRS.
- 3.6 Based on its current traffic forecasts and a change to the sharing rate to reflect opex savings that HAL has made during the covid-19 pandemic, HAL estimated a total adjustment of £2.6 billion, which is slightly below the level of its previous submissions.⁷ This intervention is broadly in line with Packages 3 and 4 discussed above.
- 3.7 Airlines' responses generally preferred a no intervention or "do nothing" option. But some airline responses set out that they could support an intervention under Package 1, depending on how it is calibrated and if it leads to a lower cost of capital. No airlines supported an early intervention under Package 2.
- 3.8 Most other respondents did not support any early intervention under Package 2. The exceptions were the HSPG and HATF, which supported an early RAB adjustment earmarked to enable specific environmental projects.

Our assessment of the intervention options

- 3.9 In this section, we set out our assessment of the evidence we have seen from stakeholders and use our own analysis to assess the packages of options for intervention. It shows how we have considered and balanced the key objectives in Figure 1 in chapter 2 for each package.
- 3.10 We provide further detail on our responses to the points raised by HAL and other stakeholders in Appendix C.

No interventions now and no further consideration of these issues as part of the H7 price review

- 3.11 The circumstances created by the impact of the covid-19 pandemic are unprecedented and have raised several difficult issues for the H7 price control review. These include issues in relation to the management of future risks, affordability and financeability.

⁷ HAL has changed its share of revenue losses (beyond the first 8% of revenue losses) from 5% in previous submissions to 14% in its most recent submissions, reflecting the level of opex savings it has made as a proportion of revenues (excluding costs and revenues from other regulated charges).