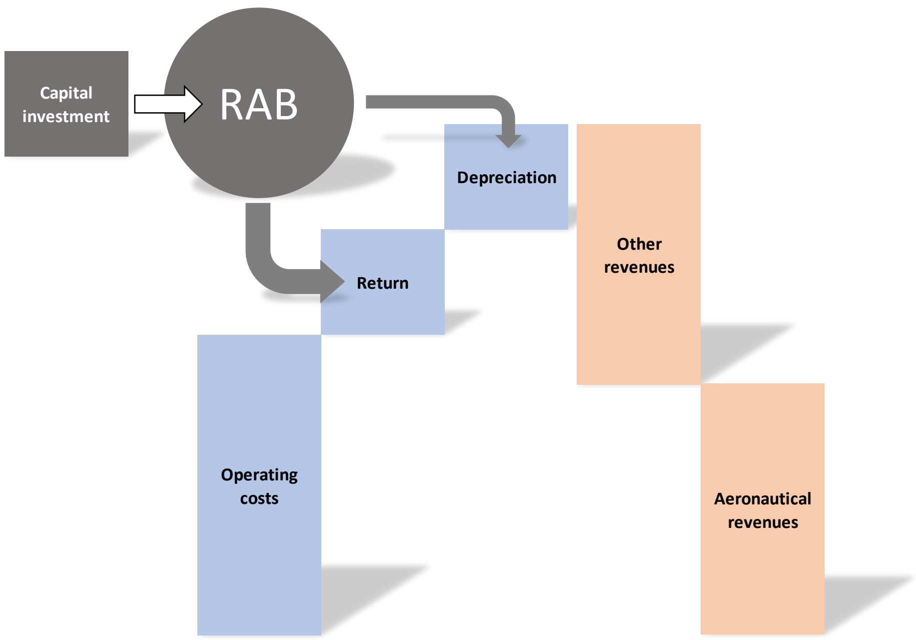
Economic regulation of Heathrow Airport Limited: H7 initial proposals - summary

The CAA's latest capitulation in the face of Heathrow Airport Limited's (HAL's) belligerent posturing comes as no surprise. In a history of appeasement and retreat, the CAA has finally and unconditionally surrendered. It was probably inevitable. It was certainly foreseeable, that at this watershed for aviation, the regulator would again fail to grip the situation.

How regulation is supposed to work

1. Airport regulation should be quite straightforward. Because HAL is a natural monopoly and therefore, if unconstrained, could increase consumer prices to unacceptable levels, the CAA is required to regulate its revenues, so that consumers are protected, while investors are fairly remunerated for the risks they bear. The CAA does this by setting a price cap.

2. The price cap is calculated by adding capital investment to a 'Regulated Asset Base' (RAB), against which HAL is allowed to recover depreciation and to realise a return, at a rate considered by the CAA to reflect a fair cost of capital. Then, once operating costs and other revenues have been factored in, the shortfall is made up by aeronautical revenues – that is, airport charges, which are regulated through the CAA's price cap.



3. A few forecasting and efficiency mechanisms aside, and notwithstanding proponents' over-complication and obfuscation, that's more-or-less all there is to it. The purpose of regulation is simply to ensure that in the low investment risk and capacity constrained environment of Heathrow, consumers are protected from the abuse of an airport monopoly.

What has gone wrong?

4. Resisting temptation to set out a litany of regulatory failure, this note will restrict itself to the three most damaging aspects.

5. The first is that the CAA has lost sight of **the purpose of the RAB.** Rather than being a reflection of investment, it has become a regulatory lever, to be pulled as and when more cash is required. Although it had been the case for many years, this transformation became perfectly evident during pre-Covid discussions over a third runway at Heathrow, during which the CAA repeatedly backed down to HAL's threats of non-investment, by arbitrarily increasing the RAB, thereby providing HAL a return against investment it hadn't made (and potentially will never make).

6. It is testament to the CAA's regulatory capture that its latest consultation sets out, as if it merited serious consideration, HAL's request for an upward RAB adjustment of £2.6bn. The CAA counter-proposes a £300m upward adjustment, as if that was somehow reasonable or fair to the consumers its purpose is to protect. Gifting HAL a £300m revenue uplift against the backdrop of its £2.6bn request makes it neither!

7. The second is that the CAA's regulation has encouraged HAL to raise debt against unconstructed assets, and for the proceeds to be directly passed through to shareholders. So, in anticipation of ever-increasing traffic and with the regulatory promise of a benevolent CAA to maintain price caps above levels required for a fair return, HAL has effectively mortgaged all its assets.

8. Despite **financial gearing** approaching 100%, capital markets remained content to lend to HAL at attractive rates. This is unsurprising in the context of HAL's monopoly position in an air-transport market in which demand significantly outstripped supply, combined with the CAA's refusal to accept the reality of HAL's over-leveraged capital structure and enduring regulatory assumption of 60% financial gearing.

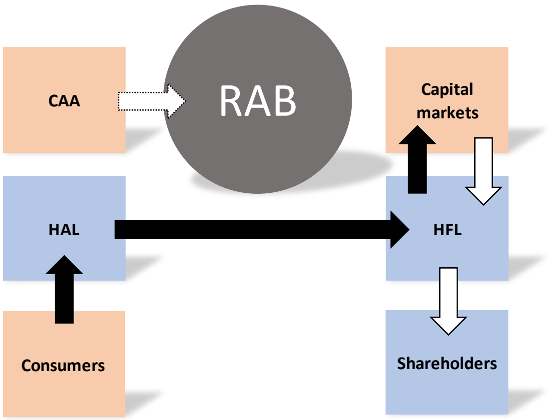
9. This fictitious capital structure was the rationalisation for the CAA's allowance of much higher rates of return than was being experienced by HAL, which was financed through much cheaper debt. In these circumstances and while there was no perceived risk to traffic volumes, the financially rational course became to mortgage everything, pass the proceeds to shareholders and then service the debt with the ever-increasing revenues being facilitated by the CAA. This is precisely what HAL did, and it must've seemed that if for some unforeseen reason traffic did fall off, then there was so little equity at stake that it was well worth the risk!

10. The third is that the CAA has wrongly assumed responsibility for **HAL's financeability**. In drafting The Civil Aviation Act 2012 (the Act) there was much debate between the DfT, the CAA, airports and airlines on the question of HAL's (BAA plc's, as it then was) financeability. HAL (with support from the CAA) said the CAA must ensure its financeability, because if revenues were capped, they must also be guaranteed. The DfT (and airlines) disagreed, saying that any such guarantee would be a licence for financial irresponsibility.

11. In the end the DfT prevailed and responsibility for HAL's financeability was left with HAL, the CAA's going no further than being required to facilitate HAL having the means to ensure its own financeability. Since then, the CAA has repeatedly misrepresented and misquoted the Act, suggesting that it bears responsibility for HAL's financeability. It does not!

How Heathrow works

12. Given this regulatory context, it is unsurprising that HAL has become what it now is: a vacuum for cash, undertaking incidental aeronautical activities.



13. There are two discrete phases to the organisation of Heathrow, both of which are triggered by the CAA increasing the RAB; although, they do not necessarily run consecutively.

14. The first is that capital markets, responding to the CAA's regulatory promise of increased revenues, issue debt to HAL's sister company, Heathrow Funding Limited (HFL), which is domiciled in Jersey. HFL then passes through the proceeds directly to shareholders – and in this way, has issued £4bn+ in dividends over the 12 years to 2019, at the same time as HAL received almost £700m net in tax rebates.

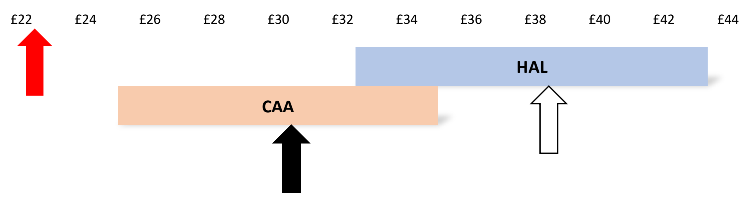
15. The second consequence of increasing the RAB is that the price cap is increased, so consumers pay more to HAL, which in turn passes the additional revenues through to HFL to service the additional debt. Under these arrangements, HAL is able to offset 100% of debt interest against profit, through a 'Public Infrastructure Exemption' (PIE); hence its surprisingly thin profitability, despite massive cash generation.

16. It is therefore apparent that HAL has two primary functions: to persuade the CAA to increase the RAB; and to channel cash generated in the UK to HFL. Similarly, HFL has two functions: to issue debt; and to channel the proceeds to shareholders. While both HAL and HFL are good at what they do, this organisational structure relies on an ever-increasing RAB and could not have evolved under any reasonable application of economic regulation.

What now?

17. Covid and the consequential collapse in traffic led to an immediate and unprecedented crisis in aviation. Airlines were quick to react, cutting costs wherever possible, furloughing staff and shoring up balance sheets. Whilst HAL was slower to see the danger, that is not the point. The point is that it is on the hook for large swathes of debt interest, for which it is without obvious means to service. Having consistently relied on the CAA's benevolence, for the first time HAL finds itself under commercial pressure, with which it is ill-equipped to deal.

18. It is typical of HAL's lack of commercialism, management approach, relationship with the regulator and condescending attitude towards consumers that it has assumed that the CAA will simply increase the price cap and then everything will get back to normal, after a few years. It is typical of the CAA that it appears likely to accommodate HAL.



19. The current price cap is the world's most expensive, at around £22. HAL has proposed this be increased to between £32 and £43, with an interim level for 2022 of £38. The CAA counter-proposes a price cap of between £24.50 and £34.40, with an interim level for 2022 of £30, suggesting that this would further the interests of consumers. How it could possibly do so, or why it should horse-trade with HAL, the CAA fails to mention!

20. Given the history of appraisement, it seems likely that the CAA intends to impose a price cap within the range proposed by HAL and that it will attempt to spin anything below the upper reaches of this as a victory for consumers. This behaviour is so ingrained, in both the CAA and HAL, that in the absence of resolute challenge, of which there has hitherto been little evidence, this consultation will doubtlessly run its inevitable and predictable course.

What doesn't need to happen

21. The CAA is not responsible for ensuring HAL's financeability: HAL is – and whilst it may be in a hole, it is not for the CAA to dig it out, especially not with consumers' money. There are other, much better, courses of action available, if only the CAA would stand its ground.

22. The first thing to know is that no airport operator or administrator would ever close down operations at Heathrow; they are simply too cash generative. So, whether or not there would be enough cash to meet HAL's financial commitments, it is unarguably better to have more than less. This should put the CAA's mind at ease, had it been concerned by any threats made by HAL, to the effect that without a significant increase in the price cap, the airport would have to close.

23. The second is that for 30 years the CAA has given HAL the benefit of traffic growth, along with its generous rate of return, based partly on a misplaced perception that the airport (as opposed to airlines) bears the volume risk. It would be perverse if volume risk, now manifest in reduced traffic, was now fully inflicted upon consumers; however, if the CAA increases the price cap as it is suggesting, this is exactly what it will be doing.

What does need to happen

24. HAL is privately owned, its overseas shareholders have deep pockets and capital markets know what they are doing, so the CAA should let economic forces run their course. If it is to meet its financial commitments, HAL needs capital, but that is a matter for HAL and its creditors, not for the CAA or consumers. Was the CAA to not arbitrarily increase the price cap, several scenarios could transpire, any one of which would be better for consumers than the CAA's proposals to make them pay for HAL's financial impropriety.

25. The first is that HAL renegotiates its debt and works through the current crisis, just like other aviation actors are having to do, potentially becoming more efficient and responsive to consumer needs as a result. Over the short term, shareholders may have to forego anticipated dividends, but that is natural characteristic of investment; you don't always get to win! Loss of anticipated dividends is the least of current troubles for many airline shareholders.

26. A second is that HAL's shareholders inject much needed equity; although, given the existing extremely low level of paid-up share capital, funding the significant sums required might present an unattractive option; however, shareholders took their dividends and now they must take their choice. None of this is the fault of consumers and the CAA should not make them pay for it.

27. A third option is that the banks convert HAL's debt into equity. This would be an economically efficient outcome, because it would represent a trade-off between shareholders seeking to maintain equity stakes, while resisting injecting capital, against debtholders arbitraging the value of interest rates and equity returns, over time. It would be most enlightening to see what value capital markets might put on HAL shares – and what consumer benefits having new shareholders might bring.