

## **Cost of capital airports (Q6)**

### **Overall aims:**

1. To estimate the appropriate costs of capital to be used by the CAA in the economic regulation of airports Q6 (Heathrow, Gatwick and Stansted) price controls.
2. The purpose of this work is to safeguard the CAA's ability to regulate prices and should not be interpreted to imply that the airport in question will be regulated in Q6, and if it is regulated in Q6 the form of that economic regulation.
3. The work will take into account, but by no means bound by:
  - a. previous CAA publications and decisions;
  - b. Competition Commission recommendations for previous airport reviews; and
  - c. recent decisions and publications by sectoral regulators and the Competition Commission.
4. The work will also assess, and take into account where appropriate, the submissions received to by the CAA in respect of Q6 cost of capital; and relevant academic literature.
5. The work will recommend a range for each cost of capital and an appropriate point estimate in that range.

### **Phase 1 Scope**

6. .To advise on whether to, and if so how to, take account of:
  - a. the split cost of capital; and
  - b. skewness of returns;in the calculation of the cost of capital.
7. To calculate the broad magnitude and directional impact of the cost of capital of each of the split cost of capital and skewness of returns.

### **Phase 2 Scope**

8. To estimate the cost of capital for Heathrow, Gatwick, and Stansted airports using company, market and academic evidence using the following components and considerations:
  - a. cost of debt estimate including, but not limited to, the following considerations:
    - i. appropriate debt portfolio;
    - ii. airport specific data;
    - iii. market data (and its interpretation);
    - iv. allowance for fees as appropriate;
    - v. cost of pre-funding if appropriate;
    - vi. the appropriateness of indexation of the cost of debt; and
    - vii. any other cost of debt issues.
  - b. cost of equity estimate including, but not limited to, the following considerations:
    - i. Capital Asset Pricing Model (CAPM):
      - risk-free rate;

- equity risk premium;
  - risk and beta (including the asset, debt and equity beta);
  - the affect of asymmetric risk and skewed returns;
  - any other CAPM issues; and
- ii. sense checked by other approaches to estimating the cost of equity.
- c. Gearing
- i. notional, actual, forecast and alternative estimates.
- d. The appropriate treatment of corporate tax within the WACC.
- e. Assessment/comparison to cost of capital decisions by other sectoral regulators as appropriate.
- f. The choice from the range of a point estimate.
- g. Implications for the accuracy with which the cost of capital can be estimated given recent, current and possible future economic conditions and how this is incorporated in the cost of capital.
- h. Any other issues identified by the consultants.

### **Phase 3 Scope**

9. Update the Phase 1 and 2 work including an estimate for the cost of capital to be used in the final proposals for Heathrow and Gatwick.

### **Form of regulation, price control design and risk for airports**

10. The form of regulation and price cap design should be assumed to be the same as Q5 unless otherwise instructed by the CAA. (This should not be interpreted to imply that the airport in question will be regulated in Q6, and if it is regulated in Q6 the form of that economic regulation)

### **Publication**

11. The CAA expects to publish final reports for Phase 1, 2 and 3 on its website.