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British Airways Response to CAP2139
Economic regulation of Heathrow Airport Ltd: Consultation on the Way Forward

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

Executive Summary

Heathrow holds significant market power through its privileged position as the UK's busiest airport, yet proposes significant increases in charges for the H7 period; the CAA must be aware that Heathrow is motived to seek "the best of all monopoly profits…the quiet life"[1]

Economic regulation of Heathrow and the H7 price control are therefore of great importance to our business and our customers; the regulatory settlement must restrain its exercise of Heathrow's market power, otherwise consumers will ultimately be harmed and will pay more than necessary for Heathrow's excessive and inefficient costs

There is now **limited time remaining to finalise the H7 periodic review before January 2022, but it should be possible to reset the building blocks and design a price control within the remaining six months**

Our main points are as follows:

a) Heathrow's RBP proposes an airport charge that is significantly higher than necessary, and **airline analysis suggests prices should instead fall over the next regulatory period**; Heathrow cannot delay the inevitable reset of its building blocks, with the RAB adjustment request having frustrated the process to date

b) We support a 5-year incentive-based price cap, which offers the **best balance between updating the building blocks and allowing incentives to play out**; however, we continue to advocate for the introduction of CPI as a more appropriate index than RPI

[1] Hicks, J.R. (1935) "The Theory of Monopoly", Econometrica, Volume 3, Issue 1

c) We are **concerned that significant works remains to be done in order to support a January 2022 start** of the H7 quinquennium, and highlight risks to the annual rate setting process that exist should the periodic review be further delays

d) We **agree with the CAA's assessment of Heathrow's Revised Business Plan** ("RBP"), which **does not present an integrated plan across individual building blocks**, and lacks specific content, objective analysis and transparency

e) Forecasting passenger volumes is incredibly difficult at present; we are **uncomfortable that the CAA might rely solely on Heathrow's modelling**, and are concerned that Heathrow has not developed integrated scenarios as required

f) To mitigate forecasting risk and solve for incentive issues, **any traffic risk sharing must be designed to achieve certain efficiency, consistency and symmetry principles**, and should **baselined at the existing total capacity of the airport** (demonstrated by passenger throughput in 2019)

g) In contrast, **Heathrow's proposals for risk sharing contain weak incentives**, and **result in consumers inappropriately insuring against Heathrow's tail risks** for a minimal reduction in the WACC

h) Incentives are critical to the design of the price control; Heathrow appears to have a poor understanding of principles that sit behind the WACC calculation and the Capital Asset Pricing Model, and **continues to demand innovations to the regulatory regime that are inconsistent with good economic outcomes**

i) **Operating costs must be built up based upon detailed cost analysis**, and must be based upon the activities that Heathrow plans to undertake during H7, linked with traffic scenarios and capital investment plans; efficient costs should be supported by more competitive tendering

j) **Commercial revenues must similarly be built up based up forecast demand scenarios**, distinguishing between markets, categories of outlets and busines models with commercial partners, and reflect its historical strong performance

k) We **agree with Heathrow's proposals to restructure Other regulated charges ("ORCs") to move to marginal cost pricing**, but require that the governance protocol surrounding these is updated, and that a stronger transparency condition is placed on Heathrow to support greater oversight

l) The capital plan for H7 needs to have a degree of flexibility due to uncertain demand, and **we continue to support the CAA's proposals for capital efficiency incentives**, whose strength and operation might be best informed by those in operation at Thames Tideway Tunnel, supported by detailed delivery obligations; additionally, more competitive tendering needs to be supported in H7

m) We support the CAA's introduction of Outcomes Based Regulation ("OBR") to update the Service Quality Rebates and Bonuses ("SQRB") scheme for H7, but **cannot accept a weakening of incentives over key operational infrastructure that is required by airlines**

to deliver services to consumers; in particular, those incentives must be measured correctly, resolving issues that have persisted in Q6

n) The **financing incentive must remain clear and consistent, and we support the continued use of the notional company**; we suggest that gearing assumptions and any glidepath to achieve them should be based upon the point at which WACC is minimised, which represents optional and most efficient gearing

o) For equity financeability assessments, it is **entirely appropriate that dividend pay-outs will fall across the aviation sector in response to the pandemic**, and equity will need to be re-invested to re-build balance sheet equity buffers

p) We **support profiling of revenues should charges appear excessive, but only having correctly reset all building blocks**, which themselves determine the actual value consumers derive from the airport

q) We **support the CAA's approach to setting a tax allowance that is consistent with the notional basis and WACC calculation**, and that a clawback mechanism to limit shareholder benefit from highly leveraged financial structures is appropriate

r) We **welcome the CAA's rejection of Heathrow's request for a RAB adjustment of up to £2.8bn in CAP2140**, and reserve final judgement of the £300m adjustment to support notional company credit ratings until the H7 price control can be fully assessed; it remains our view that further adjustments would be inappropriate

s) Furthermore, **we have yet to see any evidence that Heathrow intends to make any further investment in 2021 as a result of the RAB adjustment**, and ask the CAA that this is taken into account in the review that will take place to assess this

t) We note that the legal status of the Airports National Policy Statement ("ANPS") has now been restored, but **see no prospect of expansion in the near future; it would be inappropriate for Heathrow West or any other promoter to recover its costs through the RAB**, though we welcome competitive tendering in future

u) We **support the CAA's ring-fencing and financial resilience proposals in general**, noting our concern over the complexity of Heathrow's highly leveraged financial structure; we **further support the information requirements set out by the CAA as being reasonable, balanced and pragmatic**

1. Introduction

1.1. **Heathrow is presently regulated under a price cap set on a per passenger basis**, alongside capital and service quality incentives that are designed to support airline operations and – ultimately – the high standards expected by our customers

1.2. As a result of many years of necessary investment – particularly in terminal infrastructure – **Heathrow's Regulatory Asset Base ("RAB") has swelled to over £16bn**; in addition, Heathrow has forecast in its Revised Business Plan ("RBP") that operating costs must remain elevated despite the collapse in passenger numbers

1.3. In conjunction with this, Heathrow has forecast far lower commercial revenues available to fund its total revenue requirement through the single till, resulting in an **aeronautical revenue requirement that is significantly higher than necessary**

1.4. Further, spreading this aeronautical revenue requirement over a lower forecast of passenger numbers than those achieved in Q6 and Q6+1 naturally **results in a <u>potential</u> price path that places upward pressure on airport charges per passenger**

1.5. We **welcome the CAA's intent to take steps to smooth the path of prices** over the period, since this would be in the best interests of consumers and the wider travel industry during the period of recovery from Covid-19

1.6. However, we are **not convinced that there should be such an upward pressure on prices as portrayed by Heathrow**; indeed, the airline community has presented an alternative business plan ("ABP") based on information available to us that **suggests prices should fall from today's levels over the next regulatory period**

1.7. Ultimately, the **building blocks of the price control need to be set on an appropriate basis, informed by a high-quality business plan that is internally consistent**, based upon objective analysis of Heathrow's costs and revenue opportunities, and reflective of the risk to which the business is exposed

1.8. This has been an unchanging CAA requirement of Heathrow since the early stages of H7 when runway expansion was the main focus of its planning; nevertheless, **Heathrow has continued to present subjective, misleading or incomplete analysis that is internally inconsistent throughout the process**, substantially contributing to delays in the H7 review to date

1.9. Furthermore, **Heathrow has deliberately frustrated the process through the introduction of a failed request to adjust its RAB upward by up to £2.8bn**, developing an unrealistic RBP that failed to address substantive issues whilst attempting to coerce the CAA into re-writing both the substance of its existing price control and fundamental principles of UK incentive regulation

1.10. We are now six months away from the requirement to put in place a new Heathrow licence, and substantive details the H7 price cap have yet to emerge; **the CAA cannot allow Heathrow to further derail the process and delay the inevitable reset of its regulatory building blocks**

1.11. Consumers and airlines deserve an update of Heathrow's building blocks, which at present **remain based upon a periodic review conducted nearly nine years ago**; if we are unable to achieve a full reset of the price cap, it would be to the detriment of consumers who would likely pay more than is necessary through airport charges

1.12. Whilst we have been supportive of alterations to the CAA's proposed timeline to date to support the introduction of a new price control in January 2022, we are keen to see substantive progress towards achieving that goal, and have been concerned by delays to consultation releases; **we are committed to working with the CAA and Heathrow to avoid any such further delays**

1.13. **Heathrow is the home of our hub network, and Heathrow one of the largest suppliers to our business**; its importance cannot be understated as a supplier of capacity that allows our business to function effectively

1.14. **We want Heathrow's business to flourish in conjunction with our own business**; however, we cannot accept an asymmetric price control determination, which places our long-term business success at risk in order to support Heathrow's financing choices

1.15. We therefore **urge the CAA to develop initial proposals that are based upon objective analysis, balance and internally consistent building blocks**; we remain committed to supporting this process despite its rocky progress to date

2. General comments on the H7 price control

2.1. In general, we **continue to support the CAA on an introduction of a five-year price control** with incentives based upon a building block approach, supporting by the RAB and a single till approach to calculating charges

2.2. This **should be a better economic outcome for consumers than rate of return regulation** that might result should a shorter price control period be considered in response to pressures created by the Covid-19 pandemic; in such a circumstance, the WACC must be substantially lower to reflect the removal of incentives and risk

2.3. This price cap (incentive) approach, developed as RPI-X was deemed optimal by Littlechild due to **greater incentives for efficiency and innovation in contrast to rate of return (cost plus) regulation**, which as noted in earlier literature "can impose its social costs in the form of input inefficiency"[2]

2.4. This is particularly important where data suggest the value to be gained by increasing X-efficiencies is significant[3], whose contribution towards output depends upon a degree of competitive pressure or other incentive factors

2.5. A reset of the building blocks in a periodic review enables **"stable, predictable policy, coherent and consistent across areas"[4], supporting regulatory commitment** across a multi-period set of price controls, and forms the foundational strength of UK price control regulation

2.6. A **five-year price control continues to offer an appropriate balance between incentives and ensuring building blocks do not become stale**; in conjunction with an appropriately calibrated risk sharing scheme, it should be possible to mitigate uncertainty within a five-year incentive-based control

[2] Baumol, W & Klevorick, A "Input Choices and Rate-of-Return Regulation: An Overview of the Discussion", The Bell Journal of Economics and Management Science, (Autumn, 1970), pp. 162-190
[3] Leibenstein, H. "Allocative Efficiency vs. 'X Efficiency,"' American Economic Review, Vol. 56 (June 1966), pp. 392-415
[4] Spiller, P. & Tommasi, M. "The Institutions of Regulation: An Application to Public Utilities", Handbook of New Institutional Economics (pp. 515-543)

3. Timeline of the H7 periodic review

3.1. We are concerned that **there remains significant work for the CAA to still do in order to define initial proposals for the H7 price control**; as noted above, whilst we continue to support the introduction of a five-year price control, **any further extension of the underlying Q6 price control using significantly outdated building blocks is unlikely to offer an optimal consumer outcome**

3.2. Heathrow's RAB adjustment request has risked driving the CAA off course, and substantial decisions have yet to be taken that leave many aspects of the price control in flux; there is a **risk that there is insufficient time remaining to properly engage whist taking account of the interactions between those moving parts**

3.3. Having allowed Heathrow multiple attempts to present a high-quality business plan to little avail, there **appears to be little effective incentive on Heathrow to act in a transparent manner**; the CAA now has little time to define multiple aspects of policy and the price control, whilst airlines have little time to effectively challenge, before even considering airlines' present severe resource constraint

3.4. We remain **supportive of the CAA continuing work on the H7 periodic review in a manner that allows implementation in January 2022**, perhaps reconciling final proposals if only available after that date; nevertheless, we are concerned that any alternatives are ill-defined at present and could be detrimental to consumers

3.5. The annual rate card consultation process is significantly impacted by the delay to the H7 timetable; there is **little margin remaining in the H7 timetable at present to accommodate any further delay**, which could result in a failure of the periodic review process to achieve a January 2022 implementation as a result

3.6. Whilst consultation under Airport Charges Regulations 2011 ("ACRs") can be reduced from four months to two in extreme circumstances, it is **difficult to see how Heathrow and airlines can plan sufficiently to have a meaningful discussion** on the structure of charges for 2022 at present

3.7. This is accentuated by the fact that consumers are charged the Passenger Service Charge ("PSC") element of the airport charge as an integral part of the ticket price; late determination of the rate card for the subsequent year **reduces the period in which a newly determined applicable PSC can be collected at point of sale**

3.8. It would be unfortunate if this year's consultation process were clouded by Heathrow using an unrealistic, aspirational maximum allowable yield informed by their speculative business plan; this is **likely to lead to an immediate breakdown in any consultation process** as excessive charges would preclude any conversation

3.9. It would therefore be **useful for the CAA to provide specific guidance to Heathrow on an indicative charge that might be used to enable this consultation to take place**; it would be suboptimal for consumers to experience a delay in the 2022 rate card, potentially reducing opportunity for k-factor and capital contribution refunds to flow through pricing at the first available opportunity

4. Heathrow's Revised Business Plan

4.1. The CAA's initial assessment of the Heathrow's Revised Business Plan ("RBP") is broadly in line with our view; it is unfortunate that **the RBP does not present an integrated plan across individual building blocks**, and that scenarios are not integrated across building blocks at different levels of passenger volume

4.2. This is further **compounded by Heathrow's decision to make its speculative RAB adjustment an integral part of its plans**, a decision that clouded the second round of constructive engagement in summer 2020, and polluted many aspects of its plans within individual building blocks

4.3. We **therefore agree with the CAA's assessment: a "lack of meaningful integration across different elements of the RBP**, and in particular the quantitative building blocks"[5]

4.4. In general, the RBP provided a great deal of words but **lacked specific content, objective analysis and transparency into Heathrow's business**; as a result, it has broadly failed to meet the CAA's guidance in terms of quality and content for the purpose of a periodic review of Heathrow's price control

4.5. We agree with the CAA's conclusions on Heathrow's RBP, and strongly **urge the CAA to follow best practice approaches to establishing the building blocks of the H7 price control**; these cannot follow Heathrow's preferred methodologies, as this risks the incentives at the heart of the price control risk being seriously undermined

4.6. We support all the CAA's information requirement of Heathrow as set out in the consultation[6]; we also **urge the CAA to use the material presented previously by the airline community as a guide** to asking questions of Heathrow at a fundamental and bottom-up level of detail

5. Passenger forecasts

5.1. It is **impossible to forecast passenger numbers over the next five years with any degree of accuracy** at present; Covid-19 has had an effect on the aviation industry that has been longer and deeper than anyone had expected at the outset of the pandemic

5.2. Heathrow has **traditionally been regulated on the basis of a per passenger price cap**, with Heathrow holding full volume risk; this "revenue yield" approach calculates total revenue required, uses commercial revenue forecasts within the single till to derive aeronautical revenue required, and divides this value by forecast demand

[5] Civil Aviation Authority, CAP2139 table 1.2
[6] Civil Aviation Authority, CAP2139A, Appendix G – requirements for HAL to provide further information

5.3. This has been viewed as preferable to a tariff basket approach seen in other industries, as there is a single, natural unit of output at a passenger airport[7]; however, **whilst the average revenue per passenger is capped, the total revenue on any individual passenger is not**, and risk of demand volatility additionally falls on Heathrow

5.4. This should in theory make Heathrow more responsive to changing demand, and set an incentive by which Heathrow can benefit from higher profits if demand is greater than forecast; alternatives may result in worse economic outcomes, and **there are clear issues that need to be considered when operating revenue caps**[8]

5.5. The price cap at present allows Heathrow pricing flexibility within the annual rate card that approximates Ramsey–Boiteux pricing[9], , whereas **revenue caps motivate relatively large price changes in the opposite direction to those of Ramsey pricing**[10], and therefore lead to greater pricing inefficiencies than even the Crew-Kleindorfer effect would suggest[11]

5.6. This effect is itself particularly applicable at Heathrow, demonstrated by – as suggested by Heathrow in its RBP – an **incentive to lobby or even settle for a higher price at a corresponding lower volume**, especially where terminal infrastructure might remain unavailable due to the cost structure of the airport

5.7. This would **violate any objective for price efficiency**, and further would **result in Heathrow being incentivised to avoid meeting capacity and service quality standards**

5.8. **Under its model to date, Heathrow is motivated to lobby for a lower-than-expected passenger forecast**, and this would be accentuated if any revenue-based cap were to apply, either directly or through a traffic risk sharing scheme

5.9. Furthermore, Covid-19 creates a unique motivation for Heathrow to forecast even lower than normal passenger numbers over the course of H7; forecasting is an inexact science in general, and the **illusion of validity[12] presents a risk that any passenger forecast is little more than an output that is selected as being most representative of the input**, with little regard for factors that limit accuracy

5.10. Forecasts of **passenger volumes and the profile of any recovery have been subject to diverging opinions between Heathrow and airlines**; this is natural in any periodic review, however, this is made more difficult by the fact that Heathrow is the only party that has developed any econometric forecast of volumes

[7] Bradley, I & Price, C "Average revenue regulation and regional price structure", Regional Science and Urban Economics, 1991, vol. 21, issue 1, 89-108
[8] Stoft, S. "Revenue Caps vs. Price Caps: Implications for DSM" 1995
[9] This that dates back to the classic Ramsey, Frank P. (1927). "A Contribution to the Theory of Taxation". The Economic Journal. 37 (145): 47–61 as further developed by Boiteux, M. "Sur La Gestion Des Monopoles Publics Astreints a L'equilibre Budgetaire." Econometrica, vol. 24, no. 1, 1956, pp. 22–40
[10] This dates back to observations by Vogelsang, I., & Finsinger, J. (1979). A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms. The Bell Journal of Economics, 10(1), 157-171
[11] Stoft, S. "Revenue Caps vs. Price Caps: Implications for DSM" 1995
[12] Kahneman, Daniel; Tversky, Amos (1973). "On the Psychology of Prediction" (PDF). Psychological Review. 80 (4): 237–251

5.11. Whilst this is the priority of the regulated entity, and CAA is making efforts to understand Heathrow's modelling suite, it gives us **discomfort that the CAA aims to rely solely on the regulated entity's modelling suite to form a core part of the price control**, rather than an independent economic forecast

5.12. We would **counsel the CAA to develop its own model** based upon GDP forecasts, government policy, market demand, and airline supply to effectively regulate Heathrow, and therefore support the potential alternative option to use an existing third-party model[13]; this should be relatively easy to achieve in the remaining time available before Initial Proposals given the CAA's expertise in regulating Heathrow since privatisation

5.13. This is in contrast to other regulated sectors, where the **independent regulator has developed its own detailed econometric models in addition to the core price control model**; for example, Ofwat transparently published econometric models for every aspect of the PR19 building blocks[14] for each regulated regional water company along with a detailed data flow of how models interact[15]

5.14. The CAA has provided its price control model at various stages throughout the process, however **it would be optimal from a process perspective to develop and publish models for each building block at regular intervals during the periodic review**; otherwise we risk having little time to review and challenge any determination in the little time remaining until the start of the H7 price control

5.15. In order to mitigate the uncertainty that surrounds Heathrow passenger modelling, in conjunction with a well-defined, volume-based traffic risk sharing scheme, we **advocate setting the divisor for aeronautical revenue of the price control based upon the <u>existing</u> total capacity of the airport** (that demonstrated by passenger throughput in 2019); this represents the investments that have been made to date, and would allow a fair risk sharing at out-turn passenger volumes that arise below the airport's capacity limitations

5.16. This approach would enable the CAA to avoid continued debate over the passenger forecasting, and **in the absence of its own, independent model, develop a price control whose incentives can be designed to be fully consistent at any out-turn passenger volume**; the alternative is the implementation of a price control with a low passenger forecast that might later violate Ramsey pricing principles, and risk demonstrating the Crew-Kleindorfer effect in full

5.17. Furthermore, we agree with the CAA that the trajectory of recovery will depend, in large part, upon government policy[16], which **further supports an approach to setting a divisor based upon total capacity**, facilitating sharing of risk below this level in a manner that keeps incentives transparent, consistent and symmetrical

5.18. Additionally, **the CAA required that scenarios were developed by Heathrow, fully integrated across the building blocks, yet these have not been produced**: the sensitivities produced by Heathrow in its RBP signally fail to meet this requirement

[13] Civil Aviation Authority, CAP2139 para 2.13
[14] Ofwat PR19 reconciliations and final determinations models
[15] Ofwat PR19 dataflow of models
[16] Civil Aviation Authority, CAP2139 para 2.10

5.19. Without being able to understand what Heathrow would do in different passenger out-turn scenarios, there is a **risk that the price control cannot effectively cater for the volatility of any recovery demand** profile

5.20. **We therefore agree with the CAA's assessment that "traffic scenarios are not transparently integrated with other key elements of the plan**"[17]

5.21. We also **agree with the CAA's comments on certain issues that exist with Heathrow's forecasting methodology**; specifically, the apparent double-count of the impact of Covid-19, subjective weighting factors, and lack of disaggregation by market[18] that would allow other building blocks to be better-constructed

5.22. 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

5.23. 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

5.24. This is all the more important when using Heathrow's modelling suite, as models always reflect the biases of the modeller; **human nature is to use newer information not in accordance with objective methods set out by Bayes[19], but by over-weighting new information and under-weighting prior and longer-term information**[20]

5.25. Thaler and DeBondt noted that there is "**considerable evidence that** the actual expectations of professional security analysts and **economic forecasters display the same overreaction bias**"[21], building on Kahneman and Tversky's Prospect Theory, which noted "the **predicted value is selected so that the standing** of the case in the distribution of outcomes **matches its standing in the distribution of impressions**"[22]

5.26. Given these limitations, and having only seen the model's key assumptions and outputs as the modelling suite has not been shared with airlines, **increases our discomfort should the CAA use this to support a core part of the price control**

[17] Civil Aviation Authority, CAP2139 table 1.2
[18] Civil Aviation Authority, CAP2139 para 2.9
[19] As originally set out in Bayes, Thomas & Price, Richard (1763). "An Essay towards solving a Problem in the Doctrine of Chance. By the late Rev. Mr. Bayes, communicated by Mr. Price, in a letter to John Canton, A. M. F. R. S." (PDF). Philosophical Transactions of the Royal Society of London. 53: 370–418
[20] Bernstein, P. L. (1996). Against the gods: The remarkable story of risk. New York: John Wiley & Sons. Chicago, p. 292
[21] Werner F. M. De Bondt, & Thaler, R. (1985). Does the Stock Market Overreact? The Journal of Finance, 40(3), 793-805
[22] Tversky, A., & Kahneman, D. (1974). Judgment under Uncertainty: Heuristics and Biases. Science, 185(4157), 1124-1131

5.27. We continue to **believe that the recovery at Heathrow will be quicker than for many other markets** given airline consolidation of services at Heathrow from other airports, suggesting a faster pace recovery than might be possible in other markets

6. Traffic risk sharing

6.1. For the reasons set out above – that passenger forecasting is difficult in normal times, Heathrow being motivated to present unduly pessimistic forecasts, and that it is particularly difficult to forecast at present – **we might instead consider alternative approaches to mitigating forecasting risk**, whilst maintaining an appropriate level of incentives over Heathrow

6.2. Any change in the form of price regulation will have an effect on the incentives that Heathrow is exposed to, along with the distribution of risk between Heathrow and consumers; **there is a fundamental trade-off between any sharing mechanism and incentives to minimise operating costs**[23]

6.3. In addition, Heathrow are clearly unwilling to hold passenger volume risk to the same extent as in Q6, **demonstrated by their defeated request for an upward RAB adjustment of £2.8bn for revenues not earned** as a result of Covid-19

6.4. Any traffic risk sharing scheme must therefore result in a significant reduction in the Weighted Average Cost of Capital ("WACC"); **it would be unacceptable to offload the majority of tail risk to airlines – as proposed by Heathrow in its RBP** – and leave performance within a central dead-band unshared, since this would be a highly asymmetric assignment of risk around an already inaccurate forecast

6.5. Furthermore, the **design of any sharing mechanism may result in undesirable incentives at the ceiling and floor of any threshold**; for example, Heathrow might not seek to raise incremental commercial revenue, hold it back for a future regulatory period, or alter its price structure in a manner that conflicts with Ramsey pricing principles

6.6. Finally, any **risk sharing must ensure consistent incentives remain on Heathrow**; due to the design of the single till, these cannot become weaker when moving from the baseline average maximum yield per passenger, as it would otherwise result in significant misalignment of incentives over commercial revenues, in addition to accentuating potential Crew-Kleindorfer effects

6.7. **Heathrow's proposals based upon revenue risk sharing would result in outcomes that would be substantially inferior in certain scenarios**, which when combined with their proposed dead-band, could create highly perverse incentives in certain volume and revenue outcome combinations; this would be to the **detriment of the consumer as they would be over-charged for the actual risk borne by Heathrow**

6.8. It is therefore **essential to avoid significant disincentives for efficiency that price cap regulation is designed to eliminate, when designing any risk sharing mechanism**, and the CAA must demonstrate that any proposed mechanism achieves this

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[23] Sappington, D. "Price Regulation" in Cave, M. "Handbook of Telecommunications Economics", Vol1

6.9. We must be clear what the problem is that we are trying to solve before introducing any risk sharing mechanism; we suggest the following:

a) **Passenger forecasting** – as demonstrated, this is clearly difficult at present, and this must be the primary purpose of any risk sharing

b) **WACC pressure** – potential upward pressure on the WACC resulting from changes to market circumstances that may have resulted from Covid-19

c) **Heathrow's unwillingness to bear risk** – Heathrow's desire to be fully exposed to all volume risk is clearly lower than in the past

6.10. We suggest the following **principles that any risk sharing mechanism should be designed to achieve**:

a) **WACC reduction** – this should be substantial and quantified to reflect the significant risk that would be borne by consumers should risk sharing in any form be introduced; it would be **unacceptable to offload the majority of tail risk to airlines – as proposed by Heathrow in its RBP – and leave performance within a central dead-band unshared**, since this would be a highly asymmetric assignment of risk around an already inaccurate forecast

b) **Incentive consistency** – these must remain consistent across different outcome scenarios; this suggests risk sharing must be based upon traffic and cannot be based upon revenue, earnings or any derivative thereof: this will ensure the CAA avoid Crew-Kleindorfer effects and that **consistent incentives exist to develop incremental commercial revenues and minimise costs; a dead band of any form is also inconsistent with this principle**

c) **Efficiency of incentives** – Heathrow's incentives must remain efficient and consumer value maximised at different out-turn passenger volumes, reflecting a requirement that commercial revenues should be maximised, and operating costs minimised (subject to service quality incentives) in all out-turn scenarios, avoiding shoulder issues identified above; this suggests **sharing should be based upon a determination of efficient ex ante operating costs and revenue generation at different out-turn passenger volumes**: this is critical, and is **not** addressed by the CAA's proposed solution of revenue risk sharing[24], which would undermine incentives

d) **Symmetry of sharing** – Sharing must be **consistent and across the whole spectrum of possible passenger volume outcomes in order to be acceptable**; our previous modelling has suggested that sharing immediately from a central forecast on a 50:50 basis *after* scaling for efficient operating costs at out-turn volumes might be appropriate, though recognise that this is based upon information from Heathrow that may no longer be up to date

e) **Price stability** – Risk sharing could create significant price volatility if applied on an n+2 basis with little smoothing, Heathrow propose the use of the RAB on the downside

[24] Civil Aviation Authority, CAP2140 paragraph 4.8

but not the upside, which creates a lack of symmetry and potentially affects the financing incentives; this needs to be considered further alongside the interaction with the rate card structure, as fluctuations in the movement charge influence fleet investment decisions in particular

6.11. An alternative built upon these principles might **use a passenger number divisor that represented Heathrow's existing capacity**, which could minimise the risk of a Crew-Kleindorfer effect resulting, whilst ensuring pricing efficiency

6.12. By using capacity that represented the investment that has been made in Heathrow's assets to date, this would **remove any risk already seen in Heathrow's RAB adjustment request that it could attempt to artificially restrict capacity**, for example by keeping Terminal 4 closed for a prolonged period of time

6.13. Consistent and symmetrical incentives for efficiency would ensure Heathrow is **free to operate its business in response to any out-turn passenger scenario**, whilst out-turn **charges per passenger are adjusted to represent the ex-ante efficient outcome at that particular volume**, considering what efficient operating costs and commercial revenues might have been

6.14. The difference between an efficient outcome at full capacity compared an efficient outcome at the out-turn volume could then be shared at an appropriate level; this would ensure meaningful sharing, whilst **ensuring incentives remain effective and consistent at all potential out-turn volumes**

6.15. Other Regulated Charges **("ORCs") likely need to be scoped out of, any TRS mechanism** and the governance protocol surrounding ORCs updated to avoid any conflict with TRS implementation; furthermore, **pass-through terms in the charging formula need to be accounted for in the TRS design**, particularly capital contributions, rebates and business rates

6.16. We **agree with the CAA that a 95% sharing factor would leave Heathrow with "very weak incentives to increase traffic volumes or commercial revenues**" [25], and more importantly its non-application through the dead-band area means it is no more than a proposal for consumers to insure its business against tail risk

6.17. We note that Heathrow has altered this proposal to 86%, but this is still essentially tail risk insurance; **we are not interested in operating as Heathrow's insurer of last resort**, and Heathrow is welcome to approach an insurer to instead protect its returns from tail risks at a cost that should never be borne by consumers

6.18. An **important component of any risk sharing mechanism is understanding exactly how operating costs and commercial revenues scale** at Heathrow; it is clear that this is not straight-line, as the present closure of two terminals at Heathrow offer step changes in cost savings

6.19. It would be **inappropriate to allow capacity decisions to be gamed in a way that consumers would be affected**; the CAA appear to recognise this in their decision on

[25] Civil Aviation Authority, CAP2139 paragraph 4.13

Heathrow's RAB adjustment request, granting a £300m adjustment to ensure Heathrow is "taking proactive steps to prepare for a higher than expected increase in passenger traffic"[26]

6.20. Opening and closing of terminals must therefore be transparently incorporated into scenarios that inform any traffic risk sharing scheme, and adjusted appropriately to **ensure only efficient operating expenditure levels are incentivised at the appropriate level of capacity** that needs to be available

6.21. It is disappointing that Heathrow continue to be unwilling to develop full scenarios that would demonstrate how they actually plan to run the business in different forecast scenarios; a **rigid adherence to a central passenger forecast is unhelpful in this time of significant uncertainty**, and precludes more productive discussion on the operation of the airport were different outcomes to arise

7. Incentives

7.1. Incentives sit at the heart of regulatory economics; they are the only mechanism through which Heathrow's substantial market power can be controlled and **provide the only protection for consumers in the absence of effective competition**, particularly over operating expenses, capital investment and commercial revenue development in the single till

7.2. As noted by Thaler and Shefrin[27], **explicitly altering incentives** (if changing a firm's preferences or inputs are ineffective) **will alter behaviour** to mitigate the problem between long-term intent and what the firm might do in the moment

7.3. What is important to recognise in setting the price control is that we all have a "tendency to look at problems in pieces rather than in the aggregate"[28]; the **co-variance between the parts of the price control are therefore as important as its individual parts**

7.4. This explains why it is **critical to consider incentives over the whole price control** – particularly when designing a TRS – why it **cannot** incorporate dead-bands, and why **incentive properties over operating costs and commercial revenues must be considered at different out-turn scenarios**, and why revenue sharing remains inappropriate in a single till environment with a price cap based upon a maximum allowable yield per passenger

7.5. The issue of incentives extends to **Heathrow's attempts to design a TRS in the RBP that insulates itself from almost all tail risk**[29] whilst operating freely within a dead-band of its own design, in addition to **claiming that there would only be a minimal reduction in the WACC available for doing so:** this is unsound economics

[26] Civil Aviation Authority, CAP2140 paragraph 4.22
[27] Thaler, R., & Shefrin, H. (1981). An Economic Theory of Self-Control. Journal of Political Economy, 89(2), 392-406
[28] Bernstein, P. L. (1996). Against the gods: The remarkable story of risk. New York: John Wiley & Sons. Chicago, p. 289
[29] Heathrow H7 Revised Business Plan, p450 Figure 3

7.6. It is also **nonsensical to suggest that a TRS would only be credible if it were applied retrospectively to the existing Q6 licence**; incentives operate ex ante and the WACC is assessed upon a package based upon ex ante risks and incentives to which the firm is exposed

7.7. Heathrow's design of TRS is directly relevant to incentives, assessment of risk and portfolio theory that sits at the heart of the Capital Asset Pricing Model ("CAPM"), **since Heathrow would have us believe investors should not be exposed to tail risk** under the premise that infrastructure investors are seeking returns with low volatility, and that the price control should therefore be designed to reflect this desire

7.8. This is in **direct conflict with the economics at the heart of portfolio theory**[30] that underpins the construct of CAPM[31], where the **required return of any investment can only be considered in the context of a well-diversified portfolio**, not to mention that risk is of equal importance to expected return in pricing WACC

7.9. Heathrow's proposals might seem to be entirely rational from its perspective, given investors **suffer from the endowment effect**[32] **of already being committed and owning the business**[33]**; Heathrow's approach is entirely consistent with loss aversion**[34], particularly where existing risks were not fully appreciated in advance of Covid-19, and the CAA should be aware of the biases Heathrow is therefore motivated to display in its proposals

7.10. We are concerned that the CAA have been persuaded by Heathrow that it would only make investments in capital expenditure in 2021 of an additional £218m if it received a RAB adjustment[35]; this threat is not credible, and **we see no evidence that Heathrow is preparing to spend *any* additional money in 2021 in response to the RAB adjustment**, as set out in its recent June 2021 investor report[36]

7.11. **A well-calibrated WACC and incentive package will deliver exactly the correct value represented by the risk exposure of the price control**; Heathrow will continue to spend the right amount that secures the value of its sunk investment in the airport, and its insinuation that investors might not invest in the airport in future unless it receives its requested WACC, RAB adjustment and incentive package are not credible threats: instead, they artificially inflate the value of the business for investors to the detriment of consumers

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[30] The literature runs back to the classic paper by Markowitz, H. (1952). Portfolio Selection. The Journal of Finance, 7(1), 77-91

[31] A number of authors have contributed to the developed of CAPM, largely originating from Sharpe, William F. (1964). "Capital asset prices: A theory of market equilibrium under conditions of risk". Journal of Finance. 19 (3): 425–442

[32] Kahneman, D., Knetsch, J., & Thaler, R. (1991). Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias. The Journal of Economic Perspectives, 5(1), 193-206

[33] Shefrin, H., & Statman, M. (1985). The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence. The Journal of Finance, 40(3), 777-790

[34] Tversky, A., & Kahneman, D. (1991). Loss Aversion in Riskless Choice: A Reference-Dependent Model. The Quarterly Journal of Economics, 106(4), 1039-1061

[35] Civil Aviation Authority, CAP2140 paragraph 4.22

[36] Heathrow (SP) Ltd Investor Report, June 2021: forecast capital expenditure profile, p5

7.12. We believe **any re-openers should be well-specified ex ante to ensure that the incentives within the price control remain clear and consistent over time**; limited use of Notified Items may allow easier re-calibration of specific incentives in particular circumstances, but **in general properly-calibrated incentives should remove most need for any formal re-opening mechanism**

8. Operating costs

8.1. To inform work on OBR and as an important building block in its own right, the CAA needs to progress work on understanding the detail of Heathrow's cost base; as a result of Covid-19, the **information provided in Heathrow's investor reports and accounts offers an opportunity to better-assess the true variability of operating costs** in different demand environments

8.2. We remain available to speak with the CAA's consultants to help them assess Heathrow's cost base in depth; the **information provided to date by Heathrow in its business plans does not allow for sufficiently-detailed analysis to take place**, and therefore a more detailed bottom-up assessment is required as a priority

8.3. Without another fully regulated UK airport available against which to benchmark Heathrow, the **CAA must be careful not to be persuaded by Heathrow's arguments that it is efficient on the basis of its self-commissioned econometric analysis** against non-UK airports with significantly different business models

8.4. Not only are airports in general not particularly efficient, **none of the comparator airports are regulated on the same basis, so cannot provide an efficiency comparison** that is appropriate to the UK and CAA's longstanding incentive regime; it also **ignores specific efficiencies promised to airlines at Heathrow through capital investment** and creates a gaping allowance for Heathrow to game its incentive

8.5. In addition, there is are **no apparent adjustments for service quality in Heathrow's analysis**, which would likely suggest Heathrow is even less efficient once appropriate adjustments have been made

8.6. In light of this, the CAA should consider its approach to regulation, taking into account the fact that by nature, **immovable local monopolies are unlikely to ever be in effective competition**, and airports likely need to be considered as part of a greater system whose regulatory regime should match the reality of its capacity constraints and utilisation

8.7. Were cost information from other UK-based airports under similar regulatory regimes available, the **CAA's work on Heathrow's operating costs would be easier with a direct comparison available to shine light on Heathrow's true efficiency**

8.8. As noted by the CAA, Heathrow has forecast operating expenses to fall by less than the fall in passenger numbers, raising operating costs on a per passenger basis as a result; whilst it may not be unreasonable that some costs are fixed and other variable, **due to Heathrow's use of an econometric model, there is insufficient detail to analyse the cost base and effectively determine its appropriateness**

8.9. Furthermore, the **lack of any meaningful scenario analysis means Heathrow has not presented detailed plans of how it proposes to manage operating costs** in cases of lower or higher passenger volumes; the CAA's business plan guidance sought to understand what specifically Heathrow planned to do in different scenarios, yet we are left with little to understand how it would act in practice

8.10. **Operating costs for the purposes of a price control must be built up based upon detailed cost analysis**, taking into account the efficiencies gained over the course of the previous control period, and those savings Heathrow should be accountable for delivering as a result of capital investment projects over the same time

8.11. The **use of econometric models does not substitute for detailed cost plans required to be submitted** by UK regulated companies in other industries as part of those periodic reviews; Heathrow cannot be permitted to avoid the required level of transparency in detailing its plans for operating costs

8.12. Heathrow's **econometric approach remains inappropriate to establishing any appropriate level of operating costs for the purposes of the H7 price control**, and we continue to ask that detailed, bottom-up forecasts are developed based upon actual, planned activities across its business

8.13. We agree with the CAA that there is a **risk that expansion costs need to be transparently removed from** the 2019 base year from which Heathrow's forecasts have been developed, and that there is **little justification for upward cost overlays**[37] **as noted by the CAA**

8.14. This presents an **immediate risk in relation to the CAA's policy in relation to expansion costs**, which we address further in our response to CAP1996

8.15. Furthermore, we disagree with Heathrow that its chosen base year of 2019 represents the best it can achieve in terms of efficiency; **it is never fixed, and should be instead considered an ongoing process of continuous improvement**

8.16. The restructuring of Heathrow's business in response to Covid-19 along with statements made in its investor reports[38] **demonstrate the fallacy of the assumption that 2019 was already efficient**; during the past year, Heathrow restructured legacy employee contracts, driving out substantial costs in a process that substantially undermines the conclusions of its own efficiency reports commissioned before Covid-19

8.17. This is in addition to the **serious questions at the time from airlines and their consultants as to the robustness of modelling**, sample selection and conclusions raised in Heathrow's report on efficiency raised both during constructive engagement, and in subsequent airline community submissions

8.18. **Operating costs must be justified based upon demonstrable needs to determine the allowance for a price control**, challenging the existing structure and addressing underlying fundamental assumptions; Heathrow must demonstrate what expenditure drives

[37] Civil Aviation Authority, CAP2139 para 2.21
[38] Heathrow (SP) Investor Report: June 2021

consumer value, justify their appropriateness, and act to reduce any other costs that cannot be justified

8.19. We note for example that the accounts for FGP Topco Ltd disclose – under employment costs – that these **services are provided to Heathrow Airport Ltd at a mark-up of 7.5%, and that all employees of the Group are employed by LHR Airports Ltd**[39]; this presents a significant issue in relation to assessing the true, efficient cost of providing those services when presented with information at the level of the regulatory accounts based upon Heathrow (SP) Ltd or Heathrow Airport Holding Ltd, and the use of financial reporting exemptions to take advantage of the regulatory regime: related party transactions must be transparent

8.20. In general, we do not support the use of unjustified overlays; having established an appropriate level of operating costs on a fundamental basis, **step changes in costs and benefits from capital investment initiatives should be linked to other building blocks and be fully incorporated within core operating costs**

8.21. We therefore **support the CAA in using fundamental analysis to establish operating costs** e.g. those of specific contracts, unit cost or headcount analysis, and incorporating the bottom-up efficiencies associated with capital expenditure projects[40]

8.22. It may be valuable to ensure that regulatory accounts report and track the spending categories required to accurately set the price control in future; whilst this should be considered when updated requirements are put in place after the start of H7, **any required update to the transparency condition should also be considered**

8.23. **We support the cost of change initiative to deliver ongoing cost improvements through restructuring** during 2020 and 2021, benefitting the airport charge by reducing operating costs by agreed amounts; **Heathrow must ensure these agreed amounts are transparently modelled and included within operating cost forecasts**

8.24. To effectively deliver benefits for consumers, we **support the CAA in developing a form of ongoing reporting**, which will allow effective monitoring of the proposal

9. Commercial revenues

9.1. Heathrow has forecast commercial revenues that are significantly less on a per passenger basis than at present, yet has again **used an econometric model with insufficient detail to analyse what its commercial revenue generation plans will be over the course of H7**

9.2. With the change to the UK airside VAT regime being presented simply as an overlay, **Heathrow has offered no objective analysis of the effect of the VAT change based upon types of passenger, categories of outlet or commercial business model**

9.3. It is our belief that the **impact of VAT at many outlets is significantly lower than Heathrow's projections** due to existing high margin nature of many luxury good sales, and

[39] FGP Topco Ltd, Annual report and financial statements for the year ended 31st December 2020
[40] Civil Aviation Authority, CAP2139 para 2.28

the fact that Heathrow disclosed to investors that there was significant competitive interest in the retail space freed up by Dixon's exit[41]

9.4. Our comments on commercial revenues are similar to those on operating expenses, with a conclusion that **Heathrow has not yet presented a robust business plan upon which to base a price control**; we have not seen sufficiently detailed and objective analysis to support its use of negative overlays, and forecasts need to be fully integrated with other building blocks across scenarios

9.5. Fundamentally, Heathrow's approach has prevented any linkage between commercial revenues and capital expenditure from being established in any transparent manner, and we therefore **agree with the CAA that "links between opex and commercial revenues and the capex plan are not well evidenced"**[42]

9.6. We recognise that **Heathrow has historically been a strong performer in the development of commercial revenues**, and we expect a continued flow of strong revenue generation ideas to be articulated in H7 capital investment programmes

9.7. We are therefore disappointed that Heathrow has failed to demonstrate any substantive link between capital investment and further commercial revenue generation, and has in fact subsequently presented **capital investment cases for H7 that provide inadequate returns on investment and are therefore in stark contrast with its achievements to date** in this area

9.8. Heathrow's plans within its RBP for commercial revenues have been unambitious, presenting negative effects and few positive upsides; **Heathrow has a strong track record for the development of commercial revenues, and its ability to outperform in the past must be considered** when setting the H7 price control

9.9. To believe Heathrow's RBP, this strong track record cannot be projected into the future, and the skill shown in negotiation with commercial business partners has evaporated as a result of Covid-19; we do not believe this is the case, and **commercial revenues must be understood from a fundamental assessment of the business models it operates with its commercial partners**

9.10. We therefore agree with all the CAA's conclusions in this area[43]and **urge the CAA to follow through on its assessment of commercial revenues by category**, with bottom-up analysis informed by appropriate, objective analysis, fully-evidence and integrated with models of modal share across different revenue categories

9.11. We remain concerned that mode share targets as set out for expansion under the ANPS might no longer remain appropriate at a two-runway airfield, and we urge the CAA to ensure any modelling that stems from this model is transparent; we **also request transparency over this model alongside that for passenger demand**

[41] John Holland-Kaye's comments in the live investor presentation of Financial results for Heathrow (SP) Limited on Thursday 29th April 2021
[42] Civil Aviation Authority, CAP2139 table 1.2
[43] Civil Aviation Authority, CAP2139 para 2.37-2.41

9.12. We also **highlight our concern that cargo flights might not appropriately captured in the maximum allowable yield**; access rights to Heathrow are fungible and could be operated by either passenger or cargo aircraft (or passenger aircraft operating as freighters), therefore it may be appropriate to consider how this is incorporated in future, and at a minimum must be a separately modelled commercial revenue

9.13. During Q6 we have gradually seen Heathrow shift the structure of charges in annual rate card consultations, increasing landing and aircraft parking costs; this has **allowed Heathrow to benefit at the expense of the single till from higher cargo revenues** than envisaged

9.14. Similar to our note above, it may be valuable to ensure that regulatory accounts report and track the detail of commercial revenue categories required to accurately set the price control in future; whilst this should be considered when updated requirements are put in place after the start of H7, **any required update to the transparency condition should also be considered**

9.15. We note that Heathrow is pursuing Forecourt Access Charging as a new commercial revenue stream for H7; airlines have expressed deep misgivings over many aspects of this project in governance, and it **presents a number of regulatory treatment concerns that should be addressed for H7**

9.16. Specifically, the **ability of Heathrow to re-price leads to a potentially large impact on consumers**, particularly if Heathrow raises charges significantly above inflation; the incentive nature of commercial revenue generation would allow Heathrow to collect the entire upside in such a scenario, and there **appear to be few regulatory constraints at present to protect consumers over such increases in charges**

9.17. This mirrors the situation on Other Regulated Charges at present, where under-recoveries as a result of Covid-19 could lead to huge unit price increases, and there is **no regulatory mechanism available to control prices to which consumers of services are exposed**

9.18. We believe that the single till incentive mechanisms should be retained as far as possible, so would be concerned by any proposed hypothecation of particular revenue stream that could undermine incentives; nevertheless the **operation of pricing changes needs to be undertaken in a clear manner that is consistent with protecting the consumer and ensuring incentives are effective** in different demand scenarios

9.19. This is all the more **important if a TRS scheme is designed in a way that ensures Heathrow is measured against efficient commercial revenues at out-turn passenger volumes**; in addition, revenue risk sharing (which is already undesirable) would be further undermined by Heathrow's ability to price itself out of any sharing band through using forecourt access charging to fund any deficits

9.20. **Resilience is a matter of critical importance to British Airways and we remain supportive of developing specific proposals with Heathrow and the CAA**; we note that this work has yet to take place

10. Other regulated charges

10.1. Extensive work has been undertaken on Other Regulated Charges ("ORCs") between Heathrow and airlines over the course of the past year, with **proposals to restructure these charges in H7 to move to a more marginal cost-based approach**

10.2. Whilst we agree with the CAA that some further work to be done on how ORCs would be included within any risk sharing mechanism, it is **important to also define an updated governance process to account for difficulties experienced at present** as a result of Covid-19, and the **transparency condition should be updated to provide greater oversight of contracts and costs** within ORCs

10.3. We **agree with Heathrow that annuities from the RAB and allocated costs should be removed from ORCs**; they do not form the basis of productive conversations in governance, since they are fixed and cannot therefore be reduced through contract re-negotiations

10.4. As a result, ORCs do not reflect marginal cost-based pricing at present, therefore moving these to the aeronautical charge will **result in pricing that better-reflects the marginal costs of providing the service**

10.5. We are **supportive of check-in costs (including automation) and IT services being moved to aeronautical charges** as these are now a standard necessity for all airlines and their customers; however, this **must be complemented with appropriate service quality standards to protect service levels**

10.6. We also recommend – as noted in the ABP – that **certain other direct costs currently classed as operating costs also be removed as they are not able to be influenced by ORC governance**; these include rates and depreciation in baggage, and fixed electricity costs in FEGP and PCA

10.7. However, **we do not agree that business rates should form a separate ORC**; these are unrelated to the operational conversations that take place in ORC governance

10.8. **Business rates should remain a cost pass-through in the charging formula** (adjusting the annual price cap as at present), though we agree with Heathrow that enhanced governance should be introduced to bring relevant stakeholders and experts together; this will enable Heathrow and airlines to come together biannually to challenge the council's estimates of rateable value

10.9. We **remain opposed to CAA fees being either an ORC or direct cost pass through**, as the fee is based upon certain activities that Heathrow undertakes and controls; **Heathrow must remain accountable for managing its costs and cannot incrementally change all of its costs to a pass through mechanism** to avoid incentive regulation

10.10. We agree with the CAA that the governance mechanism and the treatment of any over- or under-recovery needs to be updated; in light of the difficulties experience during the Covid-19 pandemic, the **arrangements need to cater for more extreme variations than those normally experienced, and must dovetail with any TRS**

10.11. Nevertheless, the **changes proposed for ORCs to a marginal cost structure means that any extreme variations should be proportional to cost variations** and thus resulting in minimal over and under recoveries in future

10.12. Similar to our note above, It may be valuable to ensure that regulatory accounts report and track the detail of other regulated charge categories required to accurately set the price control in future; whilst this should be considered when updated requirements are put in place after the start of H7, **any required update to the transparency condition should also be considered**

11. Capital plan

11.1. As we have previously stated, **we have few major capital investment priorities for the H7 period due the required recovery period from the Covid-19 pandemic**; as a core building block alongside the RAB in the price control, we cannot sanction investment that is not necessary from our perspective in this price control period

11.2. Our priorities at a high level are that **the airport continues to operate, efficiency of airline and airport operations continues to improve, and our past capital investments in the RAB are protected** for use in the future; in conjunction with well-defined consumer outcomes, we are engaging with Heathrow to better-define what investment priorities might result

11.3. Nevertheless, we **recognise that flexibility is essential due to potentially different recovery profiles that might result in the H7 period**, and we are supportive of Heathrow in ensuring that we can step up or down to different levels of capital investment should it be necessary to do so

11.4. We also **remain supportive of the CAA's intent to introduce incentives for capital efficiency as a core part of the H7 price control**; we recognise the significant work that has taken place to implement this in practice, and will continue to work with Heathrow and the CAA to define the incentive

11.5. Our priority remains to ensure that **we have appropriate oversight** of Heathrow's capital investment programmes, allowing definition of outcomes and **holding Heathrow to account on cost and delivery**

11.6. Heathrow's H7 capital plan in the RBP of £3.5bn was **not well-defined, with little description of substantive deliverables or outcomes**; as a result, there was originally little of substance to assess within those programmes

11.7. We therefore **agree with the CAA that "the RBP capex plan lacks evidence and required detail"** and that "the **top-down capex plan does not provide a basis for setting a core capex allowance or baseline for H7**"[44]

[44] Civil Aviation Authority, CAP2139 table 1.2

11.8. Furthermore, **we agree that Heathrow's RBP does not define delivery objectives or obligations** that can be used for the H7 capex incentive framework"[45], and is not therefore sufficiently well-developed in this area: see our detailed comments later on this topic

11.9. We **recognise that Heathrow has engaged with the CAA and airlines to better-define its capital programme in recent months**, and we are committed to continued engagement in this process

11.10. **We are concerned by the reality that all capital investment could be treated as development**[46]; this outcome could be to the detriment of consumers if Heathrow is unable to articulate a sufficiently mature capital investment plan

11.11. Furthermore, **moving large capital values from development to core capital expenditure within the price control could result in large adjustments to the annual charge**, making airline financial planning for the whole of the H7 price control period particularly challenging

11.12. The CAA is correct that **no capital expenditure other than an "efficient estimate of the required expenditure** to deliver outputs required by airlines and consumers"[47] should incorporated into any price control; whilst **we cannot at present foresee a requirement for many large, capital projects** aside from T2 future baggage and Mandated Security, we will always consider incorporating any well-defined project that delivers value for consumers

11.13. **The RAB should only represent historic, logged-up and efficient capital expenditure**, indexed to preserve value, forming a component building block of the airport charge through depreciation and cost of capital charges, exposed to volume risk

11.14. At any time, the level of the RAB is correct based upon the value derived by consumers from investment that has taken place; there is neither an obligation on the CAA for the RAB to be at any particular level, **nor does Heathrow have a right to a particular level of RAB if it is not supported by required capital expenditure**

11.15. We **support the CAA in using updated evidence** from Heathrow's business plan in June alongside working with Arcadis to develop independent estimates based upon available information, **focussing on a core capital requirement to safely maintain and operate the current airport infrastructure**[48]

11.16. **Leadership and logistics can no longer be permitted as a blanket allowance at a fixed percentage** that is neither reflective of actual support costs, nor is incentivised to ensure efficiency in project delivery; this must be rectified in the H7 regulatory framework and integrated into the ex-ante capital efficiency incentives

11.17. Capital planning itself could benefit from opening up to greater competition, supporting the government objective to "ensure that **new infrastructure is delivered in the most**

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[45] Civil Aviation Authority, CAP2139 table 1.2
[46] Civil Aviation Authority, CAP2139 para 2.57
[47] Civil Aviation Authority, CAP2139 para 2.58
[48] Civil Aviation Authority, CAP2139 para 2.60

efficient and appropriate way…competition should be harnessed as the most reliable means of supporting innovation and providing enhancements to economic infrastructure"[49]

11.18. This supports use of new economic models, similar to Thames Tideway Tunnel ("TTT") that **allows competitive forces to play a greater role in defining and delivering capital expenditure plans**

11.19. We also continue to ask the CAA to investigate the scope for Heathrow to better-realise value from its £2.1bn of investment assets[50], justifying their continued ownership for operationally critical use or their financial contribution, which appears to be just £78m in 2020; **if they cannot be justified on this basis, they should be sold to realise cash and reduce the value of the RAB**

12. Capital efficiency incentives

12.1. We **continue to support the CAA's broad approach for capital efficiency incentives as set out in the June 2020 consultation**; an ex ante incentive framework is critical in promoting efficiency in capital spending, and remains appropriate for H7

12.2. In particular, we **support assessing performance against evolving baselines** that reflect more accurate capital expenditure requirements and cost information[51], **setting delivery obligations for each capex category** so Heathrow is held to account against agreed delivery obligations[52], **and combining cost incentives and delivery obligations** to develop arrangements that best protect the interests of consumers

12.3. Furthermore, **we agree with the CAA that the price control should flex in line with emerging investment requirements**[53], and understand **tramlines might better act as upper and lower bounds for certain capex categories**[54], since the core and development framework for project-level investment decisions is not intended to facilitate significant step changes between capex envelopes[55]

12.4. We **agree with the CAA that a 15% incentive is not sufficiently strong for the purpose of capital efficiency**[56]**;** Thames Tideway Tunnel ("TTT") uses at rate of 30% on underspend and 40% on overspend[57], which is a far more appropriate incentive for large-scale infrastructure projects that are undertaken by Heathrow, and we note that CEPA consider a 25% incentive as only being moderate in strength[58]

[49] National Infrastructure Strategy, p.75
[50] Heathrow (SP) Ltd Annual report and financial statements, 31st December 2020
[51] Civil Aviation Authority, CAP2139 para 4.31
[52] Civil Aviation Authority, CAP2139 para 4.33
[53] Civil Aviation Authority, CAP2139 para 4.38
[54] Civil Aviation Authority, CAP2139 para 4.39
[55] Civil Aviation Authority, CAP2139 para 4.40
[56] Civil Aviation Authority, CAP2139A, Appendix M – Capital Efficiency Incentives, para 9
[57] CEPA, Possible ways of implementing ex-ante efficiency incentives for Heathrow's capital expenditure, March 2019
[58] Ibid.

12.5. The design of how this applies on overspend or underspend should be **optimised to ensure that gold-plating is avoided, and that estimates reflect competitive**, market-based estimates of costs established through tendering; this might support the differential rates used by TTT, which is likely to be appropriate for Heathrow given how risk allocations are managed at present

12.6. The **specific incentive rate and symmetry of any incentive should be defined to incentivise the most appropriate procurement strategy for H7** noting the different models available under NEC contracts[59], noting that in the past, NEC3 Option C was most often used to attempt to incentivise cost efficiency[60]

12.7. As the CAA note, **Heathrow's capital plan in its RBP was relatively undeveloped, and we agree with many of the conclusions the CAA has reached on Heathrow's proposals**; as a result, we continue to work closely with Heathrow to better-define its capital programme, since capital efficiency incentives are long overdue and must be introduced for the H7 price control

12.8. We are **not supportive of Heathrow's alternative capital framework as set out in its RBP, particularly in applying incentives only to a subset of the capital programme**; specific delivery obligations are a core part of the proposed framework, and Heathrow's proposed streamlined governance process removed much effective airline oversight as compared to the existing Gateway structure

12.9. Additionally, **we refute the suggestion that ex ante incentives would result in worse outcomes for consumers were costs to rise due to higher cost estimates**; the point of capital efficiency incentives is to establish the right level of costs upfront and hold Heathrow to account for their delivery with the incentive

12.10. Were costs to be significantly higher than expected under an ex ante capital efficiency incentives, **rather than being automatically burdened with the cost** – as consumers are today since ex post assessment of inefficiency are not an effective means of controlling costs – **airlines would have a transparent cost estimate for a project to allow that project to be accepted or rejected at the appropriate Gateway** in the capital governance process

12.11. Under effective capital efficiency incentives, the project would therefore either progress based upon a **transparent and established cost, outcome and time estimate**, or the project would be halted, reassessed or cancelled before spending proceeded, **preventing costs spiralling out of control**

12.12. Nevertheless, we recognise that Heathrow is trying to establish how exactly to implement the CAA's proposals; **bridging the gap between the proposals and governance is critical to ensuring practical implementation is possible**

12.13. We agree with the CAA that **capex categories – however defined by Heathrow – must be those projects that are subject to common risk, outputs or objectives**, with similar levels of risk and controllability

[59] NEC4 available contracts
[60] CEPA, Possible ways of implementing ex-ante efficiency incentives for Heathrow's capital expenditure, March 2019

12.14. This **categorisation by Heathrow should be relatively straightforward based upon corporate knowledge of how risk money has been utilised in the past**, gained from previous project experience and risk management

12.15. We agree with the CAA therefore that **each category should have a clear definition prior to the start of H7**, with a vision describing the purpose of the spending, clear objectives, outcomes, benefits and risks at sufficient granularity that allows airlines a decision on whether such a category is worth pursuing

12.16. These **must be more than high-level statements of intent, but contain sufficient detail** to enable assessment of the cost categories and "ensure oversight of any changes that occur compared to the initial plan"[61]; examples of the level of definition likely to be required were set out by CEPA in their work[62] for the CAA on ex-ante incentives in 2019

12.17. As noted by CEPA in that report "**detailed delivery obligations reduce the ability for the regulated entity to 'game' the incentive** by earning rewards for capex efficiency that are due to reductions in scope (either in volume or in quality)"[63]

12.18. It is therefore **essential that the delivery objectives set out for each capex category become detailed delivery obligations when the baselines are finalised** during the H7 price control

12.19. We note that Heathrow has suggested that there should be no delivery obligations for its asset replacement programme; **this would defeat the point of capital efficiency incentive, removing its effect entirely**

12.20. The SQRB scheme and its proposed replacement are designed to ensure that Heathrow does not excessively reduce operating costs in delivery of its service in areas deemed critical to the airport operation; **this has nothing to do with the efficiency of capital expenditure programmes**

12.21. We note the CAA suggest that triggers would not be needed for most capex categories as the new framework would incentivise for timely delivery; we agree that **this should be the case, but only if delivery obligations are sufficient in isolation and specified for time, quality and output** alongside the cost incentive itself – otherwise the airport charge would be based upon an asset incorporated within the RAB that derived no benefit to consumers

12.22. This is particularly the case **where projects are co-dependent within a capex category; triggers may still be required to ensure timely delivery of such projects** in addition to any specified delivery obligation at category level: such projects must have clear contribution to the overall capex category delivery obligations, and this **must be well-articulated, particularly where projects enable later projects** to take place

[61] Civil Aviation Authority, CAP2139A, Appendix M – Capital Efficiency Incentives, Table M1
[62] CEPA: Possible ways of implementing ex-ante efficiency incentives for Heathrow's capital expenditure, March 2019
[63] Ibid.

12.23. However, we are **not convinced that an additional 10% reward for early delivery is appropriate on a timing trigger**; these triggers are most likely required on complex projects that are co-dependent enabling projects for later works: early delivery is unlikely to derive any tangible consumer benefit, whereas late delivery would have a direct impact on the ability to initiate any subsequent work on a follow-on project

12.24. **We agree with the CAA that wider timing incentives over capex categories should be incentivised through the ex-ante incentive arrangement** on projects that do not have associated triggered projects, since this will be achieved through appropriately defined delivery obligations

12.25. Furthermore, **we support the CAA on ensuring NPV neutrality through making financing cost adjustments when incentives are reconciled**; this will ensure the incentive remains at a consistent strength throughout H7

12.26. It may be the case that during the course of investment in a capex category, priorities change or there is a decision to no longer proceed with a certain category of capex; **capex categories and enhanced governance therefore need to cater for project termination, particularly if cancellation is based upon an inability to achieve established delivery obligations** in order to avoid gaming

12.27. The enhanced governance arrangements should also **require capital projects in the near future to be more defined than those more distant projects within a capex category, updated on an ongoing rolling basis**; this would enable airlines and the CAA to have greater visibility of the pipeline of projects required to achieve certain delivery obligations at capex category level

12.28. It is our view that the CAA needs to have an enhanced role in the governance arrangements during H7, particularly during the introductory phase of the new arrangements; this will **ensure that projects, delivery obligations and capex categories are appropriately documented** to enable the appropriate reconciliation to take place and adjustment for the final baseline made

12.29. To that end, **we support the CAA's use of its own technical advisors to supplement the role of the Independent Funds Surveyor ("IFS")** if Heathrow is unable to provide sufficient information as part of the periodic review process

12.30. **Heathrow need to develop programme structures that dovetail with the CAA's proposed capex categories** and set out clear outline structures for projects within each category; we are concerned that for larger projects, waiting until all projects have proceeded to Gateway 3 ("G3") before resetting the baseline may undermine the incentive – **the project and risk profile of the capex category will define the most appropriate interval for updating the baseline**, which will likely be different for each capex category

12.31. In order to ensure that the capital efficiency incentive is effective, the reconciliation process needs to be able to transparently and unambiguously assess whether delivery obligations were met in the capex category, and the stated benefits delivered; **Heathrow needs to be measurable and accountable for its business cases as presented at G3, represented in the final baseline**

12.32. When setting capex baselines, the proposals at present note that projects not taken through G3 are still added to the RAB based upon the development spending incurred; one key problem at present is that there is **little clear ability for airlines to stop projects in governance if they do not offer any apparent benefits**, or we disagree with Heathrow on spending priorities

12.33. Any **speculative spending that has never and does not ever achieve airline support should be treated as an operating expense at Heathrow's own sole risk** if it does not result in any actual capital investment (similar to accounting treatment under Generally Accepted Accounting Practices ("GAAP") for research spending)

12.34. We **support CAA proposals to adjust baselines based upon explicit airline agreement through enhanced governance**; the transitional arrangements and backstop reconciliation proposals appear sensible at this stage

12.35. Similar to our note above, it may be valuable to ensure that regulatory accounts report and track the detail of capex categories in future; whilst this should be considered when updated requirements are put in place after the start of H7, **any required update to the transparency condition should also be considered**

13. Outcomes based regulation

13.1. Service quality remains an important aspect of Heathrow's price control, being the **only effective mechanism to ensure service delivery standards are upheld**, and Heathrow does not use the incentive created by the price cap to reduce operating expenses to an inappropriate level below that required for effective delivery

13.2. We **continue to support the CAA on the introduction of Outcomes Based Regulation ("OBR")** that will refresh the existing Service Quality Rebates and Bonuses ("SQRB") scheme to **better align with consumer outcomes**

13.3. Nevertheless, there **needs to make significant progress to ensure measures are in place in key operational areas, to ensure they are properly measured**, unlike the situation today where the incentive has now become ineffective

13.4. With the best will in the world, **Heathrow and airlines are naturally in opposing places as to the strength and placement of the incentives** that should exist over Heathrow's business in the next price control period

13.5. This is since **any incentive places a direct constraint on Heathrow's freedom to manage its operating costs**, a freedom it has continued to seek throughout the Covid-19 crisis in order to effectively manage its cost base without constraint

13.6. The **CAA should be wary of any claims by Heathrow that the cost of measurement is requires significant additional capital investment or operating expense to achieve**; whilst some measures might not be readily achievable, Heathrow must be transparent in the information it already gathers, and equally proposals should be reconsidered if costs of compliance are truly excessive

13.7. We will continue to work with Heathrow and the other airlines engaged in the H7 periodic review to identify our exact areas of difference, however the **CAA must also be prepared to gain a sufficiently deep understanding of airlines' operational requirements and how those translate into Heathrow's operating costs** to ensure the incentive remains appropriate, consistent and balanced

13.8. Heathrow has engaged with consumers in an attempt to define consumer priorities as part of a move to more consumer-focussed Outcomes Based Regulation ("OBR"); we recognise that the **RBP presents an update of this to account for Covid-19 and attempts to draw appropriate conclusions** from the evidence

13.9. Nevertheless, we agree with the CAA that this does not appear to follow through to form a consistent basis for its plans, and instead operates more as a standalone piece of analysis; **Heathrow would be better-served by attempting to understand the intricacies of the consumer journey**, and using its work to understand how it can jointly deliver with airlines a continuously improving and integrated experience for consumers

13.10. Associated with this, the replacement measures for the Service Quality Rebates and Bonuses **("SQRB") scheme presented by Heathrow would have undermined the existing incentive structure and rewarded Heathrow** for no tangible service quality improvement; we therefore agree with the CAA that "proposed targets and incentives would result in a more generous service quality framework"[64]

13.11. Our priority is to ensure that incentives are in place to **support and continuously improve the experience of each and every passenger through any new framework**; in particular, this means that measures should apply at an individual passenger, departure or experience level as far as possible, and are not averaged or smoothed over months or across a broad set of infrastructure

13.12. We support the CAA's stated aims for OBR, particularly that the measures should "**cover all aspects of airport operations that are either directly <u>or indirectly</u> important to consumers**"[65]

13.13. Furthermore, it is **important that continuous improvement should be incorporated into the framework** to ensure that it can evolve periodically to reflect the "outcomes and quality of service that consumers expect and value"[66]

13.14. Given previous SQRB measures typically average across a number of days and assets, we are keen to ensure that replacement OBR metrics are **focussed as much on the individual passenger experience, with each passenger, flight or activity as valuable as each other, measured at a granular level when the service is needed** and not over a 24 hour period when services are not utilised

13.15. We **support the CAA's initial analysis of Heathrow's proposals**, though we note the 7% downside range could be better calibrated if the actual operating cost of delivering such services were better understood through the operating cost workstream

[64] Civil Aviation Authority, CAP2139 table 1.2
[65] Civil Aviation Authority, CAP2139 para 5.6
[66] Civil Aviation Authority, CAP2139 para 5.8

13.16. We are **engaging with the airline community on delivering a joint report with Heathrow** on areas of agreement or disagreement on potential OBR measures

14. Financial framework: capital structure

14.1. The financial framework is a fundamental part of the price control, setting out the **risk allocation between Heathrow and consumers, which has a direct bearing on the incentives** under which Heathrow can operate its business

14.2. It is important from our perspective to ensure that **incentive regulation continues to have a sufficiently consistent effect over Heathrow's operating costs and commercial revenue development**; we recognise that the detail of the price control can have important effects on the incentives of the regulated firm, particularly to fund an efficient level of investment

14.3. We agree with the CAA that developments since the previous consultation conducted in June 2020 may warrant a change in approach to the development to the financial framework[67]; nevertheless, **we do not wish to see incentive regulation undermined or weakened by any potential developments**

14.4. The **financing incentive on Heathrow must remain in force and consistent**; Heathrow's response to financial pressures to date as set out by the CAA[68] are entirely appropriate given a clear and fixed ex ante incentive to manage its debt in the circumstances

14.5. We **agree therefore that the broad approach to a financial structure based upon a notional company should continue**; this is consistent with the approach in most of UK regulated utility sectors

14.6. We note that **the challenge facing the CAA surrounds how the assumptions for losses are now addressed** in order to establish the opening balance sheet for the notional financial company for H7

14.7. We note the two approaches[69] to the notional company set out by the CAA, being:

a) **Restoring equity reserves**, to target 60% gearing at the start of H7, or;
b) Issuance of **new debt**, implying higher gearing at the start of H7

14.8. Equity reserves may naturally be **increased either through not paying distributions as dividends, or alternatively by injecting new money** to bolster the balance sheet reserves of any company

14.9. The **CAA set out barriers[70] to issuing new equity, being the cost of issuance and a potentially higher cost of equity** in the H7 period, and that equity reserves are instead supported by not paying dividends alongside issuance of debt

[67] Civil Aviation Authority, CAP2139 para 3.9
[68] Civil Aviation Authority, CAP2139 table 1.2
[69] Civil Aviation Authority, CAP2139 para 3.17
[70] Civil Aviation Authority, CAP2139 para 3.17

14.10. As a result, the **CAA assumes that gearing would have increased to around 67% at the start of H7**; this would result in one of the highest notional gearing levels of any recently published UK regulatory settlement[71]

14.11. Linked to our later comments on the RAB adjustment, once the CAA's assessment of the notional company's financial structure is completed alongside the remainder of the H7 package, the **CAA should set out these calculations and benefits in a transparent manner to ensure that they can be fully reconciled**

14.12. We remain concerned that a reconciliation of outperformance over Q6 has yet to be completed, which will further alter any assumptions over the position of the notional company before the start of the Covid-19 pandemic; this is **important as it would ensure that notional company incentives remain consistent**, particularly when RAB adjustments have an overspill effect on the real company

14.13. It would be **useful for the CAA to set out a clear position on additional financing, particularly if it diverges from the existing 60%/40% debt to equity mix used for the notional company**, alongside a clear cost of issuance for new equity that may be required to support the notional company in future

14.14. Were injections assumed with a **mix of debt and equity that is consistent with the notional company's gearing assumption, notional gearing should not rise in response to either profits or losses** and gearing would remain consistent both in good times and bad times; this approach would appear to be more symmetrical, ensuring the financing incentive is constant over the period of the price control

14.15. We note that a notional gearing range of 52.5% to 60% was developed from analysis in the previous Flint global report[72], a **level that may or may not now be appropriate, and certainly may not be optimal to target initially for H7** given losses as a result of Covid-19

14.16. Nevertheless, the **optimal gearing is fundamentally the point at which the Weighted Average Cost of Capital ("WACC") is minimised**; since the cost of debt and equity both rise with the higher levels of gearing, we should establish the correct balance as rigorously as possible by aiming to use dynamic modelling in a way that will minimise the WACC across the H7 price control

14.17. We note that analysis of comparator gearing[73] showed the book value of debt to market capitalisation naturally spike upwards as market valuations fluctuated over the course of 2020; however, as the CAA notes, this is simply shows the relationship of "debt relative to the perceived value of the business"[74], and note that a **company's gearing is usual measured on the ratio of debt to total balance sheet capital (or the RAB in the case of UK regulated businesses)**

[71] UKRN annual cost of capital report 2020, table 2 & 3
[72] Civil Aviation Authority, CAP2139 para 3.6
[73] Civil Aviation Authority, CAP2139A, Appendix I – Financial Framework, Table I1
[74] Civil Aviation Authority, CAP2139A, Appendix I – Financial Framework, para 9

14.18. Therefore, it is our view that the **optimal level of gearing and the pace of any required de-levering should be demonstrably based upon analysis, informed by the lowest WACC**, and transitioning to that point on a glidepath that minimises the effect on charges by reference to the other building blocks

14.19. Heathrow should not be insulated from the consequences of their financial engineering, and the **notional gearing should fundamentally reflect capital expenditure since privatisation that has not yet been depreciated and already charged to consumers**; that value would likely demonstrate significant financial capacity to insulate against the effect of the pandemic

14.20. The CAA note several key factors that will determine this appropriate level of gearing[75], all of which will have an impact; **we agree that de-levering is possible without RAB adjustments (which we continue to object to in principle)**, but also refer back to our previous comment on assumptions surrounding capital injections

14.21. Reinvestment of dividends by **reducing pay-outs is a valid response to increased levels of debt, and the primary means of reducing leverage over time** in any company; a company does not necessarily have to pay dividends, nor it is obliged to do so in order to achieve a particular return on equity

14.22. For example, Anglian Water note in their recent results that "we are grateful for the **ongoing support of our shareholders, who have foregone dividends since June 2017** for the long-term benefit of the company and its customers"[76]

14.23. The **CAA should not be persuaded by Heathrow's arguments in its RBP that it should be entitled to a particular level of assumed dividends**, and therefore a higher than necessary level of gearing in the notional company for a longer period of time; this directly raises the WACC, and allows Heathrow to reward itself at the expense of consumers by muting its financing incentive

14.24. Noting that "a company's value is not affected by its dividend policy"[77], it is only **appropriate that dividend pay-outs fall in response to financial stress, ensuring the equity buffer is retained or restored** within an appropriate time frame; notional gearing should be informed by an efficient notional capital structure that itself represents the lowest WACC achievable

14.25. We note the CAA comments surrounding a £300m RAB adjustment to "provide Heathrow with the incentive to make investments and spend money to delivery good customer outcomes during the recovery of traffic volumes" **does not have "a sufficiently material impact to warrant taking a different approach to capital structure to that discussed above"**[78]

[75] Civil Aviation Authority, CAP2139 para 3.23

[76] Anglian Water Service Ltd, preliminary results, 17th June 2021

[77] Brealey, R. A., Myers, S. C., & Allen, F. (2006). Principles of corporate finance, 8th edition. New York: McGraw-Hill International

[78] Civil Aviation Authority, CAP2139 para 3.27

14.26. As a result, in addition to our comments on the RAB adjustment later in this document, **we consider there to be no case for any further RAB adjustment as part of the H7 review**; equity and debt capital markets have remained open and available for airlines and airports throughout the pandemic, and adjustments to the RAB have grave long-term consequences for the financing incentive

14.27. The stark reality is that **any RAB adjustments directly transfer value from consumers to investors**; with recent transactions of UK regulated businesses valued at 1.6x RAB[79] combined with an ability to raise debt and extract dividends against an increased RAB, such adjustments have the **potential to generate windfall gains that are not reflective of any real capital investment that deliver value** to consumers, represented by charges

14.28. We remain available to contribute to any further CAA work in this area in the run-up to the publication of Initial Proposals later in 2021

15. Affordability, profiling of revenues and financeability

15.1. Airport charges are defined by the single till and RAB-based building blocks, which are intended to **represent the value derived by consumers from the costs associated with running and investing in the airport, offset by commercial revenue generation opportunities**

15.2. **Our priority remains to properly reset the building blocks of the price control** at this periodic review, such that the level of airport charges and their price path over time can be properly ascertained

15.3. **Price is therefore the value that consumers derive from the airport**, and we are cautious of defining a particular level of airport charge that is deemed to be more or less affordable than another, since this may be incorrectly used to define an acceptable level of airport charges that is divorced from the underlying value

15.4. In competitive markets such as those in which airlines operate over the long run, firms are price takers, operating at a price that minimises economic profit across the industry; as a result, **the price paid by consumers is directly related to all associated costs** of production

15.5. Therefore, **any incremental cost is borne by consumers**, and whilst an incremental cost might be characterised as being no more than the price of a cup of coffee, all costs are ultimately borne by consumers

15.6. Any price change affects the consumption decision of the marginal consumer who is most price sensitive, and **it would therefore be naïve to dismiss any incremental cost as irrelevant due to this very consumption decision by the marginal consumer**

15.7. Characterisations such as the above analogy to the price of a coffee to justify a level of **charges that are not reflective of underlying value generated for consumers** risk undermining the process of properly establishing appropriate building blocks

[79] National Grid plc: Proposed acquisition of Western Power Distribution

15.8. We cannot therefore determine what is or is not an affordable level of charges without **first establishing the value generated for consumers from the building blocks of the price control, analysed in detail and on a bottom-up basis**, ensuring efficiency of operations and appropriate capital investment

15.9. Heathrow's airport direct and indirect charges are independently assessed by a number of consultancies[80], which might suggest **existing charges are already at an elevated level when compared to other airports globally with similar facilities**

15.10. As a result of the elevated nature of Heathrow's RAB, **small changes in the building block parameters may result in relatively large price changes**, particularly when combined with a reduction in single till revenue generation opportunities, and offering fewer forecast passengers over which to recover revenue

15.11. Having established appropriate building blocks, **were a price path to emerge that resulted in changes that are inappropriate for an industry recovering from the ravages of Covid-19**, having first minimised all upward pressure through the building blocks, it may then be appropriate to curtail upward pressure through other regulatory mechanisms

15.12. We are therefore pleased that the CAA sees an opportunity to profile revenue or depreciation to deliver affordable charges and support financeability of Heathrow's investment programme, but **must stress this is <u>always</u> secondary to establishing an unprofiled price path through fundamental analysis of the building blocks**

15.13. We **agree with the CAA that some credit rating agencies tend to reverse out NPV-neutral revenue profiling adjustments**[81] with Moody's having stated that intertemporal movements of "cash flow do not fundamentally alter a company's credit quality"[82]

15.14. There is therefore **unlikely to be any justification for a large initial P0 adjustment**, which would certainly harm consumers during the recovery phase from the pandemic, and artificially reduce volumes at Heathrow, leading to a Crew-Kleindorfer pricing inefficiency[83]

15.15. Whilst it is important to consider credit rating agencies' approach when assessing overall financeability of the efficient notional company, there is **no requirement to maintain an investment grade credit rating in the CAA's ring-fencing provisions for Heathrow**, unlike some regimes designed by Ofwat, Ofgem and that for NATS En-route Ltd ("NERL")

15.16. Therefore, there may also be more freedom for the CAA to choose **the most efficient possible financing incentive structure to optimise the consumer outcome**, since any financeability assessment might be less constrained by ring-fencing obligations than for other regulators

15.17. We agree with the CAA's analysis[84] that conclude that "**a RAB adjustment does not materially influence whether or not Heathrow is financeable under the notional financial**

[80] For example, Jacobs: Review of Airport Charges 2020
[81] Civil Aviation Authority, CAP2139A, Appendix I – Financial Framework, para 9
[82] Moody''s Investors Service: 2018 outlook changed to negative as tough price review outweighs current performance (2018)
[83] Stoft, S. "Revenue Caps vs. Price Caps: Implications for DSM" 1995
[84] Civil Aviation Authority, CAP2139A, Appendix I – Financial Framework

structure"[85]; this again demonstrates the unprincipled nature of Heathrow's proposed RAB adjustment, which demanded a long-term elevation of charges only to enable a short term reduction through profiling depreciation

15.18. Whilst we recognise there may be more limited cashflows available in the early years of H7, it is **important to establish assumptions and finalise analysis of the opening notional financial structure**; this will determine any capacity to reprofile charges having established a price path using efficient single till building blocks

15.19. In terms of equity, **we agree with the CAA that "a period in which no dividends are paid would be consistent with precedent and market expectations**"[86]; following from our comments above on dividends, it is axiomatic that dividends are restrained across the aviation sector for the short to medium term whilst balance sheets are being repaired and debt is being paid back

15.20. Despite this, the **aviation industry has been capable of raising equity continuously throughout the pandemic despite the distant prospect of dividends**, with restoration likely to be several years in the future; this clearly demonstrates dividends are not necessary in the short term to secure equity financeability and continued investment in the aviation sector

15.21. Notwithstanding our earlier comments, we agree with the CAA that there is naturally "a degree of tension between affordability and financeability"[87]; **any intervention must be net present value ("NPV") neutral by definition, and should be transparently set out** to ensure it is appropriate in the circumstances

16. Weighted Average Cost of Capital

16.1. We continue to disagree with the CAA on the application of RPI instead of CPI; whilst the transition will inevitably present Heathrow with a small, additional financing risk, it remains the **UK Statistics Authority's ("UKSA") policy to address the shortcoming of the RPI measure in full at the earliest practice time, which is legally February 2030**[88]

16.2. This is demonstrated in the Office for National Statistics ("ONS") June 2021 release showing an RPI of 3.3% against CPI including consumer housing costs of 2.1%[89]; the UK National Statistician comments as follows: "our position on the RPI is clear: **we do not think it is a good measure of inflation and discourage its use**. There are other, better measures available and **any use of RPI over these far superior alternatives should be closely scrutinised**"[90]

[85] Civil Aviation Authority, CAP2139 para 3.42
[86] Civil Aviation Authority, CAP2139 para 3.47
[87] Civil Aviation Authority, CAP2139 para 3.58
[88] UK Statistic Authority, response to the Consultation on the Reform to Retail Prices Index (RPI) Methodology, 25th November 2020
[89] UK Office for National Statistics: Inflation and Price Indices
[90] UK Office for National Statistics: Shortcomings of the Retail Prices Index as a measure of inflation

16.3. In terms of Heathrow's financing, RPI-linked financing with maturities beyond 2030 amount to **£1.817bn of a total notional outstanding balance of £16.616bn** as at March 2021[91]; with other regulators having already moved to CPI, we **ask what the potential costs or benefits to consumers of not moving the index** are?

16.4. Not changing the Heathrow price control to CPI at this time also presents a future risk that – should the H7 price control need to be extended in a similar manner to the Q6 extensions – **it might be impossible to extend H7 if the appropriate index were no longer published and available**

16.5. We note that the current RPI-CPI wedge is 1.2%[92] in May 2021[93], but that the long-term wedge has consistently remains c.0.9% to 1.0%, and **agree with the CAA that "the Bank of England's stated objective of achieving 2% CPIH inflation over time** and the evidence that periods of higher and lower inflation have been met with corrective actions that **pushed average inflation back towards the long-term target within a short time-frame**"[94]

16.6. In terms of asset beta, risk free rate, total market return, cost of embedded debt and cost of new debt, we refer to the airline community response from the London (Heathrow) Airport Consultative Committee ("LACC"), and CEPA's technical appendix to that submission

16.7. Nevertheless, **we agree with the CAA that "an appropriately specified TRS mechanism could substantially reduce the risk borne by Heathrow's shareholders**" [95], and that "the impact of [incentive regime] changes on Heathrow's equity beta in H7 will also need to be considered"[96]; these measures will reduce Heathrow's systematic risk yet further compared to its comparators

17. Tax allowance

17.1. Heathrow's tax allowance could either be set on a notional basis, or alternatively where there are no apparent benefits from setting an incentive to reduce tax burden, estimated on a pass-through basis

17.2. We **agree with the CAA approach to set any allowance on a notional basis consistent with the WACC calculation, and that a "clawback mechanism to limit shareholder benefit of developing highly leveraged financial structures"[97] would be appropriate**

17.3. We further **agree with the CAA's assessment of Heathrow's use of a pre-tax WACC its RBP as being non-compliant** with its guidance, and that doing so would be "less transparent, inaccurate, and prone to being overly generous" [98]

[91] Heathrow SP Ltd, Consolidated Debt Summary at 31 March 2021
[92] UK Office for National Statistics: Inflation and Price Indices
[93] Consumer price inflation, UK: May 2021
[94] Civil Aviation Authority, CAP2139A, Appendix J – Weighted Average Cost of Capital
[95] Ibid.
[96] Ibid.
[97] Civil Aviation Authority, CAP2139 para 3.60
[98] Civil Aviation Authority, CAP2139 para 3.63

17.4. We support the CAA in accessing the appropriate information from Heathrow, particularly due to the **substantial capital allowances that are likely a key component of its tax calculation**, with benefits flowing throughout the FGP Topco Ltd ownership group; in particular, the **Public Benefit Infrastructure Exemption** as per the Finance Act 2017[99] **and the Group Ratio Rule are likely to be material**

17.5. A pass-through mechanism is not likely to lead to an outcome of the same efficiency as setting an incentive, and the **mechanics of the true-up mechanism could be hard to establish ex ante in order to ensure it has the desired incentive effect**; not providing the required information is a clear example of Heathrow's attempts to game the H7 periodic review

18. Heathrow's requested RAB adjustment (CAP2140)

18.1. We **welcome the CAA's decision to reject Heathrow's request to adjust the Regulatory Asset Base ("RAB")** by up to £2.8bn in order to recover revenues not earned as a result of Covid-19[100]

18.2. Our understanding is that the CAA has decided to make a £300m intervention (in 2018 prices) to adjust Heathrow's Regulatory Asset Base ("RAB") on the basis that:

a. This will **prevent a higher cost of debt finance** arising in Heathrow's "notional" company, enabling the notional company to **continue to access cost-effective investment grade debt finance**;

b. It will **incentivise additional investment** by Heathrow during 2021, creating an expectation that Heathrow will be proactive in undertaking necessary investment to **maintain service quality and provide necessary capacity for a higher than expected increase in passenger traffic during the remainder of 2021**; and

c. **You will take further steps to protect consumers** by conducting a review of these matters **should Heathrow fail to deliver on quality of service**

18.3. As we have made clear in previous submissions, **Heathrow's proposal had no justification in UK ex ante incentive regulation**, and adjusting the RAB in this manner would have undermined regulatory consistency

18.4. Our opinion has remained that the RAB is a **mechanism for logging up of efficiently-incurred capital expenditure** to form the basis of charges in future regulatory periods; it is a mechanism for ensuring that the business can earn a **reasonable return on its sunk capital expenditure, and its indexation suggest a very low cost of capital should be the appropriate result**

18.5. We applaud the statement that the CAA "disagree[s] with Heathrow that it is a fundamental principle of UK regulation that companies are guaranteed a recovery of

[99] Finance Act 2017
[100] Heathrow Airport Ltd, Application for Covid-related RAB adjustments, 21st July 2020

regulatory depreciation"[101]; **we agree that "no explicit protection for regulatory depreciation was built in to the regulatory regime** for airports in CAA12 (the Civil Aviation Act 2012) or Q6/iH7"[102]

18.6. **Regulatory depreciation is neither separable from the other building blocks** of a price control ex-post once it has been set, **nor is it not appropriate to later attempt to distinguish** between them when Heathrow is remunerated through the WACC to hold volume risk on the revenue requirement in aggregate

18.7. We therefore **disagree that Heathrow has raised any valid question over future recovery of regulatory depreciation either in full or in part under a price cap regulatory regime with volume risk** once it has been established as part of a price control

18.8. Nevertheless, the CAA has decided to make a £300m intervention to adjust the RAB in order to **prevent a higher cost of debt finance arising** in Heathrow's "notional" company, enabling the notional company to **continue to access cost-effective investment grade debt finance**

18.9. This intervention **can only ultimately be considered as part of the H7 periodic review**, and recognise that **early intervention is intended to support the H7 package**, acting to "reduce Heathrow's notional gearing below an important threshold used to assess consistency with strong investment grade finance"[103]

18.10. We expect as a result that "**the benefits to consumers from a lower cost of capital and greater service quality in H7…outweigh these costs from the RAB adjustment**"[104]; this will need to be demonstrated transparently once the other parameters of the price control are finally set

18.11. We agree with the CAA that issues raised by Covid-19 can only be considered within the context of the whole of H7, and any solutions – such as traffic risk sharing alongside this targeted RAB adjustment – that reduce the risk Heathrow faces, must **manifest themselves in a way that allows "consumers to benefit from a lower cost of capital in H7"**[105]

18.12. Given that the decision will be reflected in the modifications made to Heathrow's licence to implement the H7 price control, which we anticipate will come into effect in 2022, and that those other aspects of H7 will not be finalised until later this year or early 2022, we **therefore cautiously reserve final judgement on the CAA's early intervention until we can assess the H7 price control as a package**

18.13. It is clearly important to ensure that the notional company is able to efficiently finance its activities; we note the **CAA estimate that gearing of the notional company would have increased to just over 70% in 2021** from 60% prior to Covid-19 as a result of the fall in demand[106]

[101] Civil Aviation Authority, CAP2140 paragraph C39
[102] Civil Aviation Authority, CAP2140 paragraph 3.24
[103] Civil Aviation Authority, CAP2140 paragraph 26
[104] Civil Aviation Authority, CAP2140 paragraph 31
[105] Civil Aviation Authority, CAP2140 paragraph 5
[106] Civil Aviation Authority, CAP2140 paragraph 4.12

18.14. Furthermore, we note that **credit ratings agencies have signalled 70% as a threshold level beyond which credit ratings might be downgraded**, and that the CAA aim to provide a strong signal to the market that the notionally-financed company should be regulated in a manner consistent with accessing cost-effective investment grade debt finance[107]

18.15. It therefore appears reasonable to expect that this intervention, which provides an estimated 2% headroom to this threshold level, **would control any rise or even reduce the Weighted Average Cost of Capital** ("WACC") to a level below which was expected for H7 before Covid-19 occurred, resulting in a net benefit to consumers from having made this adjustment through the H7 package

18.16. Given the ongoing nature of the H7 periodic review, we appreciate that **the CAA's decision on an early intervention involves an element of judgement at this stage** prior to crystallising views on the remainder of the building blocks, incentives, and implementation of any risk sharing mechanisms; we welcome the comment that the CAA "may consider partially offsetting any adjustment in order to take account of Heathrow's outperformance against assumptions used for the Q6 price control"[108]

18.17. Nevertheless, it is reasonable for us to expect that the H7 package can demonstrate that both this RAB adjustment – along with any further adjustment and other measures introduced to control risk within the H7 package – should be **clearly and transparently attributable to a WACC reduction and net reduction of consumer charges**, an expectation clearly set out in the CAA's publication[109]

18.18. The **relevant WACC in this case is that indicated early in H7 process** by CAA, CMA and CEPA analysis, informed by the RP3 periodic review of NERL and settlements in other UK sectors, rather than the existing and outdated WACC underlying the Q6 settlement

18.19. Whilst we note the CAA view that it "would be undesirable for us to reverse interventions we make now during the H7 process"[110], we would like to understand what will happen to the adjustment in the H8 or H9 periodic review; once appropriate gearing is restored in the notional company, **might it be reasonable to assume this and any other RAB adjustments are subsequently reversed once they have fulfilled their purpose?**

18.20. We believe that this should be the case, since the consumer would otherwise be paying in H8 and beyond for support of the notional company that is no longer required; this will have spill-over to Heathrow's actual financing elevating the RAB for longer than is necessary.

18.21. Similarly, we would like to seek clarity over whether the additional investment of £230m – that Heathrow has persuaded the CAA will occur should any RAB adjustment take place – would be **substituted for this RAB adjustment, such that consumers are not paying twice** for the benefit of such investment

[107] Ibid.
[108] Civil Aviation Authority, CAP2140 paragraph 4.28
[109] Civil Aviation Authority, CAP2140 paragraph 3.62
[110] Civil Aviation Authority, CAP2140 paragraph C20

18.22. We agree with the CAA that the risk allocation for H7 is extremely important, determining **allocation of risks between Heathrow and its customers**, and setting a level of allowed return consistent with the risks that Heathrow has to manage but that is no higher than is necessary to fund an efficient level of investment

18.23. In addition, the CAA state that the decision to adjust the RAB **should signal "to Heathrow the importance of maintaining appropriate investment and service quality levels**", alongside "providing strong incentives and financial capacity for Heathrow to be proactive in planning for potentially higher than expected traffic levels"[111]

18.24. **We welcome the additional protections the CAA has introduced**, which might result in the CAA "reducing the £300m RAB adjustment or making offsetting reductions to revenue"[112] should evidence emerge of Heathrow failing to deliver on an appropriate quality of service in 2021

18.25. In terms of capital expenditure, we note that **Heathrow has persuaded the CAA that it intends to make additional investment of c.£230m (£218m in capex and £9m in opex)**[113] should it have appropriate incentives; we agree with the CAA that its intervention should provide a strong and clear incentive to:

a) Undertake any necessary investment;
b) Maintain service quality; and
c) Provide necessary capex in 2021

18.26. Whilst we maintain the position that – as noted by the CAA – "Heathrow already faces incentives to undertake necessary investment through including efficient investment in the RAB and earning an allowed cost of capital"[114], **we expect the contingent nature of the CAA's intervention applied alongside incentives from the SQRB regime to incentivise Heathrow to invest** as indicated whilst accommodating:

a) Any "lumpy" recovery of Heathrow's passenger traffic
b) Delivery of service quality as traffic recovers
c) An uncertain pace of recovery for some time

18.27. It is our expectation that Heathrow delivers on these commitments, returning terminal capacity to active status at an appropriate time to ensure passenger service is not compromised in any aspect of its operation, and in the CAA's words "taking proactive steps to prepare for a higher than expected increase in passenger traffic"[115]; we will be collating evidence in this regard throughout 2021; in particular we expect to see Heathrow act to ensure:

a) Terminals 3 and 4 re-open in advance of rising passenger numbers;
b) Airlines are promptly returned to their home terminals and able to access their property;

[111] Civil Aviation Authority, CAP2140 paragraph 24
[112] Civil Aviation Authority, CAP2140 paragraph 32
[113] Civil Aviation Authority, CAP2140 paragraph 4.15
[114] Civil Aviation Authority, CAP2140 paragraph 3.39
[115] Civil Aviation Authority, CAP2140 paragraph 4.22

c) Address bottlenecks that exist in the infrastructure;
d) Work with service providers and partners to alleviate emerging issues; and
e) Work with the Department for Transport to ensure Border Force are fully resourced to meet expected demand

18.28. The existing Service Quality Rebates and Bonuses ("SQRB") scheme provides some protection from Heathrow excessively reducing operating expenditure, however it only covers limited aspects of Heathrow's infrastructure; **we will be documenting and providing the CAA with evidence of any under-investment or lack of service quality to support its review**, and look forward to any additional guidance provided as part of the H7 periodic review

19. Heathrow expansion

19.1. As noted by the CAA, in December 2020, the Supreme Court reversed the decision of the Court of Appeal, **ruling that the Government's decision to designate the Airports National Policy Statement ("ANPS") had been lawful**; as a result, the legal effect of the ANPS was restored

19.2. **We see no prospect of runway expansion taking place in the near future** due to the effect of Covid-19 on Heathrow's balance sheet; from the perspective of the H7 price control, it is therefore pragmatic to base this upon a two-runway airfield

19.3. However, should runway expansion return during the H7 price control, we **cannot allow a situation to develop where consumers are charged a third time** for Heathrow's (or any other promoter's) speculative attempts at expansion

19.4. We comment further on these matters in our response to CAP1996, however we must insist that the **regulatory framework for any further work on expansion is more fully-defined in advance of any spending**, is supported by clear and well-defined governance throughout, but in a way that does not prevent the underlying price control from being updated whilst seeking alignment with any DCO

19.5. In respect of Heathrow West's application to recover its costs associated with its Development Consent Order ("DCO") application, estimated at £30m, **it would be inappropriate for Heathrow West to be allowed to recover these costs**

19.6. Under the Civil Aviation Act 2012 ("CAA12") section 7, the Market Power Determination ("MPD") as set out in CAP1133[116] explains that it is **Heathrow Airport Ltd ("HAL") that has met the tests A to C in section 6 of CAA12**[117]

19.7. This in an important distinction, since the Explanatory Notes to CAA12 set out that "**These tests are designed to ensure that operators of airport areas are only subject to economic regulation** if: (A) the operator has or is likely to acquire substantial market power; (B)

[116] Civil Aviation Authority, CAP1133, Market power determination in relation to Heathrow Airport - statement of reasons
[117] Civil Aviation Act 2012, Section 6

competition law on its own is not sufficient to address the risk the operator may abuse its market power; and (C) the benefits of regulating the operator outweigh the costs”[118]

19.8. Heathrow West is **neither the operator of the airport area that is subject to economic regulation, nor has it acquired a dominant airport area** over which an MPD has been made

19.9. We also **agree with the CAA[119] that Heathrow West’s proposals were commenced without any prior agreement of funding**, and that the CAA had not set out any policy under which a competing terminal provider might recover costs, and are firmly of the view that **these costs should not be permitted to be recovered through Heathrow’s existing RAB,** which would otherwise result in a highly unorthodox regulatory and economic outcome

19.10. Nevertheless, **British Airways welcomes competition in all its forms, particular in the area of competitive tendering**, which would have the effect of driving out inefficiency from capital investment projects, benefitting consumers; future terminal competition could be a welcome prospect that the CAA might consider in greater depth

19.11. Furthermore, Heathrow West and other promoters are likely to have an important role to play in any future development of Heathrow; if expansion is to become more likely again in future, the CAA must seek to capture the benefits of competition, and **develop a complete framework that allows competitive forces to play a fuller role, such as that used for the Thames Tideway Tunnel (“TTT”)**

19.12. This is the **best available model now being actively used in other regulated industries for large projects** – notably used by Ofwat and Ofgem – and ensures that as a separate entity, consumers are not unduly exposed to financial risks of any project that does not deliver its stated benefits

20. Financial resilience and ring-fencing

20.1. It is clearly important to ensure the work on financial resilience focusses on “managing the risk that consumers would suffer detriment from disruption to services and investment if HAL experienced financial distress”[120], and **we support the CAA on appropriate strengthening of protections in this area as required**

20.2. It is also important that regulation **strikes the right balance between cost of compliance and consumer benefit**, and that regulation is neither onerous nor drives costs through creating activity that is vastly more than that already performed for internal financial and business reporting purposes

20.3. We recognise that what is appropriate for airport regulation differs from the level of regulation required for financial resilience in other sectors; nevertheless, the consumer needs assurance that specified measures will have the desired effect in practice, and it is **critical for our business that we are assured of Heathrow’s continued operation in times of financial distress**

[118] Civil Aviation Act 2012, Explanatory Notes to Section 6
[119] Civil Aviation Authority, CAP2139A, Appendix O – Heathrow West’s cost recovery request
[120] Civil Aviation Authority, CAP2139A, Appendix K – Heathrow West’s cost recovery request

20.4. We are minded to agree with the CAA that **regulation should not seek to cut across the existing financial platform**, especially if this could otherwise cause a re-financing that would drive up costs and ultimately the airport charges to the detriment of consumers

20.5. Nevertheless, **airlines and consumes must be assured that any measures contained within Heathrow's common financing terms operate as intended**, and that they do not incentivise a suboptimal outcome

20.6. For example, **certain specialist hedge funds focus on businesses in distress**, with a sole focus on purchasing debt instruments at a cost below the value they are able to realised upon their sale, and **those funds may deploy tactics that could be incompatible with the continued operation of the airport in certain circumstances**

20.7. **This would be entirely rational from their perspective if their investment were in a certain tranche of debt**, and the consequence of their tactic were to force those in other more senior or junior traches to act in a way that ultimately benefitted their investment position

20.8. This is **particularly important when certain businesses have no clear delineation between regulated operations and non-regulated operations**; we recognise that Heathrow is relatively more straightforward as a business entity, though should **consider whether existing measures remain appropriate if Heathrow's business or ownership changes in future**

20.9. **Of particular concern to British Airways is Heathrow's highly leveraged structure, which presents risks that might not always been apparent**, particularly when complicated by financing structures at multiple levels below FGP Topco Ltd, Heathrow's ultimate holding company in the UK; we have previously made comment on these in our consultation responses[121] to Heathrow's requested RAB adjustment, a request that has ultimately been rejected by the CAA

20.10. **For example, nominal net debt excludes the debenture between Heathrow (SP) Ltd and Heathrow Finance Ltd**[122]; this functions to capitalise interest payments due that cannot be released as a result of the financial ring-fencing in place, but which also distorts certain working capital metrics due to its accounting treatment, and it **remains unclear what assurances have been pledged or required as a result of the subordinated debt injected at ADI Finance 2 Ltd in late 2020**

20.11. The point of this is that the **CAA should have sufficient understanding of Heathrow's complex leveraged finance structure**, that the common terms agreement[123] provides appropriate assurance, and without a formal ring-fencing of Heathrow's business activities, the CAA is clear where risks may materialise in a distressed situation

[121] British Airways response to CAP2098

[122] Heathrow (SP) Ltd Q4 2020 results release

[123] Heathrow Common Terms Agreement dated 8th August 2008, as amended on 28th February 2019

20.12. We note that there is no special administration regime in place at present, and that the CAA note the **implementation of such a regime could drive expensive and time-consuming re-financing should it cut across existing financing**

20.13. This might be hard to justify should any perceived benefits of doing so already be contained within Heathrow's common terms agreement[124]; **this assumption should continue to be tested at periodic intervals to ensure this remains appropriate**, and avoid excessive divergence from other UK regulatory regimes[125]

20.14. In light of Heathrow's attempts to have its RAB adjusted upwards to avoid financial repercussions of its leverage financial structure, we are **concerned that the financing platform may not be as robust as has been assumed in the past**, particularly as our business is so heavily dependent upon Heathrow's continued operation

20.15. Has the CAA recently tested its assumptions that special administration regimes and ring-fencing would indeed cut across Heathrow's financing platform in a manner that is detrimental to consumers? This is particularly important in light of the recommendations of the National Infrastructure Commission ("NIC") that "Regulators should be more **proactive in addressing financial risk and corporate governance, to ensure that rewards reflect performance and risks are genuinely taken by investors**"[126]

20.16. We **agree with the CAA that provisions do not at present readily protect Heathrow's cash or assets** for the benefit of consumers, and that **it would be proportionate to improve the flow of information to the CAA**[127]

20.17. This will **ensure that the CAA is kept informed of financial developments ahead of hearing about them through media sources**, with appropriate opportunity to hear the same information at the same time investors do at present, allowing the CAA to promptly take any necessary action that may be required

20.18. The CAA should not seek to be just a repository of information, but **seek to be fully-informed by Heathrow as to its financial and business developments**; it is not onerous for Heathrow to provide the CAA when published all and any information provided to debt investors across various forums and websites

20.19. It is also not onerous to invite the CAA to all investor meetings, ensuring that they are **able to hear live questions from research analysis and investors**, or receive information by email when published on Heathrow's investor website

20.20. **Such information should include all and any information provided to debt investors in open and closed forums**, including:

a) All regulated news releases, including transcripts of investor calls and direct invites to the CAA to attend all and any investor calls hosted by Heathrow

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[124] Heathrow Common Terms Agreement dated 8th August 2008, as amended on 28th February 2019
[125] UKRN annual cost of capital report 2020, table 10
[126] HM Treasury response to the regulation study: strategic investment and public confidence, 25th November 2020
[127] Civil Aviation Authority, CAP2139A, Appendix K – Heathrow West's cost recovery request

b) All statutory financial reports and accounts for all entities under FGP Topco Ltd when submitted to Companies House

c) All investor reports and other financial releases, such as monthly summaries of debt, and ad hoc presentations on certain financial matters

d) Credit ratings updates and reports from credit ratings agencies

20.21. **None of this imposes any real regulatory burden on Heathrow** as it already exists and is provided to debt investors, and could be considered a simple act of courtesy to ensure that the regulator is provided information at the same time as investors are provided that information

20.22. We **agree with the CAA that separate certification of financial and operating matters would help to provide better oversight of operational matters** without increasing regulatory burden significantly

20.23. We agree that it should be **relatively straightforward to present sensitivities, and considering these internally should already be good business practice**; there should therefore be little regulatory burden to providing this information, though the CAA might wish to specify a two/three/four terminal operation as opposed to an un-defined low/mid/high scenario

20.24. We also **support the CAA's review of the regulatory account rules to ensure that they are updated and appropriate for the future**; regulatory accounts should provide sufficient information in addition to statutory accounts produced under financial reporting standards

20.25. We agree that **dealing with all parties on an arm's length basis and normal commercial terms should be a fundamental requirement of a regulated entity**, and this is a welcome development considering ownership and potential perceptions of conflicts of interest involving construction work at Heathrow

20.26. In addition, LHR Airport Ltd presently provides services to Heathrow through shared service agreements; however, the **company takes account of an exemption under FRS102 not to provide information on related party transactions** with entities that are wholly owned subsidiaries of FGP Topco Ltd[128], as noted in its accounting policies

20.27. The accounts for FGP Topco Ltd disclose that – under employment costs – these **services are provided to Heathrow Airport Ltd at a mark-up of 7.5%, and that all employees of the Group are employed by LHR Airports Ltd[129]**; this presents a significant issue in relation to the true, efficient cost of providing those services, and the use of financial reporting exemptions to take advantage of the regulatory regime: related party transactions must be transparent

[128] LHR Airports Ltd, Annual report and financial statements for the year ended 31st December 2019

[129] FGP Topco Ltd, Annual report and financial statements for the year ended 31st December 2020

20.28. We therefore **agree with the CAA's proposed changes as set out in Table K1**[130] **as being reasonable, balanced and pragmatic**, and commit to working with the CAA to later review and update the requirements for regulatory accounts

Yours sincerely,

Alexander Dawe
Head of Economic Regulation
Networks & Alliances
British Airways Plc

[130] Civil Aviation Authority, CAP2139A, Appendix K – Heathrow West's cost recovery request