

Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues (CAP1876) Heathrow's response

Date: 13th March 2020

Prepared by: Heathrow Airport Limited

Status: Final

Executive summary

1. The CAA's consultation (CAP 1876) was published primarily in the context of delivering new capacity at Heathrow, starting early in H7 (i.e. 2022). Our response is based on this context.
2. On 27th February, the Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the Airports National Policy Statement (ANPS). The ANPS is therefore suspended. Heathrow has sought permission to the Supreme Court to appeal the Court of Appeal's findings. Nevertheless, this will undoubtedly affect the speed in which we can deliver expansion and thus the relevance and timing of regulatory issues raised in CAP 1876.
3. Expansion is still in the interests of consumers. We thus believe that making definitive progress on the regulatory framework to underpin the delivery of expansion is still very relevant. This would amongst other things avoid additional delays generated by regulatory uncertainty following legal or policy progress. In this response we therefore address the CAA's thinking regarding the regulatory framework that will underpin expansion (i.e. most of its proposals in CAP1876).
 - Heathrow is supportive of the CAA's approach to assessing financeability in an integrated manner, including the discussion on setting the expansion price control consistent with an A- credit rating. Equally we are clear that providing longer term regulatory certainty is instrumental to delivering expansion. Albeit the options outlined by the CAA are not fully consistent with and were produced before the CAA had time to review the proposals in our Initial Business Plan (IBP), we are encouraged that a solution in the interest of consumers can be found.
 - We also welcome the CAA firming up its thinking on return and WACC. In particular, we believe it has made some progress on an approach to calculating an expansion premium. We acknowledge the importance the CAA indicates it will give to the CMA's decision on NERL. We are concerned by the CAA's thinking on tax treatment, in particular where the CAA appears to move away from established practice at Heathrow. We believe that the CAA should first consider and address the CMA's findings in this area before reaching any final views. Thorough financeability analysis is also required before forming any definitive views on this issue.
 - Heathrow is surprised that the CAA's thinking on investment incentives has not evolved materially since the last time it consulted on the topic. We maintain our position that in depth analysis of the current framework should be done, followed by comparative analysis against any notional framework. There should also be a realistic and evidence-based view of the trade-offs in setting any incentives – history at Heathrow and elsewhere shows that multiple different incentive frameworks can be made to work but each has different impacts and outcomes. Those real-world impacts need to be considered before discarding a process that has worked very well in Q6. We believe that any potential changes should build on the existing Development and Core framework. We offer a number of considerations when investigating changes to the current framework or the introduction of additional efficiency incentives for capital investment. We nevertheless remain open to engage on this area, as demonstrated by our open engagement with the airline community in the Capital Efficiency workstream of H7 Constructive Engagement (CE).

4. The regulatory timetable will need to adapt to recent developments. If the CAA is so minded, there is enough time to develop a robust regulatory process that results in an outcome that furthers the interest of consumers and that allows the H7 price control to start in January 2022. We offer our views regarding a potential programme of work between now and the start of H7. We think that in order to facilitate a 2022 H7 start and meaningful engagement around our IBP, we need to reflect the Court's decision into our plans. We are committed to doing so in the most expedient and sensible manner for the benefit of consumers. We are currently working on how best to do so, and what elements of the plans should be updated. We are working with the airlines and the CAA to find an optimal solution to this.
5. We recognise that the H7 regulatory framework may have to adjust given the implication that the Court findings have on the timetable to deliver expansion. We believe many of the proposals raised in our IBP continue to be relevant. We will update our views on the H7 regulatory framework as soon as possible and will discuss it through CE with the airlines. We would nevertheless like to progress work on the regulatory framework for expansion in the coming months with the CAA and the airline community. We believe that the CAA should allocate time and resources to this end.
6. Finally, this consultation was published two working weeks after we published our IBP at the end of December. In our IBP we outlined a comprehensive regulatory framework with clear answers to each of the policy proposals discussed by the CAA in this consultation, including regulatory framework, capital efficiency incentives, WACC and financeability assessment. It is regrettable that the CAA has published CAP1876 without properly considering our IBP, to some degree undermining the significant milestone that the IBP represents in the H7 regulatory process. Throughout this response we refer back to our IBP as our position on most of the CAA's proposals was clearly outlined in the IBP.

Chapter 1: The regulatory timetable

7. On 27th February, the Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the ANPS. The ANPS is therefore suspended, impacting Heathrow's ability to expand (including the timetable to do so). Heathrow has sought permission to the Supreme Court to appeal the Court of Appeal's findings.
8. Our IBP presented an integrated 3R plan and was developed using the M4 Gateway plan as the base for it. We intended to publish a Final Business Plan (FBP) in 2020, based on the M5 Gateway plan. Following the Court of Appeal decision, the timetable for delivering our plans as set out in the IBP are no longer achievable. We therefore need to consider how best to adapt our plans to enable the regulatory process to continue its course.
9. We have always been clear that, where possible, aligning the regulatory process and statutory process would be our preference, enabling us to develop a single and integrated 3R Masterplan that meets the needs of both processes, enabling us to integrate feedback and optimise governance around them. We have also been clear that there will never be perfect alignment between both processes, and that the regulatory process could not continuously hold off for the statutory process. The Court of Appeal decision has not changed our position.
10. We are open to any proposals to adjust, extend or alter the iH7 or H7 periods. We will approach such suggestions based on pragmatic criteria. This is doubly so given the business shock airlines and airport are currently experiencing due to the coronavirus. We

do believe that using the IBP as a base, it should be possible to deliver a H7 that starts in 2022.

11. We would also highlight our proposed use of trigger-based regulation to deal with the uncertainties around expansion and timing. This should allow the framework for expansion to be in place with clarity for all as how that might operate based on objective triggers for whenever in H7 that might become realistic. Establishing this framework should be an objective for the H7 regulatory process. This should be achievable without an unmanageable programme of work if there is a pragmatic mindset and approach.
12. If we were to deliver a January 2022 start to H7, the CAA, the airline community and Heathrow need to work together. We outline below important considerations that are required to achieve a 2022 start:
 - We will update our plan to reflect the Court's decision. We have already started working on this. An updated plan would be mainly based on a 2R Heathrow for the first years after 2022. We understand the importance of providing the most up to date information to the CAA and the airlines in order to facilitate meaningful engagement on the plan in addition to enabling the CAA to make a robust H7 price control determination. We would propose finding ways to update key numbers, rebasing not only for a more prolonged 2R world, but also for the current economic shock to inform discussions ahead of a full business plan.
 - As soon as possible, the CAA needs to define a workable timetable from now until the beginning of H7. The timetable should be fully defined, including clear milestones for Heathrow to publish the FBP, as well as for the CAA to issue its initial and updated proposals and required licence modification process. In defining the timetable, the CAA should reassess whether consultations planned in the context of the expansion process could be consolidated and re-sequenced given the Court's decision. Equally, we would strongly encourage the CAA to consider how best to avoid situations like the one created by the publication of CAP1876, which was published just weeks after our IBP and did not address any of our proposals in our plan. This produced a misalignment between the proposals in the CAA's publication and Heathrow's proposals in the IBP and subsequent CE discussions with the airline community.
 - Heathrow, the CAA and the airline community should exercise pragmatism and focus on the things that are important for consumers. In this regard, we believe that we should focus on the outcomes we are seeking to achieve in H7, including the resulting airport charges. We are very concerned that endless debates regarding the forecasting methodology for individual building blocks would delay the process without providing any real benefit for consumers, airlines or the airport. This is even more the case given the extraordinary circumstances the industry, airlines at Heathrow and the airport find themselves in as of March 2020 with the impact of coronavirus.
 - The H7 CE process successfully started following the publication of the IBP. While we recognise that we need to provide an updated version of the IBP, we believe that there is value in continuing to engage under the banner of H7 CE. Although parts of the plan will be updated such as the capital plan, other elements are unlikely to change, such as the passenger forecast methodology and output for the first 5 years, ORCs, and the opex and commercial efficiency proposals and forecasting methodology, which were deliberately designed to be flexible to changes. Equally, other areas such as the regulatory framework or capital efficiency would benefit from an open discussion while Heathrow develops an FBP.

We therefore strongly believe that there is value to be gained from continuing the CE process.

13. We have looked at previous CAA documents on the regulatory process as well as the timetable leading into Q6 to propose appropriate timescales for each stage to deliver a January 2022 start date for H7. For discussion, we outline below a workable regulatory timetable leading into H7 that broadly replicates the Q6 timings. We think that this timetable is achievable. It would provide sufficient time for meaningful CE, as well as for the CAA to fully consider the materials from Heathrow's business plans, and to complete its own consultations. It is closely aligned to the regulatory timetable adhered to in Q6.

Dec 2019	Heathrow provided IBP
Nov 2020	Heathrow provides its Final Business Plan (FBP)
Feb 2021	CAA's initial proposals for the H7 price control
Jul 2021	CAA's updated proposals
Oct 2021	CAA's statutory notice proposing modifications to Heathrow's Licence
Nov 2021	CAA's decision modifying Heathrow's Licence
Jan 2022	New H7 price control commences

14. We are very keen to find a suitable timetable for all stakeholders; therefore, we extend an offer to engage on this as soon as practicably possible to all stakeholders.

Chapter 2: Incentives for capital efficiency

The Development and Core framework

15. The established Development and Core framework provides strong, hard financial incentives for Heathrow to deliver capital investment efficiently. These incentives sometimes appear to be either underestimated or misunderstood. In this section we explain them clearly.
16. Firstly, at the outset of Q6 we jointly developed a definition of capital efficiency and inefficiency with the airline community set out in the Capital Efficiency Handbook. This is set out below:

“Efficient Capex is the delivery of an asset in a manner which optimises and balances Scope, Time, Cost, and Risk, procured in an appropriate manner having followed a structured Development process with appropriate decision points and governance”

“Inefficient Capex is the delivery of an asset in a manner which significantly fails to balance Scope, Time, Cost, and Risk, or which is procured in an inappropriate manner or has failed to follow a structured Development process with appropriate decision points and governance; and which has directly resulted in a financial or benefit loss”¹

¹ Capital Efficiency Handbook, page 38 and 39.

We believe that this definition provides very clear direction for Heathrow to deliver capital investment, it has therefore guided the way we deliver capital investment since 2014, including how we have set up ourselves to do so.

17. Having established the definition of capital efficiency and inefficiency, we jointly designed a delivery, governance and regulatory framework that provides strong incentives to achieving efficient capital investment. We outline below the main elements as per the description we provided in our IBP:

- Gateway process: our investment decisions go through a gateway process known as the Heathrow Gateway Lifecycle, which means that our business cases are reviewed at key points in their life. Gateway 3 (G3) represents a key milestone where the airline community agree to the business case proceeding into implementation, the right cost estimate for the scope and where triggers (where relevant) are defined.
- G3 value and triggers: The G3 business case value represents the cost allowance for Heathrow to recover through airport charges in the regulatory period. Once set, this allowance provides significant, financial ex-ante incentives for cost of delivery – this mechanism is further explained below. In addition, G3 sets ex-ante time incentives for Heathrow in the form of trigger payment definition for timely delivery of investment.
- Independent Fund Surveyor (IFS): the IFS is jointly commissioned by Heathrow and the airline community to guide, review and scrutinise in real time our spending decisions. The IFS plays a role throughout the majority of the gateway process. Its input is also used in the ex-post evaluation of final expenditure by providing impartial records and judgements of decisions at the time they were taken as opposed to years afterwards.
- The Capital Efficiency Handbook also outlines additional processes in place to ensuring that investment in design, governed and delivered in the right way. Including clear initial ambitions/outcomes to pursue with the investment and processes to assess that the benefits pursued with projects have been realised².

18. In addition to these structural elements that provide real time oversight and incentives on Heathrow to progress investment in a structured manner, consistent with the efficiency definition, the Development and Core framework defines strong ex-ante cost incentives:

- Following the airlines' endorsement of a particular project at G3, Heathrow is entitled to recover, via aeronautical charges, the return associated with the agreed value at G3 with the airlines. This means that if a particular project is delivered below or above the G3 value, Heathrow is fully exposed to the financial outperformance or underperformance. A stylised calculation is provided below. Throughout Q6, Heathrow has thus ex-ante incentives on average of 13.4% of the difference between the G3 value and the outturn value. The actual value at risk has varied through the Q6 period.

² More details are provided in the Capital Efficiency Handbook.

£m	Year 1	Year 2	Year 3	Year 4	Year 5	Cumulative ex ante incentive	Cumulative ex ante incentive (%)
G3 Value	100						
Outturn	110						
Deviation from G3	10						
Average value of Deviation (ie. Average RAB)	5	10	10	10	10		
WACC	5.35%	5.35%	5.35%	5.35%	5.35%		
Outperformance / Underperformance of return year 1	0.27	0.54	0.54	0.54	0.54	2.41	24%
Outperformance / Underperformance of return year 2	0.00	0.27	0.54	0.54	0.54	1.87	19%
Outperformance / Underperformance of return year 3	0.00	0.00	0.27	0.54	0.54	1.34	13%
Outperformance / Underperformance of return year 4	0.00	0.00	0.00	0.27	0.54	0.80	8%
Outperformance / Underperformance of return year 5	0.00	0.00	0.00	0.00	0.27	0.27	3%

19. The Development and Core framework also provides strong ex-post evaluations of expenditure at the end of the price control period. The CAA reviews whether Heathrow has efficiently delivered projects. Any expenditure that is considered inefficient is removed from the RAB and therefore not allowed to be recovered through airport charges in subsequent price control periods. Therefore, in addition to the in-price control ex-ante incentive described above, Heathrow is exposed to RAB disallowances of those projects that the CAA assesses to be inefficient and therefore not in the interest of consumers. Previous regulatory periods have had disallowances of between £30m to £50m of capital invested (in Q4 and Q5), showing this is not merely a theoretical incentive.

The need to assess the value of the current framework

20. Heathrow has consistently argued that before replacing the current regulatory incentives to delivering capital expenditure efficiently, the CAA needs to assess, understand and demonstrate any shortcomings of the current framework. This is of particular importance as a lot of progress has been made throughout Q6. We should be building on strength rather than starting from zero as if there had been no previous thought given to capital incentives.

21. We are very concerned that the CAA has not carried out this assessment. Indeed, based on assertions such as the ones provided below, it appears to misunderstand the current framework and pre-judge a need for change without supporting evidence.

“Without appropriate capital efficiency incentives, HAL’s potential returns would not be linked to timely delivery of the full scope of works required”.

The CAA demonstrates that it may have not fully understood how the Development and Core framework does indeed link realised returns to timely delivery of projects. This is through the trigger setting, the G3 ex-ante properties described above and the ex-post reviews.

“There would be a risk that HAL would not be properly incentivised to deliver capacity expansion in a way that would be affordable or most beneficial for consumers”

It is unclear how the CAA can conclude that absent changes to the incentives regime there is a risk that Heathrow would not be properly incentivised, when it does not appear to understand the incentives within the current framework.

“if we do not establish carefully calibrated new incentives it is likely to make it more difficult to deliver a regulatory framework that supports both financeability and affordability”.

The CAA’s assertion is that the current framework may not be the best answer to achieve an affordable and financeable framework. Again, this is not qualified by any evidence or analysis.

22. We encourage the CAA to assess and fully understand the relative merits of the current framework and also analyse other frameworks based on the well-established evidence base across the construction industry, before attempting to introduce changes. This would serve two purposes, to define a clear benchmark for future comparison and to identify any key areas that need to be addressed going forward.

Next steps

23. The current framework jointly developed by Heathrow and the airline community and supported by the CAA, works well. We are nevertheless, not opposed to improving it or even changing parts of the framework if this results in positive outcomes for all stakeholders. We are therefore happy to engage on this topic with the CAA and the airline community. Indeed, as part of the H7 CE process we have defined a Capital Efficiency workstream, allocating significant Heathrow and airline community resource, to discuss how best to deliver capital investment in H7. We envisage that capital incentives will be discussed at length.

24. We believe that the following considerations should be taken into account when investigating or introducing changes to the Development and Core framework:

- Proposed innovations need to be assessed relative to the current framework. This involves addressing the following questions:
 - i. How would a particular change generate the right incentives to deliver capital investment efficiently as per the definition agreed between Heathrow and the airline community? There needs to be a clear articulation of the risks that any incentives focus on - as there are multiple distinct risks in capital investment, not all of which can necessarily be incentivised simultaneously.
 - ii. Do the integrated changes provide for a better outcome than the existing Development and Core framework? In essence, any proposal for change should consider how it may impact the framework holistically. We have been clear that capital efficiency has to be analysed as a holistic package of measures that aim to incentivise and optimise delivery of investment from a cost, quality and time perspective, providing flexibility to adjust to unforeseen circumstances in the dynamic airport environment and the requirements of consumers, airline and airport.
 - iii. Any proposed innovations should be discussed by airlines and airport in the CE meetings. If Heathrow and the airline community reach an agreement, this should be ratified by the CAA. In this sense, we are surprised that the CAA appears to disagree with the industry view regarding the introduction of ex-ante incentives. From a cursory review there appears to be little to no appetite from either Heathrow or the airline community for introducing ex-ante incentives but rather to work together improve the current framework.

- Incentives should support an affordable and financeable outcome. We have strongly argued that the capital incentives framework should contribute to delivering an affordable and financeable outcome. We are therefore supportive of the CAA's ambition in this regard.
- Incentives should be reflective of the underlying characteristics of the investment that it aims to incentivise. We agree with the CAA that it may be unlikely that a "one size fit all" approach would be appropriate. This is also the case even when we delay or remove expansion related investment from the H7 investment plan. We agree with the CAA that the controllability of costs is an important consideration when defining efficiency incentives. However, controllability, and the costs of control, need to be considered in relation to the level of definition and development of a project, its position in the gateway lifecycle and the level of risk allocated at any given point.
- Incentives for capital efficiency should be considered under a wider package of measures for delivering capital investment. These include, the Heathrow Gateway cycle, governance associated with the delivery of investment, the role and responsibility of each party and ex-post reviews of efficient delivery. Introducing changes to the regulatory/financial incentives may trigger changes to other elements of the framework. These requirements need to be considered and addressed. For example, say the CAA was to introduce significant further ex-ante incentives at some point of the Gateway process (i.e. Gateway 3). In this case, following the definition of the scope, budget and incentives associated with it, Heathrow would be incentivised to deliver the project within these parameters, managing the risk and reward defined by the incentive arrangements. In order to provide clear cut incentives that worked, and to avoid double jeopardy, the CAA might then need to eliminate ex-post retrospective assessments of whether the project has been delivered efficiently.
- Incentives for capital efficiency, in particular cost incentives should reflect project maturity. We agree with the CAA that increasing maturity of costs estimates would facilitate setting more robust incentives for efficiency. This is of particular importance to delivering a regulatory framework that enables an affordable and financeable outcome. Setting strong cost incentives at early maturity of projects would have a significant impact on the overall risks of the framework, which would manifest itself in higher than otherwise airport charges.

Chapter 3: Allowed return

25. The issues raised in this Chapter were largely addressed at length in our IBP submission Chapters 12 and 14. These chapters should be read alongside our response to this consultation.

The CAA's early work on allowed return

26. We agree with the CAA on the importance of the CMA determination in respect of market wide parameters. It is likely that the CMA will set out important precedents and approaches for identifying the TMR and risk-free rate.

27. We also consider that it is possible that the CMA will set out important principles in respect of the approach towards some more company specific issues such as estimation of asset betas and the cost of new debt. Although the specific estimates for NERL may not be relevant, the principles behind the approach could have an important impact.

Determining the cost of equity finance

28. Given the importance of the CMA determination in respect of the allowed return for Heathrow, we encourage the CAA to delay any updates on WACC until this process is complete in May. In particular, we consider that basing a consultation on any interim findings in March could lead to the need for additional consultations if the CMA was to alter its view between its initial and final findings. Given that the final view is due in May this should not lead to an inappropriate delay. In addition, given the recent Court of Appeal findings⁷ the need for providing a preliminary view of the expansion WACC to guide M5 Gateway conversations between Heathrow and the airline community is no longer required.
29. The CAA has set out its initial thoughts on the reasons why expansion might lead to the requirement for additional returns. We agree with these initial thoughts, and the IBP set out a detailed assessment of the additional risks and consequential premium that would be required. In respect of some of the issues raised we offer the following comments:
- It is important to consider all risks around expansion and not just construction risk. Financing risk and volume risk are also higher;
 - The consultation identifies that the risk can be covered by either a specific allowance or an adjustment to the rate of return. It is important that the approach used is transparent and simple to explain to stakeholders. We consider that a rate of return adjustment is likely to be more transparent to stakeholders and has less risk of being misinterpreted by rating agencies. As such we consider that this is likely to be more beneficial for consumers;
 - The consultation suggests that some aspects of the risk assessment could be deferred to the following price control. As we set out in the IBP, financing expansion requires a long price control (15-years in the IBP). Credit Rating agencies derive a high degree of comfort from having certainty over the regulatory framework and potential cashflow generation over 15-years when assessing credit metrics in H7. In addition, using a shorter control would require a significantly higher premium for the first period (see IBP) creating affordability issues. Finally, deferring decisions on appropriate remuneration to subsequent periods does not allow investors to be confident about the later treatment and would lead to a perception of increased regulatory risk;
30. We agree on the importance of not double counting and in our IBP submission we were very careful to ensure that there was no double counting. In assessing construction risk, it is important not to overestimate the amount of risk that can be passed on to the supply chain. Passing on risk in this way can lead to higher costs and be a sub-optimal risk allocation from the point of consumers.
31. In respect of the scenario approach the CAA seems to conclude that adjustments for risk need to reflect the difference between the median and mean scenarios. In our IBP we also identified that the impact on p90 (downside) scenarios was also key as it reflects the potential change needed to avoid cliff edge outcomes (such as financial failure). Focusing on the change of central elements of the distribution can hide significant changes in risks at the tails that investors will be concerned with.
32. It is important that any benchmarking work is robust both in terms of considering the full range of risk, but also in terms of the time period over which the premium is applied. The PwC estimates were erroneous because they did not adjust for period and they did not

consider the full range of risk as we set out in our response to their estimate. It is disappointing that the CAA has referred again to this work without transparently referring to shortfalls in its analysis. The IBP sets out a robust analysis of benchmarks based on work by KPMG.

Determining the cost of debt finance

33. In the IBP we submitted a cost of debt estimate based on adjusting for ex-post iBoxx yields compared to the forecast iBoxx yields included in the plan. This approach is very similar to that proposed by Ofwat.
34. The consultation identifies the additional risk that Heathrow is exposed to compared to utility sectors as a result of its greater exposure to foreign currency interest rate risk and considers alternative approaches in which this could be mitigated:
- We agree that use of non-sterling indexes would not be a good approach to mitigate this risk;
 - We consider that the limited pass through mechanism suffers from being overly complex and lacking proper incentives for good treasury management;
 - We can see merits in the tramline approach if it were suitably calibrated.
35. We consider that the best way to implement a tramline approach would be to use it as a second potential adjustment around a debt indexation mechanism, this is like Ofwat's approach that automatically adjusts for the movement in the iBoxx index. There would then be an additional test to see if the actual cost of debt incurred by Heathrow was outside a range (e.g. +/- 25 bp) around the costs that would have been assumed for the outturn iBoxx in that year.
36. A key aspect of Ofwat's approach to introducing debt indexation was to set out a spreadsheet alongside its consultations that showed how its proposals would work in detail. This was good practice and allowed companies and stakeholders to engage on the proposals thoroughly. It would be helpful for the CAA to follow such an approach as it develops its policy in this area.
37. The consultation raises the potential for using a nominal cost of debt approach. A key concern with such an approach in the context of expansion is that it would lead to a significant increase in costs in the short term at a time when costs are likely to peak as a result of the expansion programme. Such a price profile is not likely to be preferred by airlines or other stakeholders. Given this, we do not consider that such an approach is appropriate.
38. The CAA also sets out a need for it to consider liquidity and embedded debt costs. Chapter 12 of our IBP submission included a significant amount of evidence in respect of these issues.

Determining allowed tax costs

39. The CAA sets out two options for treating corporation tax. The first was a continuation of the current pre-tax approach. The alternative was to move to a post-tax WACC with an explicit allowance for tax. In our IBP we set out our preference for option (i), a continuation of the current pre-tax approach. We provided detailed evidence in the regulatory framework chapter on why this was the appropriate approach (See Section 3.11 of Chapter 14).

40. In our IBP submission we noted a number of difficulties in actually undertaking an effective post-tax approach. We noted that a post-tax approach is difficult to validate given that historic actual tax rates may not be settle until many years after the specific tax year. We noted that the gearing of the company was likely to be close to the notional assumption during the period.
41. Finally, we noted the previous review by the CMA into this in 2007. In the review, the CMA recommended that the CAA continue to use a pre-tax approach on the grounds that there was no good reason to change and a post-tax approach would give undue added complexity. We are surprised that the CAA has not referred to this review in its consultation paper.

Chapter 4: The regulatory framework and financeability

42. The issues raised in this Chapter were addressed in Chapters 13 and 14 of our IBP submission. These chapters should be read alongside our response to this consultation.

Responses to the March 2019 consultation

43. We welcome the CAA's statement that it will consider a wider range of factors than solely affordability in its assessment of charges. We agree that such a wider approach is consistent with its primary duty under CAA12. We consider that this approach applies to both a 3R and a 2R H7 determination.

Providing longer term regulatory certainty

44. Providing longer term regulatory certainty is key to enable an affordable and financeable delivery of expansion. This is above all in the interest of consumers. Heathrow agrees with the CAA's discussion regarding the merits (flexibility to manage the profile of airport charges and greater certainty of returns) and drawbacks (increased forecasting risks and difficulty in responding to uncertainty) of setting a price control period for a longer period of time.
45. In the IBP we set out why a 15-year price control was required for expansion and outline a number of options to implement it. We also explain what elements of the price control should be fixed during the period and what elements could be subject to reopeners during this period. These options aim to build on the merits of providing longer term certainty and address the drawbacks identified by the CAA. A key further benefit of longer term certainty is that debt investors and credit rating agencies assess credit metrics on a forward-looking basis. Credit Rating agencies may tolerate weaker credit metrics within the regulatory period as the runway nears completion and debt levels peak if they have a higher degree of comfort on revenue generation over the following years of the regulatory period.
46. It is important to note that Heathrow's proposals do not seek a guarantee of realised returns (which will vary based on actual business performance) over the 15-year price control period but longer term certainty over how risks are allocated and priced (including incentives design) throughout the development, delivery and early operation of an expanded Heathrow. We are therefore encouraged by the CAA's assertion that it is investigating how to provide longer term regulatory certainty of the costs of equity and approach to incentives over a 10 to 15-year period.
47. Throughout CE, we are engaging with airlines over potential approaches for providing longer term regulatory certainty, including understanding their preferences over price

certainty, risks allocation, incentives and practical implementation. The discussions include price control re-openers, elements subject to these re-openers. We consider that it will be possible to construct a 15-year framework that provides the appropriate assurance for debt investors and shareholders regarding the regulatory framework and allows a smoother and predictable price profile for airlines whilst still being able to manage forecasting risk and wider uncertainty.

48. We consider that joint work on a potential framework remains an important priority despite the potential delay to expansion following the recent court judgement. We hope to be able to work with the CAA to develop an expansion regulatory package by the end of 2020.

Equity commitment

49. The CAA sets out that it is considering whether to ask Heathrow to provide support letters at various milestones to give increasing levels of assurance on equity commitment.
50. We consider that it is important that the CAA takes comfort from the commitments that are already in place or planned through the process. In particular, shareholders have already provided an equity capability statement to the DfT and signed off an IBP which they believe is deliverable and financeable. Shareholders will also support the FBP and provide a funding statement with the DCO submission. We consider that the CAA should take sufficient assurance from these existing milestones.
51. We are not persuaded by the CAA's argument that Heathrow should provide an equity commitment ahead of the CAA making its own final proposals / decision based on certain PFI bidding situations. This comparison is not valid in our opinion. In a PFI contract a bidder would provide an equity commitment associated with its own bid for the particular contract, not an open-ended commitment. In this regard, Heathrow's investors support for the FBP and funding statement as part of the DCO submission are a direct comparator to equity commitments expressed in a PFI bidding process.
52. Equity investors are highly unlikely to be able to make equity commitments before there is clarity on the commercial and regulatory terms on which expansion would proceed. Heathrow and its investors have noted this reality since at least the Statement of Principles agreed with government and seen by the CAA.

Calibrating the price control

53. We welcome the CAA's recognition that Heathrow will need to retain an A- credit rating to be able to finance expansion. We believe that this should be the cornerstone of the CAA's financeability assessment for the expansion regulatory framework.
54. In terms of financial structure, our current view is that the regulated business will have gearing close to the notional assumption of 60% during expansion. As such, we do not consider there is a requirement to assess more highly geared structures or to use a 'twin track' approach. This also means that gearing will no longer be a driver to move from the current approach to taxation.
55. The CAA sets out potential approaches for help manage financeability and affordability. We do not consider that adjusting regulatory depreciation is an appropriate lever to manage financeability as rating agencies are likely to look through such adjustments. As discussed above, credit rating agencies assess credit metrics over a relatively long timeframe – the exact number of years varies by agency. As such, adjusting depreciation provides no incremental benefit as by definition it improves short term cashflows but weakens cashflows in the future.

56. In addition, approaches such as using a nominal cost of debt cause affordability issues in the short term and can lead to even greater financeability pressures in the future. In the IBP we show that expansion is financeable at the WACC included in the plan and that there is no need for additional adjustments.

Equity investability

57. Our investors have expressed their will to provide sufficient fresh equity to deliver expansion under the right regulatory and financial conditions. Equity investability is key for expansion for several reasons including:

- Significant new equity is required directly to deliver expansion;
- Heathrow also needs to retain an A- rating to enable affordable debt financing at an appropriate scale. Without sufficient equity support, our credit metrics will fall below credit rating agencies tolerances or debt investors may have reduced confidence in our ability to raise finance in future. That will lead to higher costs and reduced access to funding.
- Equity support is needed to support credit metrics in the event of a wide range of reasonable down-side scenarios. If equity is not properly incentivised, then the ability to manage the risks of expansion is severely curtailed.

58. Our shareholders invest on a global basis. In order to attract sufficient equity financing, our plan therefore needs to deliver appropriate returns that are commensurate with the risks that shareholders are exposed to benchmarked against other investment opportunities world-wide. Equity investability is highly sensitive to both the level of WACC and the future certainty of the cost of equity in particular. For example, every 0.5% reduction in WACC increases the net equity required to support an A- rating by approximately £2.2 billion driven primarily by the need to reduce leverage to maintain the same credit metrics.

59. An additional consideration to assessing investability is the time until returns on investment start being delivered. The nature of expansion means that free-cashflow is negative for a long period so recovery for equity investors is delayed. In the IBP we showed that free cash flow was anticipated to be negative until after 2028, and cashflow after taxes and interest negative until after 2030. This long period until free cashflows turn positive increases equity risk and means that regulatory risk remains a key concern.

60. We set out the key issues around equity investability in Chapter 13 of the IBP. These issues should drive the assessment of whether the regulatory determination is investable from an equity perspective. In this, we set out that the key requirements affecting equity investability were that:

- The expected returns from the investment are commensurate with the associated risks and in line with global benchmarks;
- The requirements for and quantity of new equity is appropriate and manageable;
- Equity risk is clear, predictable and mitigated; and
- Regulatory risk is mitigated through use of a sufficiently lengthy (15-year) regulatory framework and cost of equity.

61. To help reduce this regulatory risk, in the IBP we propose to fix certain elements of the regulatory settlement over a longer period (see Chapter 14 - Regulatory Framework) to ensure that there is clarity and high visibility, particularly on the cost of equity and key elements of the framework over a longer period.
62. The CAA outlines a number of proposed metrics to assess equity investability. While these metrics provide insight into whether a determination attains a particular level of financial performance our shareholders will take a holistic view in assessing the returns achievable by investing in an expanded Heathrow versus the level of risk associated with their investment over the longer term.
63. Shareholders are likely to use a wide range of tools to assess the risk adjusted returns available from additional investment in Heathrow versus returns available to them by investing elsewhere. As a result, long term regulatory stability is a key non-financial metric which drives the fundamental issues outlined above. We would like to work with the CAA to define a clear and holistic process to assessing equity investability.