CDPQ

9 August 2022

CDPQ STATEMENT ON THE CAA's H7 FINAL PROPOSALS

1. INTRODUCTION

1.1 This statement is submitted by Caisse de dépôt et placement du Québec ('CDPQ').

1.2 CPDQ is a major investor in Heathrow and other infrastructure assets around the world (the second largest globally). We are a long-term investor: for instance, we invested in Heathrow in 2006.

1.3 This statement consists of four sections:

1.3.1 An introduction to CPDQ as an investor in regulated infrastructure business (around the world) and in Heathrow in particular.

1.3.2 The impact on investment of the CAA's H7 decisions from an investor's perspective.

1.3.3 The impact on investment of the CAA decision to make no further adjustment to the RAB.

1.3.4 The impact of the CAA decisions on CDPQ's preparedness to invest in Heathrow expansion.

1.4 Where this statement is silent on any point made by the CAA it should not be inferred from that silence that we accept it or consider it to be true. Only the most concerning CAA positions are commented upon here.

1.5 CDPQ has also submitted a letter dated 4.3.21 in support of Heathrow's position on the RAB adjustment.

2. SUMMARY OF THIS STATEMENT

2.1 In summary:

2.1.1 Regulatory systems, and more importantly how they are implemented in practice, are a key input into our investment and divestments decisions. It is not just a question of regulatory theory but how regulators exercise their powers within the legal framework. Above all, we seek evidence of fairness, stability and predictability in the system and in its application.

2.1.2 We have previously considered the CAA's approach, in most instances, as a fair and consistent environment from a regulatory perspective (even though returns have been less that we had realistically expected);

2.1.3 However, COVID has fundamentally changed things;

2.1.4 From our perspective as an investor, we do not consider the CAA has behaved fairly during the COVID crisis and more recently the H7 Final proposals exhibits the same issue. The CAA's approach since COVID hit has introduced some real weaknesses into the UK regulatory regime;

2.1.5 This manifests itself, to our mind, in clear errors in the CAA's decision, especially in relation to:

2.1.5.1 The H7 WACC (and in particular the asset beta); and

2.1.5.2 The RAB adjustment.

2.1.6 Introducing weaknesses matters from an investability perspective:

2.1.6.1 We now have less confidence that we will in the future earn a reasonable return from our investment over the long term.

2.1.6.2 The RAB reopener and H7 decision proposals damage Heathrow from an equity investment perspective.

2.1.6.3 Pre-COVID, CDPQ saw a path for the regulatory system to evolve to reflect the evolving circumstances of Heathrow expansion. On this basis, we expected to be ready to invest and support expansion. As it stands now, we are much less confident in our ability to invest in any future expansion; unless the Final Proposals are changed to demonstrate more fairness in the application of the regulatory system.

3. AN INTRODUCTION TO CDPQ AND ITS APPROACH TO INVESTMENT

3.1 CDPQ is a world leader in infrastructure investment, with over 20 years of experience. Our team makes direct investments in companies involved in various types of infrastructure in developed markets as well as in targeted growth markets. These assets include ports, airports, highways, wind farms, public transit systems, and energy transportation and distribution networks. A significant proportion of these investments are and have been in regulated markets.

3.2 Through our subsidiary CDPQ Infra, we are also acting as a developer of a light rail transit system by providing integrated management of the planning, financing, construction and operating phases. This gives us additional insight into the challenges and opportunities in these markets.

3.3 Our infrastructure portfolio was valued at around CAD$ 45bn as at 31 Dec. 2021 and we invest in 16 countries around the world. We are the world's second largest infrastructure investor.

3.4 We are thus well placed to assess the position of Heathrow as an investment. Of course, we want to realise reasonable returns in the short and medium term but we put more significant store on long term returns and long term certainty. Our holding in Heathrow is the perfect example of this long term view since we first invested 16 years ago.

3.5 With regard to investment in regulated entities, these long term returns are a function of both the regulatory system and its practical application by regulators. In short, we need the regulatory regime and its application to be fair, stable and predictable.

3.6 For equity investors, fairness is not just a question of regulatory theory. Fairness needs to be continuously evidenced in the regulator's decisions. In other words, rules have to be fair but importantly they need to be applied fairly and consistently, not adjusted after the fact to suit a particular agenda.

3.7 This perception of fairness is fundamental to our investment decisions. For instance, when, in November 2021, CDPQ held conversations with HM Government and its advisers about nuclear power generation financing, CDPQ set out the rationale for why it would be challenging to invest in this sector if the government was proposing a regulatory framework as flawed as Heathrow's, as evidenced by the CAA's Initial Proposals at the time (***<u>Note</u>***: the Final Proposals were not available at the time but CDPQ has not changed its views on the matter with the publication of the Final Proposals).

An overview on CDPQ's initial decision to invest, and continue to invest, in Heathrow

3.8 CDPQ has a long history with Heathrow. We were one of the three shareholders which invested in 2006.

3.9 There is a bargain inherent in investing in regulated markets: we give up uncapped return upside (usually associated with pure commercial businesses) for a lower volatility of returns (ie. actual returns are expected to fall within a narrow predictable range centred around the allowed return). This lower volatility is in large part achieved through the return of the efficiently incurred investments via the recovery of depreciation. The lower volatility is also achieved through the careful forecasting of the other building blocks. Both the recovery of efficient investments and the expected narrow forecasting error of the building blocks have been challenged by COVID. Neither have been fairly remedied by the CAA.

3.10 The point we would like to make here is that this is not just a question of regulatory theory or policy. Application of the rules by the regulator in real life situations genuinely impacts on our investment decision-making.

3.11 As noted above, CDPQ is a long-term investor. For us, short-term dividend returns are not necessarily as critical as perhaps for other investors. We lived through Heathrow's underperformance during Q4 and Q5, but were at least enjoying Heathrow's overperformance in Q6 until Covid hit during iH7. We understood and expected that over time Heathrow would sometimes perform (slightly) below or (slightly) above its regulatory settlement.

3.12 Our investment decisions in this context are based on the principle that over time the overperformance and underperformance can reasonably be expected to balance each other. This is, though, only possible if the underperformance is "moderate". That is because, due to Heathrow's capped passenger movement capacity, overperformance will always, de facto, be "moderate". In regulatory jargon, we would not invest unless we are confident that the regulatory system offers us a "fair bet".

3.13 This balancing of under- and out- performance is, inter alia, largely predicated upon the return of capital via depreciation which ensures a floored return (i.e., avoids a negative return) for investors.

3.14 This balance of over- and under-performance is crucial in CDPQ's decision process. If such balance is lacking, CPDQ will choose not to invest in a new company, or even divest of an existing investment.

4. THE H7 SETTLEMENT FROM AN INVESTOR'S PERSPECTIVE

The impact of Covid on our perception of the regulatory system

4.1 CDPQ – and other investors in our position – have traditionally seen airports as a good investment from a regulatory risk perspective. Aeronautical charges tended to be apolitical – unlike (say) energy or water, and volumes have historically been relatively stable. Returns on investment have certainly not been spectacular in the case of Heathrow; but our investment had been seen as relatively safe. Above all, we took the view that the UK was a stable and fair regulatory environment which should, in theory, offer us a fair return over time. Even if we did not make a profit at the expected, or allowed by regulation, level we took the view that the deviation from this expected return would be quite limited and certainly we never expected to experience any negative return.

4.2 COVID, however, has changed all that.

4.3 During the Q6 settlement initial consultations, Heathrow and its shareholders argued that Heathrow's beta did not reflect the asymmetric risk Heathrow was exposed to. Ultimately the CAA rejected Heathrow's arguments but offered to reopen the settlement in exceptional circumstances to cater for these extreme "risks" that Heathrow was highlighting and the CAA did not, at the time, recognise. We never expected this reopening of the settlement to guarantee the regulated return in full, but we certainly expected that it would at least ensure Heathrow avoided a negative return (once reopener actions were considered). The CAA decisions to date invalidate that assumption and, if upheld, create an inherent unfairness in the system.

4.4 In refusing to act with fairness in the face of an exceptional event the CAA has failed to maintain a level-playing field. Indeed, a tilt in the playing field in favour of airlines seems to be emerging to the detriment of Heathrow and the regulatory model.

4.5 As an investor we now have concerns with the CAA's ability to act as a fair, objective and independent regulatory body. Covid has exposed an apparent unwillingness to deliver a fair outcome if it involves taking contentious decisions.

The CAA's treatment of the WACC

4.6 In considering investments, CDPQ attach significant weight to past regulatory practice as it allows us to understand how the legal regulatory framework is interpreted in practice by the regulator – regulatory consistency is very important. Further, CDPQ, in general, takes a lot of comfort in the independence and accountability of UK regulators, and their use of market data which feeds into their modelling and conclusions.

4.7 In the cost of equity assessment, the most vital independent evidence is the market data of comparable companies on which the beta for the licensee company has been based in the past. The use of such data never guarantees an outcome but leaves stakeholders knowing what to expect in terms of process and the likely range of possible outcomes.

4.8 In the Final Proposals, the CAA has seemingly disregarded the independent market data and instead proposed its own, arbitrary, logic to determine Heathrow's beta post pandemic (as opposed to the airport betas previously experienced before COVID) – discussed more below. This change in approach has produced an outcome that has created uncertainty about the regulatory framework (with lasting effects in quinquenniums to come as this has removed the consistency of approach in this regard), and resulted in an outcome which is not acceptable from an investor perspective.

4.9 In a series of steps, the CAA estimates the asset beta post pandemic. However, instead of using market comparators as the CAA and other regulators have done in the past which would provide, by definition, the market's view on an airport beta post pandemic, the CAA chooses, for reasons unknown, to substitute its own view for the market's view. Through a series of unfounded "guess-timates" based on outdated and incomplete[1] data, the CAA makes up what an airport beta post pandemic could be. In the absence of any reliable market data, this approach may have been a possible solution to assess Heathrow's beta post Covid. In this instance however, reliable and up-to-date market data is available and proves the CAA estimates wrong. This departure from regulatory practice is of particular concern to CDPQ because it has not been explained or appropriately justified.

4.10 In addition to the above errors made in the cost of equity calculations, the CAA has also incorrectly calculated Heathrow's cost of debt.

4.11 CDPQ finds it particularly worrying that the CAA is arbitrarily also deviating from its own past practices in this area (including practices used as late as in the Initial Proposals).

4.12 To name but two of these deviations, the CAA has chosen to (a) use a 13.5 year debt maturity for Heathrow's embedded debt (when it previously used 20 years) and (b) deflate Heathrow's cost of debt using inflation forecasts adopting short to medium term inflation forecasts instead of its previously consistent approach using long term inflation estimates.

4.13 Both of these examples are significant departures from the Initial Proposals but more importantly depart from previously consistent established regulatory practice. This cannot be left unchallenged.

[1] By using Q6 data only, the CAA is choosing to ignore data derived from AENA which had not been listed at the time for long enough

4.14 Lastly, the CAA made another change to regulatory practice by changing the way it calculates the RAB on which return is obtained. This change has not only not been consulted on, but it has also not even been identified in the CAA consultation. The CAA must be open in its dealings with all parties by identifying and justifying all such material changes during the process. The CAA's failure to do this undermines our trust in the fairness of the system.

Lack of credibility of the traffic risk sharing mechanism

4.15 While we understand the benefit of introducing a mechanistic TRS to cater for exceptional events, it will only achieve its intended benefits if investors and the licensee company trust in its fair application.

4.16 There must be an assurance that the methodology will be followed and provide expected outcomes that go towards the CAA's objectives of increasing investors' confidence in the settlement and reducing Heathrow's risk.

4.17 While a TRS might, if carefully designed but more importantly carefully applied, alleviate these concerns going forward, we have currently no confidence that its application would be fair. Heathrow had "protection" for Q6 for exceptional circumstances through the possibility of a reopener. However, the application of this protection has not even ensured the recovery of depreciation (let alone the full opex recovery). Until we have a fair resolution of the Q6 reopener it is hard to have any confidence that the TRS mechanism would achieve its stated purpose.

4.18 In addition, one can see what happened with NERL where a TRS mechanism was in place pre pandemic, but was not applied at the time it was most required. This shows that having an established TRS mechanism does not necessarily remove the subjective issues that Heathrow is currently facing with the RAB reopener.

4.19 Traffic risk sharing has merits in principle but we have to be confident that it will work irrespective of how the results of its application will be perceived by the airlines or the media. As mentioned before, CDPQ put a lot of weight on past regulatory actions (and not just on the legal framework). Based on our own experience with the RAB reopener and what is happening at NERL, we are sceptical that the TRS will work as intended, and especially at a time when it most needs to work (i.e. in the aftermath a crisis). We cannot conclude that the TRS, in practice, actually materially derisks the investment.

5. THE IMPACT ON INVESTMENT OF THE CAA'S DECISION TO MAKE NO FURTHER ADJUSTMENT TO THE RAB

Key issues with the CAA's decision to make no further adjustment to the RAB

5.1 Aside from the various errors the CAA made in its determination of H7, it has also erred in its assessment of the RAB reopener – if only by conflating it with the H7 determination.

5.2 One should get back to first principles: the regulatory system works by calculating the allowed aeronautical revenues to cover (1) operating expenses; (2) the return of capital (depreciation); and (3) an allowed level of return on said capital (all this after consideration of commercial revenues). As these calculations are based on forecasts the achieved returns will always differ from the theoretical returns. Nonetheless, the difference should, by design, lead to a narrow range of actual returns, and certainly never to any negative returns. This stability of returns is what is required to achieve a low cost of capital.

5.3 Recovering depreciation and opex should ensure this even in the most adverse scenario. This is the very foundation of our investment in Heathrow and of our perception of the somewhat limited risks to Heathrow's returns.

5.4 By not ensuring that the RAB reopener covers, at least, depreciation during the pandemic, the CAA is putting at risk the return of (not just the return on) past investments which is one of the key tenets of the regulatory system. In doing so, the CAA has chosen to expose Heathrow to unlimited risks and negative returns while de facto maintaining its capped return. This is the opposite of a "fair bet" and shatters our previous perception of Heathrow's risks.

5.5 Even if the CAA had allowed the recovery of the RAB during COVID, and no more, it would only have ensured that Heathrow achieved a nil return. The fair bet expectation is that Heathrow would be able to make its forgone return over time through outperformance. This would require Heathrow's return to be significantly above the allowed return for enough years at some point in the future to recover the pandemic shortfall. In practice, because of the physical capacity limitation of Heathrow, this is not a realistic proposition. The RAB adjustment therefore needs to cover both depreciation and opex otherwise, Heathrow faced disproportionate downside compared to restricted and capped potential upside.

6. THE IMPACT OF THE CAA DECISIONS ON CDPQ'S PREPAREDNESS TO INVEST IN EXPANSION AT HEATHROW

6.1 Pre Covid, we joined Heathrow in discussions with the CAA about ways to improve the regulatory system, or at least adapt it to expansion. The expansion situation is complex and stands in contrast to Heathrow being at or near capacity with limited traffic variability historically. The expansion world is very different. Overnight there would be significantly more capacity, but no one knows when, or even if, it will be used. The discussions with the CAA led us to believe that there would be a path to adapt the system to this new reality.

6.2 For instance, the CAA eventually acknowledged the need for a return premium for expansion which investors interpreted as a good sign. However, we were conscious of our experience with Terminal 5 when the CAA backtracked on the Q5 settlement. The CAA had agreed in Q4 to a 50bps adjustment for the risk associated with investment in Terminal 5. However, this adjustment was not retained for Q5 despite the fact that it had been calculated to allow recovery of the risk over a longer period than just Q4. This about turn is highly relevant to considerations about expansion investment.

6.3 With this experience in mind, investors also discussed with the CAA the length of the "expansion" settlement and whether some aspects of the settlement, like the asset beta, could be fixed for 10-15 years, so the incentive to invest would not be taken away as it had been with Terminal 5. These conversations between the CAA and Heathrow management seemed to be heading in the right direction at the time.

6.4 Whether we would proceed with an investment in expansion is about confidence in the system and in its application by the regulator. The regulatory developments since Covid, coupled with our experience with the reopener, now create a significant amount of uncertainty for us.

6.5 In addition, the starting point in terms of gearing would now be much higher post-Covid, whether you look at the actual or at the notional balance sheet. This means that compared to pre-Covid plans expansion will now require an even higher proportion of new equity. Maintaining the confidence of equity holders is therefore even more important than it was before.

6.6 As mentioned before CDPQ is now much less confident in its ability to proceed with expansion.