

Economic regulation of Heathrow Airport Limited: H7 Initial Proposals

Section 2: Financial issues

CAP2265C

Published by the Civil Aviation Authority, 2021

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

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First published October 2021

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Chapter 6

The H7 Regulatory Asset Base and HAL's request for a RAB adjustment

Introduction

- 6.1 This Chapter sets out how we will calculate the value of the regulatory asset base (RAB) for the H7 price control period. The RAB reflects the value of the investment that HAL has made in the regulated business and allows the recovery of investment on a smoothed basis over an extended period, allowing for stability in charges and the financing of new investment.
- 6.2 We set price controls on the basis that HAL can expect (but does not have an absolute guarantee) that it will:
- recover its efficiently incurred investment over the life of the relevant assets, through the regulatory depreciation charge; and
 - earn a return each year on the undepreciated part of that investment that remains in the RAB.
- 6.3 The use of a RAB facilitates the CAA in furthering the interests of consumers generally by helping us:
- set a smooth profile of charges over time;
 - secure that HAL can finance its activities by facilitating return and depreciation on new investment;
 - secure that the reasonable demands of consumers are met by supporting investment; and
 - promote economy and efficiency by providing for a return and depreciation of efficient investments.
- 6.4 The opening RAB in H7 will be comprised of the following component parts:
- the roll-forward of the Q6 RAB, including additions relating to efficiently incurred capex, depreciation and inflation indexation for the Q6 and iH7 periods;
 - allowed Category B¹ and Category C² costs incurred by HAL in respect of expansion; and

¹ Category B costs are those associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow. For more information please see Appendix C to the July 2019 Consultation

² Category C costs are those incurred by HAL in connection with implementation and construction of new capacity, up to entry-into operation. For more information please see Appendix C to the July 2019 Consultation

- the £300m adjustment to the RAB that we announced in the April 2021 RAB Adjustment Decision related to HAL's application for a covid-19 related adjustment.³

6.5 We indicated in our April 2021 RAB Adjustment Decision that we would consider whether it would be consistent with our statutory duties to apply a further adjustment to the H7 opening RAB in respect of losses incurred during the pandemic.

6.6 The remainder of this chapter:

- provides further clarity regarding our policy in respect of the targeted £300m RAB adjustment we announced in our April 2021 RAB Adjustment Decision;
- sets out our policy regarding a further RAB adjustment in H7;
- presents our proposed opening RAB for H7, considering each of the constituent components referred to above; and
- provides a summary of how we intend to roll forward the RAB in H7.

Targeted £300m RAB adjustment

Context

6.7 In July 2020, HAL requested that we make an adjustment to its RAB to address the shortfall in the revenue it expected to experience in 2020 and 2021 due to the severe impact of the covid-19 pandemic on its business. Subsequently, HAL has made a series of further representations to us in support of its request.

6.8 In April 2021,⁴ we decided that the best way for us to further the interests of consumers, consistent with our primary duty under CAA12, in response to the issues raised by HAL's request would be to make a targeted and focused regulatory intervention ahead of the H7 price review. Specifically, we decided that a RAB adjustment of £300 million (in 2018 prices) represented a transparent and proportionate intervention that was needed at that time to further the interests of consumers.

6.9 We considered that the adjustment would:

- fund additional investment by HAL during 2021, to maintain service quality and provide necessary capacity in the event of a stronger than expected recovery in passenger traffic; and

³ 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. HAL subsequently provided several updates to its request, ultimately seeking an adjustment of £2.5bn (2018 prices) in its Updated RBP.

⁴ See CAP2140.

- help avoid a higher cost of debt finance for HAL that could increase charges to consumers in the future.⁵

6.10 In taking this decision, we took note of the weight that credit rating agencies place on their qualitative assessment of the regulatory framework and the possible benefits of signalling support for the notional company being able to access investment grade finance. We also noted that peak notional gearing levels were high relative to certain thresholds used by credit rating agencies.

Stakeholders' views

AOC/LACC

6.11 AOC/LACC stated in their response to our April 2021 RAB Adjustment Decision that they remained opposed to a RAB adjustment that compensated HAL for losses as a result of the impact of the covid-19 pandemic on traffic levels,

*"not only as a result of the negative effect on economic incentives that would result, but also due to the precedent that would be created through the use of the RAB in such a manner."*⁶

6.12 They have also requested that we provide clarity⁷ regarding whether:

- the RAB adjustment may be reversed in H8 or H9 once an appropriate level of gearing has been restored; and
- whether additional investment of £230 million by HAL would be funded directly by the RAB adjustment and so the additional investment would not further increase the RAB.

HAL

6.13 In both its response to the April 2021 Way Forward Document⁸ and its updated RBP,⁹ HAL has indicated that it considers the £300m RAB adjustment we set out in the April 2021 RAB Adjustment Decision would:

- be insufficient to ensure the stability of the regulatory framework and the best possible outcomes for consumers in H7;

⁵ CAP2140, paragraph 4.

⁶ Letter from AOC/LACC dated 11th June 2021, titled "Re: CAA CAP2140: Heathrow's request for Covid-19 related RAB adjustment".

⁷ CEPA, on behalf of AOC/LACC, also indicated that it considers it would be appropriate for us to provide further detail on "the basis of and rationale for" our proposed iH7 RAB adjustment – see CEPA (2021), "Way Forward – Technical Appendix", June, p1. The full extent of information used to reach a decision on this adjustment were set out in our April 2021 RAB Adjustment Decision. We are therefore not in a position to provide further information.

⁸ HAL (2021), "Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (CAP2139)", paragraph 4b.

⁹ HAL (2021), "Heathrow Airport: H7 Revised Business Plan – Update 1", June, p47.

- mean that investors could in future no longer have a legitimate expectation that they will receive a return of capital invested, which would fundamentally change the investment proposition; and
- be extraordinary and at odds with decades of accepted regulatory practice in the UK.

Discussion of stakeholder feedback

- 6.14 In the April 2021 RAB Adjustment Decision, we stated it would be undesirable for us to reverse our £300 million RAB adjustment during the H7 process, with the “benefit of hindsight”, unless there was evidence that HAL was manifestly failing to deliver on necessary investment to re-open additional capacity, particularly in terminals, in a timely way and to maintain quality of service. Otherwise, reversing the RAB adjustment could undermine both investor expectations and the credibility of our decisions, leading to higher costs to consumers in future. So, we do not propose to adopt the suggestions made by airlines that we reverse the RAB adjustment set out in our April 2021 RAB Adjustment Decision.
- 6.15 We also said that if evidence were to emerge 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
 - consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue.
- 6.16 We are continuing to monitor performance at the airport including with respect to investment and service levels. Our initial view is that HAL has re-opened terminal capacity in a way that has allowed airline demand to be met, and that service quality performance has been good when measured against the metrics. We welcome further views and evidence that may be relevant to our assessment of this issue.
- 6.17 We also do not propose to substitute additional investment for the RAB adjustment. This would undermine our intervention and could provide incentives on HAL to not undertake efficient additional investment as it would bear the cost but without further remuneration through the RAB.
- 6.18 Therefore, we propose to retain the £300 million targeted RAB adjustment and do not set out proposals to reduce or reverse this amount.

Further adjustment to the H7 opening RAB

- 6.19 We indicated in the April 2021 RAB Adjustment Decision that we would consider the wider issues HAL has raised on issues such as regulatory depreciation and the cost of capital at the H7 price control review,¹⁰ in deciding whether or not to make any further RAB adjustments or other interventions.

¹⁰ CAP2140, Paragraph 5.

- 6.20 We also indicated that if we were to make allowances for the recovery of historical depreciation, we would consider whether these should be adjusted to take account of outperformance by HAL earlier in the Q6 period.¹¹
- 6.21 Since regulatory depreciation from 2020 and 2021 was £1.6 billion (in 2018 prices), we said that there would need to be a clear case that such a material adjustment would further the interests of consumers, having regard to the other matters required by our secondary duties.

Stakeholders' views

AOC/LACC

- 6.22 AOC/LACC stated in its response to the April 2021 RAB Adjustment Decision that it remains opposed to any further RAB adjustment that compensated HAL for losses as a result of the impact of covid-19 on traffic levels.¹²

HAL

- 6.23 In its response to our February 2021 Consultation, HAL put forward several reasons to explain why a total RAB adjustment of £2.6bn was needed immediately.¹³ HAL emphasised the importance to investors of the full recovery of regulatory depreciation, which it considers to be a fundamental principle of RAB-based regulation. It also said that its proposed RAB adjustment is necessary to preserve HAL's return of capital, and hence investor confidence in the regulatory framework.
- 6.24 In the light of this, HAL has then suggested that its proposed RAB adjustment would:
- reduce the H7 WACC: it suggested that *"the impact of the RAB adjustment we requested would be to reduce the increase in Heathrow's pre-tax WACC by 1.5%"*¹⁴ and has subsequently increased this figure to 1.9% in its updated RBP;¹⁵
 - facilitate deferral of revenues (through a depreciation adjustment) into future price control periods, leading to lower H7 charges: HAL had previously stated that, *"with an adjustment in place, it is possible to smooth depreciation to mitigate charge increases in H7 from fewer passengers"*;¹⁶

¹¹ CAP2140, Paragraph 35.

¹² Letter from AOC/LACC dated 11th June 2021, titled "Re: CAA CAP2140: Heathrow's request for Covid-19 related RAB adjustment".

¹³ HAL (2021), "Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098)", March, Paragraph 48.

¹⁴ HAL (2021), "Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098)", March, Paragraph 51.

¹⁵ HAL (2021), "H7 WACC updates", Table 11.

¹⁶ HAL (2020), "Economic regulation of Heathrow: response to its request for a covid-19 related RAB adjustment (CAP1966)", November, Paragraph 56.

- result in more investment and better service for passengers; and
- secure HAL's debt financeability: HAL specifically referred to impacts on its compliance with covenants and suggested that, "*action would also significantly reduce the risk of a credit rating downgrade and Heathrow having difficulty in accessing debt markets*".¹⁷

6.25 HAL also suggested that we had previously ignored equity financeability in our approach and that this was inconsistent with our statutory duties.¹⁸

HAL's Updated RBP

6.26 In its Updated RBP, HAL presented:

- (vi) a "Full Adjustment" scenario, in which it assumed that that the RAB adjustment applied at the start of the H7 period would be based on an adjustment of £2.5bn (2018 prices);¹⁹ and
- (vii) a "Low Adjustment" scenario, in which it assumed that no further adjustment to the RAB would be made at the start of H7 beyond the £300 million adjustment we made in our April 2021 RAB Adjustment Decision.

6.27 It provided further discussion of its proposed H7 RAB adjustment, including why, in HAL's view, it is necessary, how it has been estimated and its impact across the H7 price control, including in relation to:

- the scope for and size of a depreciation adjustment;
- the WACC for H7;
- the passenger demand shock factor;
- the scope for revenue profiling;
- the scale of the capital programme and the efficiencies HAL suggests this will facilitate in term of opex and commercial revenues; and
- the advisability of an Enhanced Service overlay.

6.28 HAL has also outlined the impacts it expects the RAB adjustment to have on consumer outcomes in terms of service, resilience and other outcomes.

¹⁷ HAL (2021), "Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098)", March, Paragraph 65.

¹⁸ HAL (2021), "Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098)", March, Paragraph 69.

¹⁹ This was slightly lower than its previously requested amount of £2.6bn due to the updating of various inputs.

Our Views

The role of regulatory depreciation

6.29 We explained our view of the role of regulatory depreciation in the April 2021 RAB Adjustment Decision as follows:

"We agree with HAL that a price control should be set ex ante on the basis that companies would recover regulatory depreciation plus a reasonable allowed return on a forward looking basis. This is a necessary condition for satisfying our secondary duty to secure that HAL is able to finance its activities. It is also consistent with the "fair bet" principle that underpins much of UK economic regulation.

*This does not constitute an absolute guarantee that companies will be able to recover regulatory depreciation ex post irrespective of what happens to traffic levels during the regulatory period. This would effectively amount to a guarantee that a company will never be exposed to losses. Such a guarantee does not seem proportionate or consistent with an approach to setting a price control on the basis that HAL bears traffic risk. We, therefore, disagree with HAL that it is a fundamental principle of UK regulation that companies are guaranteed a recovery of regulatory depreciation, unless this has been explicitly set out as part of the regulatory framework."*²⁰

6.30 We have carefully reviewed the evidence and representations from HAL. However, providing that the regulatory arrangements for the future are set on the basis of reasonable expectations about returns, we are not persuaded that it is necessary or appropriate to retrospectively correct for historical shocks – including in relation to the non-recovery of regulatory depreciation – unless this was explicitly provided for in the regulatory regime or was clearly in the interests of consumers.

6.31 While we acknowledge that the pandemic is likely to have heightened investor perceptions of risk in HAL and that this could persist for a significant period, we are taking the following steps to address these matters:

- the application of a TRS, which reduces HAL's exposure to future shocks.²¹ The TRS will form part of HAL's licence;
- provision of an allowance for asymmetric risk to ensure that the price control remains a "fair bet";²² and

²⁰ See CAP2140, paragraph C39

²¹ See Chapter 1.

²² See Chapter 7.

- determination of a higher asset beta (and so higher WACC) in recognition of the likelihood of heightened risk perceptions by investors even after taking into account the above two regulatory mechanisms.²³

6.32 These new arrangements that we are proposing to put in place as part of these Initial Proposals should support investor confidence in the regulatory framework and help ensure that HAL remains financeable.

Impact on the H7 WACC (cost of equity)

6.33 Investors' perceptions of risk, and hence their required returns, are driven by their forward-looking expectations.

6.34 In the absence of any other regulatory measures, a RAB adjustment could mitigate investors' perceptions of increased risk following the pandemic and lead to a lower cost of capital. However, this would depend on investors' beliefs regarding the circumstances under which a similar adjustment would be made in the future. For example, if the RAB adjustment was presented as a one-off intervention that was unlikely to be repeated under any circumstances, it might not have any effect on investors' forward-looking perceptions of risk. On the other hand, if the RAB adjustment were to be interpreted as implying that we would intervene in a similar manner with near certainty in the context of future traffic shocks, it could significantly mitigate perceptions of heightened risk.

6.35 We consider that there are benefits to consumers from reducing perceptions of forward-looking risk exposure, through

- managing investor perceptions;
- maintaining appetite for investment; and
- securing a lower cost of capital than would otherwise be the case.

6.36 We also consider that a proportionate means of signalling our commitment to containing the impacts of future traffic shocks, and hence mitigate perceptions of risk, is through a formal traffic risk sharing (TRS) mechanism as discussed in Chapter 1. We will also consider whether there is merit in issuing policy guidance that sets out the future circumstances under which it would be appropriate in the future to reopen the price control. Taken together our approach provides a framework for treatment of future traffic risks and we do not consider that a RAB adjustment would provide a material additional benefit to consumers in terms of reducing the cost of capital.

6.37 We have further considered HAL's suggestion that the application of a forward looking TRS or revenue risk sharing mechanism would not be credible, and hence could not effectively mitigate covid-19 related increases in the cost of equity, in the absence of a RAB adjustment.

6.38 The evidence we have seen suggests that:

²³ See Chapter 9.

- Regulatory announcements are generally taken into account by the market and influence perceptions of risk: for example, in our February 2021 Consultation, we ruled out a “no intervention” option, and this was explicitly recognised by rating agencies.²⁴ This contributed to a view that
 - *“the U.K. aviation regulator, the CAA, will take a balanced approach that will support Heathrow Funding Ltd.'s (HFL) financeability. We therefore think the regulatory framework in the period starting January 2022 (H7: 2022-2026) should remain supportive and transparent”²⁵.*
- We note that this view has also been expressed by equity analysts. For example, BNP Paribas noted that
 - *“we do still view the fact that Heathrow is regulated and that the CAA accepts that some intervention is necessary as a credit positive, even if any eventual compensation may well be less and more spread out than Heathrow are hoping for”²⁶.*
- Regulatory determinations, once codified and embodied in the licence, can directly affect the equity beta of regulated companies. For example, we note a study carried out by AGRF and KPMG²⁷ in the context of the PR19 determination by the Competition and Markets Authority (CMA). This study demonstrated a statistically significant impact of the PR14 price control determination on the share price and equity beta of both Severn Trent and United Utilities.

6.39 We are, therefore, satisfied that a transparent and clear TRS mechanism would be credible in informing stakeholders how future traffic risks would be treated regardless of whether a RAB adjustment was applied. It is our intention that the TRS mechanism would be set out and applied either through HAL's licence or in policy guidance. On this basis, we maintain our previous view that a RAB adjustment would not contribute to a material additional reduction in the cost of equity when applied concurrently with the other steps we are taking in setting the H7 price control. As such, we do not consider that a further RAB adjustment is warranted on the basis of its impact on the cost of equity and, therefore, would not be justified in the interests of consumers.

Impact on depreciation and revenue profiling

6.40 We consider that there are two relevant questions with respect to the impact of a RAB adjustment on revenue profiling:

²⁴ S&P Global Ratings (2021), “Research Update: Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Taken Off CreditWatch Negative And Affirmed; Outlook Negative”, March, p2.

²⁵ S&P Global Ratings (2021), “Research Update: Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Taken Off CreditWatch Negative And Affirmed; Outlook Negative”, March, p1.

²⁶ BNP Paribas (2021), “Heathrow: Dreaming of a summer traffic recovery”, February, p1.

²⁷ AGRF/KPMG report, paragraph 4.6.12.

- firstly, whether a further RAB adjustment can facilitate substantial reprofiling of revenues relative to a no-adjustment scenario; and
- secondly, whether doing so would justify a RAB adjustment of the scale that HAL is requesting.

Impact of RAB adjustment on revenue profiling

- 6.41 We consider that our Initial Proposals provide for allowed revenues that are sufficient to ensure that the notionally financed company is financeable in H7. There appears to be only limited scope for deferring any revenues into future price control periods, for example by reducing depreciation. This is because doing so would adversely affect key credit metrics, for example, FFO to debt, that are already close to relevant thresholds in the early years of the H7 period.
- 6.42 The only way to reduce the depreciation charge in H7 in a manner that is consistent with ensuring financeability would be to increase funds from operations ("FFO") in some other way, such as increasing the allowed return, and this would not allow for revenue profiling and reduced charges to consumers. Further, the immediate effect of a RAB adjustment would be to increase the allowed return and depreciation charge, which, in turn, would lead to increased charges. To offset this increase, it would be necessary to reduce depreciation by at least the same amount. Any further reductions in depreciation, and hence airport charges, could therefore cause FFO to debt to fall putting pressure on the relevant thresholds and financeability.
- 6.43 Overall, we are not persuaded that a RAB adjustment is either necessary or sufficient for deferring revenues through a depreciation adjustment.

Value of revenue reprofiling to consumers

- 6.44 Even if a RAB adjustment somehow enabled significant additional reprofiling of revenues, we are not persuaded that this would represent a sufficient justification for making such an adjustment.
- 6.45 Our primary duty is to further the interests of users of air transport services, which are defined as present and future passengers and cargo owners. This means we must strike the balance between charges in H7 and future charges that affect the interests of these classes of consumer in the manner that we consider will further such of their interests as we think best. As such, we are not solely concerned with charges in H7.
- 6.46 We acknowledge that it can be desirable to move revenues between price control periods to avoid undue volatility in charging levels. In these circumstances there may be benefits to consumers of using profiling to generate a flatter profile of charges over time.
- 6.47 However, the evidence we have seen suggests that the benefit to consumers of NPV-neutral reprofiling of revenues is likely to be small compared to the scale of the RAB adjustment that would be required to facilitate it. For example, if

consumers' discount rate²⁸ is assumed to be equal to the WACC, there would be no consumer benefit arising from reprofiling.

- 6.48 We, therefore, do not consider that making a significant further RAB adjustment to facilitate revenue reprofiling is likely to be in the interests of consumers, even if it were to result in temporarily lower charges across the H7 period.

Impact on investment, opex (including the Enhanced Service Overlay) and service quality

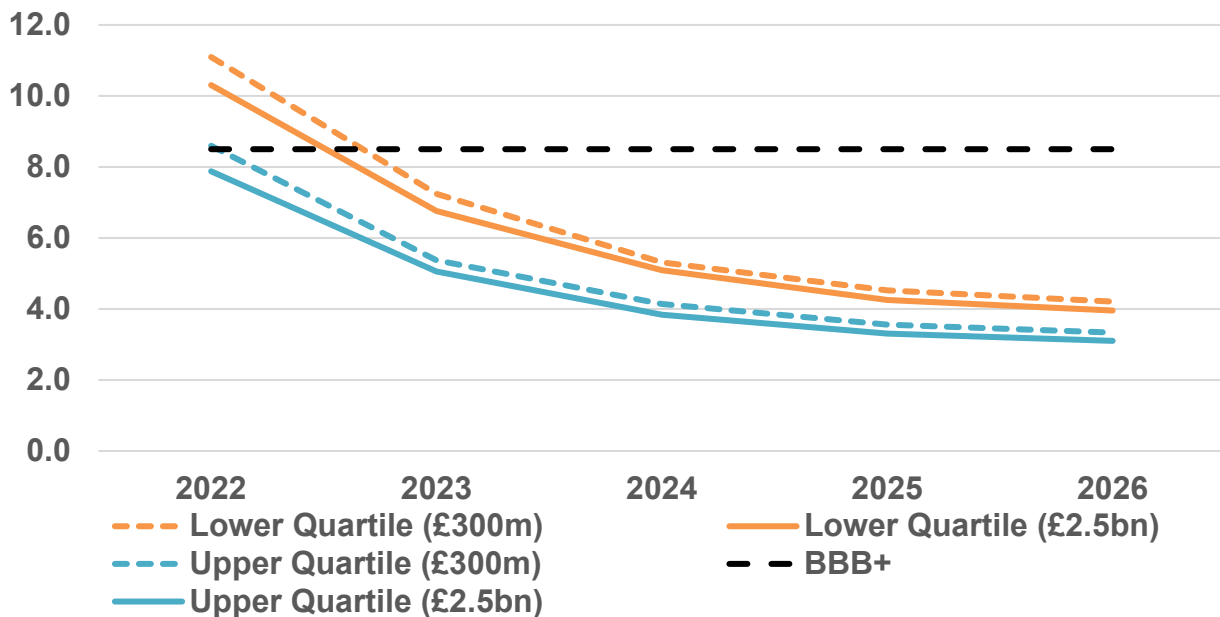
- 6.49 We disagree with HAL that a further RAB adjustment is necessary to allow for an appropriate level of investment, opex or service quality in H7.
- 6.50 In the April 2021 RAB Adjustment Decision, we considered that a £300m RAB adjustment was warranted to support investments needed to maintain service quality and support re-opening of capacity in the event of a stronger than expected recovery in passenger traffic. Under normal circumstances, we would expect such investments to be funded by HAL and its shareholders. However, in the extraordinary circumstances faced by HAL during the covid-19 pandemic, we considered that it was prudent and in consumers' interest to advance targeted funding to support investment projects needed within a short space of time in 2021, and ahead of the H7 price control review. This was particularly the case given the high peak levels of notional gearing expected in 2021, which exceeded certain thresholds considered by credit rating agencies.
- 6.51 This rationale no longer applies and we can ensure that future investment is allowed for in this price control review. In addition, HAL's proposed further RAB adjustment does not constitute targeted funding to support specific investment projects, but rather is based on the principle that it should be remunerated for historical losses.
- 6.52 We expect that the price control we will set for H7 will enable an efficient airport operator to access sufficient debt and equity capital to fund an appropriate level of investment. We consider that investors should be willing to commit capital to the business providing that they expect in future, on average, to earn their required return.
- 6.53 We are not persuaded by HAL's argument that a rational investor would react to the past crystallisation of risks, and the consequent non-recovery of regulatory depreciation in 2020 and 2021, by reducing investment and shortening the time horizons of their investments. As we have previously said, we expect investors to make decisions based on the forward-looking balance of risk and return, taking into account the protections available to them. This includes the existence of a TRS mechanism that will significantly insulate them from volume risk in future.
- 6.54 Overall, we do not consider that a further RAB adjustment is necessary to support investment and quality of service. We also do not consider that a further RAB adjustment is necessary to limit the higher opex and lower commercial revenues that HAL contends will arise in the absence of such an adjustment. As

²⁸ This is defined to be the rate at which a consumer must be paid to substitute future consumption for present consumption and remain indifferent.

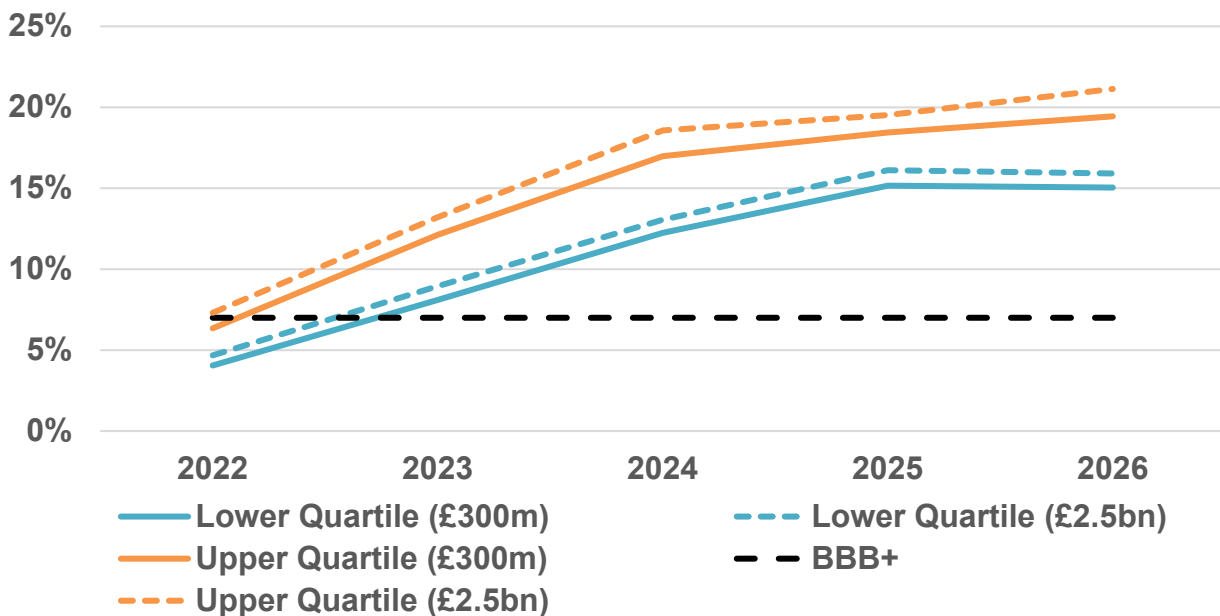
a result, we do not consider that making a further RAB adjustment is in the interests of consumers in relation to the range, availability quality or continuity of AOS.

Impact on cost of debt and debt financeability

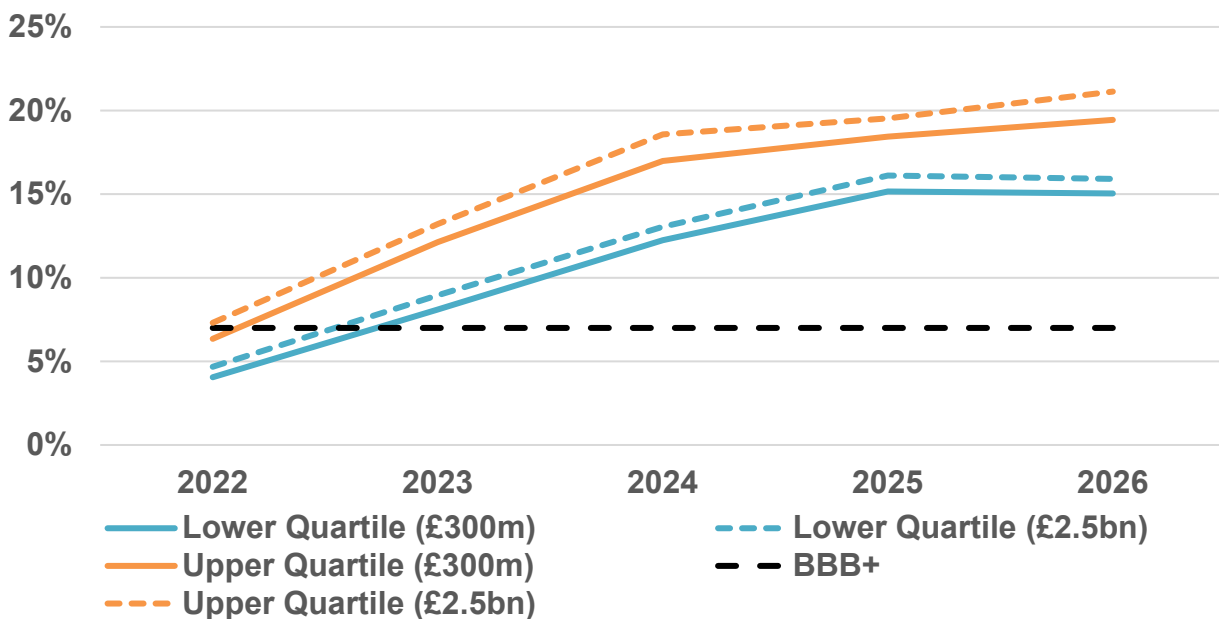
- 6.55 In the April 2021 RAB Adjustment Decision, we considered that a £300m RAB adjustment could help to avoid undue increases in the cost of debt. We considered it would do so by:
- signalling support for the notional company, which could improve credit rating agencies qualitative assessment of HAL's business risk; and
 - by limiting peak notional gearing levels, which at that time were high relative to certain thresholds used by credit rating agencies.
- 6.56 We also previously examined the forecast evolution of HAL's notional financial ratios with and without a RAB adjustment, using the information in HAL's RBP. We found that the RAB adjustment proposed by HAL did not materially improve HAL's credit metrics.
- 6.57 We do not consider that a further RAB adjustment is necessary to manage the peak in HAL's gearing, since this will be adequately addressed by the £300m RAB adjustment we have already announced.
- 6.58 We carried out analysis to assess whether a further RAB of £2.5bn adjustment (in line with HAL's RBP) could significantly improve HAL's credit metrics relative to solely making a RAB adjustment of £300m in line with the April 2021 RAB Adjustment Decision. The results of this analysis are set out below.
- 6.59 In line with our broader assessment of financeability (see Chapter 11), we have focussed on three key metrics: net debt to EBITDA, FFO to debt and PMICR. As can be seen from Figure 6.1, Figure 6.2 and Figure 6.3 below, the RAB adjustment improves each of the financial metrics considered. Under the Upper Quartile scenario, it results in net debt to EBITDA and FFO to debt being brought in line with thresholds for BBB+ in 2022. Under the Lower Quartile scenario, it results in PMICR being brought in line with thresholds for BBB+ in 2023 (but not 2022).

Figure 6.1: Impact of a RAB adjustment on net debt to EBITDA

Source: CAA analysis

Figure 6.2: Impact of RAB adjustment on FFO to debt

Source: CAA analysis

Figure 6.3: Impact of a RAB adjustment on PMICR

Source: CAA analysis

- 6.60 It is possible that these relatively modest improvements in the notional financial ratios would result in a one-notch improvement in the credit rating of the notional entity. At the same time, this is subject to some uncertainty: while they do bring some ratios in line with thresholds for a higher credit rating, this is only the case in a single year, and credit rating agencies may look beyond the temporarily depressed metrics. It is also possible that a further RAB adjustment would positively influence credit rating agencies' qualitative assessment of HAL's business risk.
- 6.61 Even if a further RAB adjustment could lead to a one notch improvement in the notional credit rating, we do not consider that this alone would justify the inclusion of an adjustment of the scale that HAL has requested.
- 6.62 We indicate in Chapter 11 that while we compare the financial ratios of the notional entity to the thresholds for a BBB+ credit rating, we would not necessarily view a notional entity that was rated BBB to be unfinanceable. We also note that there are more proportionate means of achieving financial ratios that are consistent with BBB+ in the early years of the price control available to us than a further RAB adjustment of the scale that HAL has requested. For example, we could consider reprofiling of revenues within H7, or advancing revenues from future periods.
- 6.63 Based on this analysis, we consider that a further RAB adjustment is not justified based on the impact on HAL's cost of debt or debt financeability.

Impact on equity financeability

- 6.64 In the April 2021 Way Forward Document, we acknowledged the importance of equity financeability and set out initial thinking on how we would seek to ensure HAL was financeable from the perspective of equity in H7.²⁹
- 6.65 In the absence of a RAB adjustment, the notional entity would either need to:
- reinvest a substantial proportion of its equity return in H7 to deleverage the business following the increase in gearing driven by the impact of the covid-19 pandemic. The scale of deleveraging required implies that there would need to be only very limited notional dividend payments in the early years of H7, while the level of dividends would recover in the later years;
 - obtain an injection of new equity at the start of H7, which would return gearing to its level before the covid-19 pandemic occurred; or
 - combine the above in some way.
- 6.66 We explain in Chapter 11 why we consider that our Initial Proposals are consistent with equity financeability in the absence of the full RAB adjustment. We consider that a temporary period of dividend forbearance is reasonable, providing that the overall allowed return is in line with the WACC, and there is a clear path towards a sustainable level of notional dividends.
- 6.67 We also note, as an alternative, it would be reasonable to assume a notional equity injection as a means of de-leveraging the business. In support of this assumption, we have observed several businesses in the UK aviation sector that have successfully raised equity in the last 1 to 18 months:
- HAL itself secured a £750m capital injection from ADIF2 into Heathrow Finance group in 2020;³⁰
 - Manchester Airport Group injected £300m in equity, relative to debt balance pre-pandemic of £1.8bn;³¹
 - Gatwick Airport has received a capital injection of £370m;³²
 - EasyJet raised £419m through issue of new shares;³³
 - Ryanair raised €400m of equity;³⁴ and

²⁹ CAP2139, paragraph 3.44.

³⁰ HAL (2020), "Heathrow (SP) Limited: Results for the 9 Months ended 30 September 2020", p4.

³¹ Manchester Airports Holdings Limited (2021), "Annual report and consolidated financial statements for the year ended 31 March 2020", p13.

³² <https://www.gatwickairport.com/globalassets/company/investor/2021/interim/investor-presentation-results-for-the-period-ended-30-june-2021.pdf>, p10

³³ <https://www.cityam.com/easyjet-raises-419m-through-share-placing-to-bolster-finances>

³⁴ <https://www.marketwatch.com/story/ryanair-raises-eur400m-in-share-placing-2020-09-04#:~:text=Ryanair%20Holdings%20PLC%20said%20Friday,35.2%20million%20shares%20at%20EUR11>

- IAG has undertaken a capital increase of €2.75bn.³⁵

- 6.68 We further note the CMA's position, as stated in its determination for Northern Ireland Electricity, and which we refer to in Chapter 11, is consistent with this view.
- 6.69 We therefore consider that the notional entity is financeable from the perspective of equity without a RAB adjustment, and as such, we do not consider that a RAB adjustment is warranted on the grounds of equity financeability.

Impact on passenger shock factor

- 6.70 We have carefully considered the impact of the pandemic on our proposed allowance for asymmetric risk. Our approach is set out in Chapter 7.
- 6.71 We have calculated this allowance on the basis that no RAB adjustment is applied, and that a TRS mechanism is put in place. Therefore, there is no benefit for consumers, nor is it necessary to support HAL's financeability, for a RAB adjustment in relation to these matters.

CAA Initial Proposals

- 6.72 Having considered each of HAL's arguments regarding the need for a further RAB adjustment in H7, we conclude, for the reasons set out above that no further RAB adjustment is justified in the interests of consumers.³⁶ This is because such an adjustment is either not needed to further their interests in relation to lowering the overall cost of AOS that they are exposed to, or, where there might be benefit to them, the adjustment HAL argues for is not proportionate to the benefit that it would bring.
- 6.73 As a result, we do not consider that the CAA needs to take any action to adjust the RAB in the manner that HAL has proposed.

Calculation of H7 opening RAB

- 6.74 We summarise below how we propose to calculate the H7 opening RAB. For each of the years from 2014-2020, the closing RAB is calculated as the sum of:
- the opening RAB;
 - actual capex additions in each year;
 - Category B and Category C costs incurred by HAL in respect of expansion;
 - indexation of the opening RAB; less

³⁵ <https://www.iairgroup.com/~media/Files//IAG/capital-increase-documents/en/fully-underwritten-capital-increase-10-09-2020.pdf>

³⁶ See paragraphs 6.39, 6.43, 6.48, 6.54, 6.63, 6.69 and 6.71 above.

- regulatory depreciation.³⁷

6.75 In 2021, we also include an additional adjustment of £372m to the RAB. This comprises:

- the £300m RAB adjustment we announced in our April 2021 RAB Adjustment Decision, appropriately uplifted for inflation;
- additions pursuant to our Q6 capex review,³⁸ including relevant financing costs; and
- additions pursuant to our early expansion costs review,³⁹ including relevant financing costs.

6.76 These are summarised in Table 6.2 below. The H7 opening RAB is then equal to the closing RAB in 2021. Under our current forecasts, this is equal to **£16,692m** in nominal prices.

6.77 The opening RAB for H7 will be confirmed at Final Proposals once all actual values for 2021 are known.⁴⁰

Table 6.1: Roll-forward of Q6 RAB

Nominal prices	Q6	Q6	Q6	Q6	Q6	Q6+1	iH7	iH7
	2014*	2015	2016	2017	2018	2019	2020	2021
Opening RAB	14,816	14,942	15,004	15,321	15,792	16,078	16,224	16,031
Additions in year	392	586	668	618	666	619	447	308
Assumed ordinary depreciation	(504)	(703)	(723)	(772)	(802)	(823)	(830)	(847)
Indexation to 31 st Dec	238	178	373	625	422	350	190	389
Closing RAB (pre-adjustments)	14,942	15,004	15,321	15,792	16,078	16,224	16,031	15,881
CAA adjustments	-	-	-	-	-	-	-	811
Closing RAB after CAA adjustments	14,942	15,004	15,321	15,792	16,078	16,224	16,031	16,692

Note: Q6 only included the last 9 months of 2014.

Source: CAA calculations

³⁷ For 2020, an additional item "cost of change additions to the RAB" was used as agreed between HAL and airlines.

³⁸ see Appendix E on our policy decision on Q6 capex review

³⁹ see Appendix F on our policy decision on the treatment of early expansion costs

⁴⁰ Tables 6.1 and 6.2 were updated after publication of initial proposals to correct an arithmetic error.

Table 6.2: Composition of CAA adjustments to the RAB in 2021 (£m, nominal prices)

Targeted RAB adjustment	316.6
Q6 capex review	(13.4)
Q6 capex review financing cost	(3.1)
Early expansion cost review ⁴¹	510.4
CAA adjustments	810.5

Source: CAA calculations

Roll-forward of the H7 RAB

6.78 We set out below how we intend to roll forward the H7 RAB in order to calculate the H8 opening RAB.

Annual roll-forward

6.79 In each year during H7, the closing RAB shall be calculated in a similar manner to previous price control periods, that is, as the sum of:

- the opening RAB;
- actual capex additions in year;
- indexation of the opening RAB; less
- regulatory depreciation and disposals.

End of period adjustment

6.80 We will also adjust Heathrow's RAB at the end of H7, in respect of certain regulatory mechanisms we are intending to apply during H7, including:

- the TRS;
- cost of new debt indexation;
- the tax clawback mechanism; and

⁴¹ This figure includes actual and forecast expansion costs incurred by HAL between the end of October 2016 and 2021, and reflects efficiency adjustments made by the CAA (including the upper end of the range proposed in Appendix F, which is subject to consultation). The costs included are Category B costs (and Interest During Construction associated with Category B expenditure), Category C costs, wind down costs, appeal costs and costs associated with the IPHS. We note that we have not yet reviewed wind down, appeal and IPHS costs.

- the tax uncertainty mechanism.⁴²

Next steps and implementation

- 6.81 We welcome the views of stakeholders on any of the issues raised in this chapter and will consider these carefully as part of our work to develop Final Proposals.
- 6.82 The approach to and calibration of the RAB is an important driver of the price control calculations set out in Chapter 11.

⁴² see Chapter 1 on our policy on traffic risk sharing; Chapter 9 on cost of debt indexation and Chapter 10 on tax allowance.

Chapter 7

Allowance for asymmetric risk

Introduction

- 7.1 In setting HAL's price control, we make projections of its costs and revenues and use these alongside a forecast of passenger numbers. These forecasts are important in our work to further the interests of consumers, as they help us align the price control settlement with expected volume of passengers and support our work to identify appropriate allowances for operating costs and new investment.
- 7.2 These forecasts should be set in a way such that the expected opportunities for HAL to out-perform are broadly matched against the risk that HAL could under-perform. Otherwise the price control arrangements will contain bias that could either:
- lead to windfall profits for HAL at the expense of consumers, or
 - create expectations of losses that could damage incentives for new investment and the provision of AOS by HAL, which would be contrary to consumers' interests.
- 7.3 In the case of passenger forecasts, historical experience suggests that the risks that HAL could encounter sudden downside shocks to traffic are not likely to be accompanied by an equal and offsetting set of possible upside events. To address this, it is appropriate to consider adjustments for these asymmetric risks.
- 7.4 The background section of this chapter explains the approach we adopted to these matters at Q6. We then go on to set out:
- stakeholders' views;
 - our views;
 - initial proposals; and
 - next steps and implementation issues.

Background

- 7.5 In our Q6 price control determination, we made allowance for the asymmetry of risks around volume forecasts by applying a "shock factor" adjustment of -1.2% each year to our Q6 traffic forecasts. This -1.2% figure was calibrated to match the average annual loss of volumes that HAL experienced over the period from 1991 to 2012 as a result of one-off events such as the Gulf War, the 9/11 terrorism attacks, SARS and volcanic ash.
- 7.6 The last two years of the Q5 period (2012 and 2013) and the first five years of the Q6 period (2014 to 2018) subsequently turned out to be a comparatively

benign period in which traffic growth was relatively constant. However, in 2020, HAL was severely affected by the current pandemic, a shock whose scale and duration has far exceeded any of the downside events that HAL had previously encountered.

- 7.7 In the light of historical evidence and the recent experience of pandemic risk, we need to consider how to account within our H7 price cap calculations for the asymmetry of traffic risks that HAL now faces during the period from 2022 to 2026.

Stakeholders' views

- 7.8 In their replies to the April 2021 Way Forward Document, airlines have generally opposed the inclusion of “shock factors” within traffic forecasts, arguing that demand risks are already fully accounted for in the assessment of the allowed return calculated for the WACC.

- 7.9 British Airways stated that:

“We continue to oppose the use of “demand shocks”, which are irrelevant to setting passenger forecasts as the risk is already incorporated in the assessment of WACC, along with market-based information of investor expectations; incorporating demand shocks would double count this risk. Furthermore, “demand shocks” have been highly asymmetric in implementation in Q6, charging consumers for the downside and granting Heathrow the full upside; forecasting should be realistic and based upon likely future demand.”⁴³

- 7.10 The AOC/LACC also stated that:

“Without seeing a further update to the contrary, fundamentally HAL’s forecasting remains too pessimistic, driven in part by their views on shocks, to which we fully concur with the CAA creates a ‘double count’ given the current situation, and constraining capacity. The medium to longer term general consensus within industry is of a return to 2019 levels by 2024; given Heathrow’s market power; consolidation of airlines at Heathrow; and strong past performance in recovery, we would continue to expect Heathrow to outperform the general industry forecast.”⁴⁴

- 7.11 HAL put forward an initial calculation of a revised H7 shock factor in its December 2020 RBP. That calculation followed the same method that we had used in our Q6 decision but expanded the data set by nine years to capture the final years of Q5, Q6 and the iH7 period.

- 7.12 It noted that the treatment of the pandemic shock would need to be consistent with our response to its claim for a RAB adjustment. HAL also said that, if we were to accept HAL’s preferred RAB adjustment in full, the appropriate shock

⁴³ British Airways (2021), “British Airways Response to CAP2139: Economic regulation of Heathrow Airport Ltd: Consultation on the Way Forward”, June, paragraphs 5.22-5.23.

⁴⁴ AOC/LACC (2021), “Re: Response to Economic Regulation of Heathrow–CAP2139H7 Way Forward Consultation”, June, paragraph 3.2.6.

values for 2020 and 2021 could be capped at 10% and the average shock factor for the period 1991 to 2021 would be 1.46%. However, if we were to reject HAL's claim, it said the appropriate shock values would be 75% and 50% for 2020 and 2021 respectively and the average shock factor would be 4.85%.

HAL's Updated RBP

- 7.13 HAL updated its calculations in its updated RBP in July 2021 to take account of the latest traffic outlook. Its proposed estimate remained 1.46% with a full RAB adjustment and it increased its wider estimate (even taking account of the £300 million RAB adjustment that we had proposed) to 5.16%. This increase reflected the reduction in HAL's traffic forecast for 2021 from 37m to 21m passengers and the consequently worse impact of the pandemic.

Our Views

- 7.14 We do not agree with the airlines that HAL is compensated in full for bearing demand risks through the allowed return. The Capital Asset Pricing Model ("CAPM") framework that we use when assessing the allowed return on equity assumes that the risks faced by investors are symmetrically distributed, but experience shows that risks around passenger numbers tend not to be equally balanced. This requires us to allow for asymmetric risks through a separate mechanism. We agree with HAL that our decision on the RAB adjustment is a relevant consideration in the calibration of our allowance for asymmetric risk.
- 7.15 Set out below is our thinking on two key issues:
- the form(s) that allowance(s) for asymmetric risk could take; and
 - the calibration of the allowance(s) for asymmetric risk during the H7 period.

Form of allowance for asymmetric risk

- 7.16 We have considered three possible ways in which we could potentially adjust HAL's price cap to provide an allowance for asymmetric risk:
- the first approach is to continue with our Q6 approach and make a downward adjustment to our central case H7 traffic forecasts;
 - an alternative option would be to make an adjustment instead to our estimate of the H7 cost of capital and to reflect the asymmetric risks faced by investors in the calculation of the allowed return price control building block; and
 - a third possible option would be to add an amount to HAL's H7 revenue entitlement to offset the loss of revenue that HAL might expect to suffer during the H7 period as a result of downside shocks.
- 7.17 It is important to note that each of the three options can be calibrated and applied in such a way as to provide HAL with an identical expected amount of revenue in each year of the H7 period. The approaches should, therefore, be distinguished and evaluated not by reference to the financial impact they would have on HAL and on customers but according to a range of other criteria such as:

- simplicity of calculation;
- the ease with which stakeholders can understand the rationale for and value of our adjustment (both now and in the future); and
- avoidance of unintended consequences.

7.18 We have concluded based on these factors that a different approach is warranted for:

- medium frequency, low impact shocks of the type seen prior to 2020; compared with;
- low frequency, high impact shocks that the current pandemic typifies (we use the term “pandemic-magnitude event” as a shorthand for these shocks in the discussion below).

7.19 In the former case, we have an established method from the Q6 review which we can use again in this H7 review to give an appropriate annual allowance for non-pandemic shocks. This method is relatively simple to apply and understood by stakeholders. It should also improve the accuracy of our forecasts, since history suggests that at least one such shock can reasonably be expected to occur in H7.

7.20 In the case of pandemic-magnitude events, however, our analysis is that the Q6 approach of adjusting traffic forecasts may bring certain disadvantages. Although this approach would result in forecasts that were closer to the long-term, statistical mean for traffic volumes, they are unlikely to be a good predictor of traffic volumes in H7. If a pandemic-magnitude event were to recur in H7, our forecasts under this approach would still be significantly above the outturn traffic volumes. If there was no such recurrence in H7, the forecasts would significantly understate outturn traffic volumes.

7.21 Similar considerations apply in the case of an adjustment to the allowed return. We considered during the Q6 review the arguments for making an adjustment to the cost of capital to reflect asymmetric risks and were not persuaded that it was necessary or practical to allow for the “skewedness” of returns within the calculation of the WACC. Nothing that has happened since the start of Q6 causes us to alter this assessment. Adjusting the H7 rate of return would also distort the operation of multiple regulatory mechanisms which use the cost of capital figure as a discount rate, potentially reducing the transparency of intra- and inter-period reprofiling of revenues.

7.22 The third option of making a stand-alone revenue allowance to take account of pandemic-magnitude events would seem to avoid these issues because:

- it would constitute a transparent way of recognising and compensating on a smoothed, annualised basis the loss of profit that irregular, low probability events impose on an airport operator;
- it would leave our H7 traffic forecasts and our H7 allowed return intact as the best available forecasts of H7 volumes and the H7 cost of capital respectively; and
- it would not interfere with the operation of other regulatory mechanisms.

- 7.23 Based on these considerations, we therefore propose to make allowance for pandemic-magnitude events outside the H7 traffic forecast and in a stand-alone revenue allowance.

Initial Proposals

Calibration of allowance – non-pandemic shocks

- 7.24 As set out in Chapter 2, we will apply an annual “shock factor” of -1.07% to our H7 traffic forecasts as recognition for the likely incidence of non-pandemic shocks. This is necessary because the unadjusted forecasts represent upwardly-biased estimates of outturn traffic volumes, due to the expectation that non-pandemic shocks such as those highlighted in paragraph 7.5 above may occur in H7. Even with a TRS mechanism in place, the prospect of such shocks in H7 would lead to an expected under-recovery in the absence of a shock factor adjustment, since the TRS does not fully insulate HAL from traffic risk.

Calibration of allowance – pandemic-magnitude events

- 7.25 In the light of paragraphs 7.20 to 7.23 above, we will also apply an allowance for pandemic risks, to be calculated as follows:
- step 1: estimate the traffic loss that HAL might expect to encounter if a pandemic-magnitude events occurs;
 - step 2: calculate the annual losses of profit that HAL would suffer if a pandemic-magnitude event was to crystallise in any given year of the H7 control period;
 - step 3: evaluate how frequently a pandemic-magnitude event might be expected to occur in the future, and calculate the equivalent probability of one occurring in any given year; and
 - step 4: weigh the losses of profit identified in step 2 by the probability identified in step 3 and add these amounts to HAL’s H7 aeronautical revenue allowance.
- 7.26 These steps are described in more detail below.

Step 1: estimate the traffic loss that HAL might expect to encounter if a pandemic-magnitude event occurs

- 7.27 The experience of the covid-19 pandemic provides us with very recent data on the way in which a pandemic-magnitude event can cause a near-shutdown of domestic and international travel.
- 7.28 If a similar event or event of a similar magnitude occurs in the future we assume it will:
- impact passenger numbers over a three-year period; and
 - have an impact with similar profile to that seen in and/or anticipated for 2020, 2021 and 2022: that is precipitating a traffic reduction of -57%, -73% and -37% in each of the three years respectively.

Step 2: calculate the annual losses of profit that HAL would suffer if a pandemic-magnitude event were to crystallise in any given year of the H7 control period

7.29 The last two years have demonstrated that a material step-change drop in traffic will have knock-on effects for both costs and revenues. We have, therefore, undertaken modelling to calculate the loss of profit that HAL would incur in the event of the recurrence of a pandemic-magnitude event during H7. This analysis assumes that opex and non-aeronautical revenues will vary in accordance with the elasticities used in the analysis in Chapters 4 and 5. These calculations are summarised in Table 7.1 below.

Table 7.1: Possible in-period losses due to a pandemic-magnitude event, £m nominal prices

	2022	2023	2024	2025	2026
Lower Quartile					
If an event were to recur in 2022	735	1,321	824	0	0
If an event were to recur in 2023	0	1,032	1,648	953	0
If an event were to recur in 2024	0	0	1,289	1,905	1,018
If an event were to recur in 2025	0	0	0	1,489	2,036
If an event were to recur in 2026	0	0	0	0	1,592
Upper Quartile					
If an event were to recur in 2022	941	1,653	1,022	0	0
If an event were to recur in 2023	0	1,292	2,045	1,163	0
If an event were to recur in 2024	0	0	1,598	2,326	1,230
If an event were to recur in 2025	0	0	0	1,818	2,459
If an event were to recur in 2026	0	0	0	0	1,922

Source: CAA calculations

7.30 It is also important to account for the protection that the new TRS mechanism will offer. At the end of H7, HAL will be entitled to a RAB adjustment worth:

- between 40% and 60% of the first 10% of lost revenue from airport charges; and
- between 90% and 100% of all remaining losses of revenue from airport charges above that 10% threshold.

7.31 We have adopted the midpoint of these values (that is, 50% and 95%, respectively) for the purposes of estimating the RAB adjustment that HAL will receive in the event of a future pandemic-magnitude event. These values are set out in Table 7.2 below.

Table 7.2: Adjustment to the H8 RAB under the TRS mechanism following a pandemic-magnitude event, £m, nominal prices

£m	Upper quartile	Lower quartile
If an event were to recur in 2022	3,913	2,520
If an event were to recur in 2023	4,552	3,010
If an event were to recur in 2024	4,785	3,255
If an event were to recur in 2025	3,546	2,470
If an event were to recur in 2026	1,103	800

Source: CAA calculations

- 7.32 HAL's resulting net exposure to pandemic-magnitude events, once the offsetting impact of the TRS is taken into account, is summarised in Table 7.3 below. These figures represent the net present value ("NPV") of the amounts set out in Tables 7.1 and 7.2 above as at the start of H7, when discounted at the WACC we set out in Chapter 9.

Table 7.3: Net exposure to pandemic-magnitude events, £m, nominal prices

£m	Upper quartile	Lower quartile
If an event were to recur in 2022	767	857
If an event were to recur in 2023	840	1,011
If an event were to recur in 2024	863	1,104
If an event were to recur in 2025	769	966
If an event were to recur in 2026	591	618

Source: CAA calculations

Step 3: evaluate how frequently a pandemic-magnitude event might be expected to occur in the future, and calculate the equivalent probability of a shock occurring in any given year

- 7.33 It is not straightforward to estimate the frequency of pandemic-magnitude events. Under these circumstances, we consider that the most prudent approach is to adopt a range of plausible assumptions.
- 7.34 We have therefore allowed for a probability that sits between a 1-in-20-year and 1-in-50-year range, consistent with the assumptions that we are applying in Chapter 9. This translates into a probability of 3.5% of a new pandemic-magnitude event beginning in any given year, starting from 2023.

Step 4: weigh the losses of profit identified in Step 2 by the probability identified in Step 3 and add these amounts to HAL's H7 aeronautical revenue allowance

- 7.35 We next weight the annual losses shown in Table 7.3 on the assumption that there is a 3.5% probability of a new pandemic-magnitude event beginning in any

given year, starting from 2023. This results in the expected annual losses shown in Table 7.4.

Table 7.4: Probability-weighted, expected losses due to pandemic-magnitude events, £m nominal prices

£m	Upper quartile	Lower quartile
If an event were to recur in 2022	0	0
If an event were to recur in 2023	29	35
If an event were to recur in 2024	29	37
If an event were to recur in 2025	25	32
If an event were to recur in 2026	19	19
Total	102	124

Source: CAA calculations

7.36 The projected growth in passenger numbers during the H7 period, along with our assumptions about the probability and impact of pandemic-magnitude events, mean that the expected financial loss due to asymmetric risk varies from year to year. We consider that it is appropriate for reasons of simplicity to profile our allowances so that HAL receives a constant revenue allowance in each year of the H7 period. The smoothed calculation is shown in Table 7.5 below.

Table 7.5: Revenue allowance for asymmetric risk, £m nominal prices

£m	2022	2023	2024	2025	2026
Lower quartile	30	30	30	30	30
Upper quartile	26	26	26	26	26

Source: CAA calculations

7.37 Adopting the approach set out above should deliver an adjustment to the calculation of the price control that is needed to further the interests of consumers by providing a proportionate response to HAL's exposure to the risk of pandemic-magnitude events during H7. When taken together with other measures we are intending to adopt – namely, the TRS, and our pandemic-related uplift to the WACC – we expect that our approach to the H7 price control will secure the ability of the notional company to finance its activities.

Next steps and implementation

7.38 We welcome the views of stakeholders on any of the issues raised in this chapter and will consider these carefully as part of our work to develop our Final Proposals.

- 7.39 The annual shock factor will be added to the base demand forecast, as set out in Chapter 2. The allowance shown in Table 7.5 above is added to the calculation of price control revenue in Chapter 11.

Chapter 8

The financial framework

Introduction

- 8.1 Consideration of the financial framework we use in setting HAL's price control is a key element of the way in which we have regard to the need to secure that HAL can finance its activities at Heathrow. It is also important to consumers as the financial framework influences the overall level of charges and supports HAL in financing new investment.
- 8.2 Where appropriate, we have sought to adopt an approach that is consistent with key components of the Q6 financial framework as there are advantages in the predictability and continuity of regulation in terms of avoiding unnecessary uncertainty and possible increases in HAL's cost of capital.
- 8.3 In this chapter we discuss two key elements of the financial framework:
- capital structure (in particular our approach to a notional structure and the associated level of gearing); and
 - regulatory depreciation.
- 8.4 In respect of both of these areas we are adopting a broadly consistent approach to that used in previous HAL price controls.
- 8.5 Other aspects of our approach are evolving more in response to the uncertainty associated with the impact of the covid-19 pandemic, including:
- introducing a traffic risk sharing (TRS) mechanism to make clear how volume risk will be allocated between consumers and HAL in the future (see Chapter 1);
 - updating our analysis of the cost of capital to consider the impact of the covid-19 pandemic (see Chapter 9);
 - making an explicit allowance for asymmetric risk in respect of future events having comparable impact to the covid-19 pandemic (see Chapter 7).
- 8.6 Our overall approach to the financial framework is designed to support financeability for both debt and equity, and we have retained our focus on a notionally financed company. An appropriate level of gearing for the notional entity supports both debt financeability and financial resilience, and so is important both to investors and consumers.
- 8.7 Regulatory depreciation reflects the amount that is deducted from the RAB in each year and allowed as cash flow in the calculation of the price cap. Regulatory depreciation is an important issue for consumers as it directly affects

the level of charges and HAL's overall financeability and its ability to fund new investment.

Background

The notional financial structure

- 8.8 In previous airport price control reviews, we have based our assessment of financeability, and determined HAL's allowed return, based on a "notional" or "efficient" financial structure. The "notional financial structure" constitutes a set of assumptions regarding the scale and nature of HAL's debt liabilities. These assumptions reflect our views on the efficient balance between debt and equity finance. In practice, these assumptions have differed significantly from HAL's actual financial structure.
- 8.9 The April 2021 Way Forward Document explained that, by assessing the impact of our policy proposals on this notional entity, we avoid making judgements on, or allowances for, HAL's actual financial structure. This has been a key part of our approach to the financial framework as it makes clear that we have regard to financeability in setting HAL's price control, while not seeking to regulate the actual choices made by HAL itself. This ensures that these actual choices remain the responsibility of HAL, its directors and shareholders. We have adopted this approach in setting previous price controls and it remains a central element of our policy.
- 8.10 The rationale for this approach has been that HAL's actual financial structure is the responsibility of HAL's directors and shareholders and is influenced by the particular choices they make. If the financeability test and allowed return determination were to be carried out on the basis of HAL's actual financial structure, it could weaken the incentive on HAL to manage its finances prudently and could lead to consumers underwriting particular risks that HAL's directors and shareholders have decided to take. In the Q5, Q6 and iH7 price control periods, we used a notional gearing assumption of 60%. HAL has been able to adopt alternative levels of gearing, but the benefits, risks and costs of doing so lie with HAL and its directors and shareholders.
- 8.11 Given the advantages noted above, the April 2021 Way Forward Document explained that we intended to continue to use a notional gearing assumption and would explore how the specific level of notional gearing that we assume might need to be varied to take account of the impact of the covid-19 pandemic.⁴⁵

Gearing

- 8.12 In the April 2021 Way Forward Document, we noted that many participants in the aviation sector, including HAL, had raised equity in response to the impact of the covid-19 pandemic. The provisional analysis in the April 2021 Way Forward Document assumed that support from shareholders in the H7 period was provided by way of dividend forbearance so that HAL paid no dividends but, equally, shareholders injected no cash. We further noted the broad equivalence

⁴⁵ See Appendix G for our latest thinking in respect of licence conditions for financial resilience.

between dividend forbearance and equity injection as different ways of providing equity support.

- 8.13 We presented analysis in the April 2021 Way Forward Document showing that the gearing of the notional company would have increased to 67% had it started 2020 at 60% gearing and funded the shortfall in cash from operations by issuing additional debt while not paying dividends to shareholders.
- 8.14 The April 2021 Way Forward Document also looked at gearing “glidepaths” and the trajectory for deleveraging after the covid-19 pandemic and returning the notional entity to 60% gearing. We presented analysis showing that gearing could be returned to 60% within H7 without the need for a RAB adjustment or cash injection from shareholders, provided there was a further period of dividend forbearance.

Regulatory depreciation

- 8.15 In the April 2021 Way Forward Document, we stated our intention to consider using depreciation and reprofiling, where appropriate and practicable, to develop a price control that delivers affordable charges for consumers and supports the financeability of HAL’s investment programme.
- 8.16 We also noted that in the H7 period, when demand, at least initially, is depressed by the impact of the covid-19 pandemic, it may be more appropriate to reduce depreciation so that individual passengers travelling in the H7 period do not pay a disproportionate share of depreciation costs. We stated that we would continue to look at depreciation profiles in developing our initial proposals.

Stakeholders’ views

- 8.17 Stakeholders have generally accepted that we should focus on the notional entity, but HAL has noted that we should have appropriate regard for our statutory duties, which do not mandate a focus on notional financing.
- 8.18 In its RBP update, HAL identified two conditions in which it considered the deferral or reprofiling of depreciation could be appropriate:
- that investors have confidence in the return of capital; and
 - that the gearing impact of the pandemic can be unwound (for the notional company) while still providing an appropriate return to shareholders.
- 8.19 HAL argued that the CAA was wrong to suggest that depreciation could be deferred even if there were to be no full RAB adjustment. HAL suggested that the CAA’s conclusion was unreliable as it rested on analysis which assumed that no dividends would be paid and that this was inconsistent with the CAA’s observation of a statement by Standard & Poors’ (“S&P”) that European airports will return to paying dividends from 2023 onwards.
- 8.20 In its update to the RBP, HAL brought together the concepts of regulatory depreciation and gearing by noting that if there is no deferral of regulatory depreciation, gearing would return to 60% only at the end of the H7 period. HAL

went on to suggest that this could lead to pressure to minimise capex as a way of restoring an appropriate level of gearing.

- 8.21 BA and the LACC/AOC supported the notional approach to developing policy for the financial framework. BA suggested that the gearing profile for H7 should reflect the optimal, lowest, level of WACC. The LACC/AOC made a similar point in suggesting that the CAA's decision in respect of gearing should reflect an "efficient notional capital structure".
- 8.22 BA suggested that depreciation deferral or revenue re-profiling may be appropriate as a way to support affordability during the "recovery phase" from the impact of the covid-19 pandemic, but that this should only be contemplated once the CAA is satisfied that the building block allowances are all set at the efficient level. BA also requested that the CAA transparently set out its calculations for determining the opening gearing for H7.
- 8.23 The LACC/AOC suggested that any changes to the level of notional gearing need to be well evidenced. The LACC/AOC argued that any increases in gearing due to the impact of the covid-19 pandemic should be reversed by dividend forbearance. It also suggested that the CAA should consider evidence of airports and airlines raising equity in response to the impact of the covid-19 pandemic.

Our views

- 8.24 As noted in Chapter 6, we have decided for our Initial Proposals, that no further RAB adjustment is appropriate. This is important context for the following discussion of the financial framework as it has a material bearing on the level of gearing⁴⁶ and because HAL has argued that depreciation deferral is only appropriate if it receives a full RAB adjustment.
- 8.25 We are also retaining a focus on the notional entity for the reasons set out in the discussion in the April 2021 Way Forward Document and summarised earlier in this chapter. This approach benefits consumers by focusing on an efficient capital structure while being clear that decisions on, and the consequences of, the actual financial structure are the responsibility of HAL, its directors and shareholders. We note the representations HAL has made in relation to these matters and our statutory duties and we would be open to considering any information from HAL or other stakeholders that suggests a different approach to financeability would allow us to better discharge our statutory duties.
- 8.26 Stakeholders have commented on the possibility and appropriateness of adjusting the depreciation profile to meet certain affordability or financeability objectives. We are still open minded about using depreciation to manage affordability and mindful of its impact on financeability. However, our analysis suggests that, based on our current view of the building block allowances for H7, that it is not appropriate to either accelerate or defer depreciation.⁴⁷

⁴⁶ When measured on the basis of debt or net debt to RAB

⁴⁷ See Chapter 11 for our assessment of affordability and financeability

- 8.27 Stakeholders expressed a range of views on the appropriateness of dividend forbearance, the potential need for shareholders to inject cash and the appropriate profile of gearing in H7. Our assessment summarised below shows the notional entity being able to make substantial dividend payments during H7 after an initial period in which cash generated by the business is used to restore gearing to 60%.
- 8.28 We note airlines' suggestions that the gearing level should be chosen so as to minimise the cost of capital. Corporate finance theory suggests that the cost of capital is largely unaffected by gearing. As a result, we have not sought to use the cost of capital as a tool for choosing the optimal level of gearing.

Gearing

- 8.29 The modelling summarised in Chapter 11 shows that the notional entity's gearing would peak at 64.8% in 2021 and would then fall as the recovery in passenger volumes means that operations become cash generative once again. Assuming that the notional entity pays no dividends until gearing is returned to 60%, our modelling shows that the notional entity would achieve this in 2023 for the upper end of our range and 2024 for the lower end of our range and that it would be paying dividends from 2024 onwards.⁴⁸
- 8.30 We note the statement by S&P that we referred to in the April 2021 Way Forward Document which suggested that European airports may be able to pay dividends from 2023. The S&P report in question was published in March 2021 and was based on a passenger recovery profile which now appears somewhat optimistic.⁴⁹ We also note a report produced by Barclays⁵⁰ which suggested there was scope for dividends to be reinstated at previous pay-out ratios from 2024 onwards and which also noted the need to reduce gearing as a potential constraint on dividend payments.
- 8.31 There is clearly a range of views on when it may be possible for airports to resume payment of dividends. Our assessment is that a resumption of dividend payments in 2023 or 2024 would be consistent with our statutory duties where we have a primary duty to further the interests of consumers and where the need to have regard to the need to ensure financeability is expressed as one of several secondary duties.⁵¹ We also consider that resumption of dividend payment in 2023 or 2024 would be broadly consistent with market expectations based on the reports referred to above.
- 8.32 We have considered whether it might be appropriate to assume a reduction in the assumed level of gearing given potentially higher perceptions of risk. We consider that the TRS significantly mitigates against the risk posed by another

⁴⁸ See Chapter 11 for further assessment of the dividends that we project the notional entity would pay.

⁴⁹ See <https://www.spglobal.com/assets/documents/ratings/research/100049716.pdf>. The report refers to European estimates for passenger volumes in 2021 of 30-50% below 2019 levels. By contrast HAL's base case assumption for passenger numbers in 2021 is 21.5m which represents 27% of the 80.9m passengers it served in 2019.

⁵⁰ Barclays Global airport benchmarking, June 2021

⁵¹ See Appendix A