NO 3RD RUNWAY COALITION

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Response to CAA consultation on CAP 1832: Financial Resilience and ring fencing.

9th October 2019

General

In our view the policy aim of not taking an approach that could undermine the delivery of capacity expansion by making it harder for HAL to raise finance is misguided.

Surely the purpose of a regulator is to provide protection to consumers and taxpayers, yet there appears to be placing the interests of one private company above everything else. Whilst we understand that it is the CAA's role to help deliver Government policy, we believe that it is not the job for the regulator to assist/make it easier for Heathrow to deliver their expansion.

We believe that the licence protections relating to financial resilience should be strengthened significantly to ensure that taxpayers are not exposed to the risks being incurred by Heathrow's expansion plans.

Owing to the nature of its RAB, Heathrow's capital projects are financed by debt. However, according to the 2018 accounts of the holding group (FGP Topco Ltd) and its 12 subsidiaries, there appears to be around £23billion in reserves. Rather than invest these reserves, the RAB allows HAL to offset the financial costs of borrowing and losses against these profits.

This will effectively disadvantage customers and have a negative impact on the UK economy by resulting in higher user fees.

This simply cannot be the most efficient way to regulate the UK's national infrastructure in terms of cost for the passengers or the taxpayers.

If HAL want to expand than they should be required to do so predominately from their reserves to ensure that they have the necessary self-interest/incentives to deliver value for money. This would help shift the risk of the project back onto the company that is promoting it rather than on customers or taxpayers.

Perversely, the RAB model creates the wrong incentive structure that rewards HAL the more capital they borrow. This cannot be correct from a financial risk management perspective and is surely the job of the regulator to proffer an alternative.

The (RAB) makes debt raising attractive and the price cap too high and uncompetitive. Funding the runway and terminal expansions by debt is not acceptable to the airlines as it will inevitably mean additional airport charges – despite HAL's claims to the contrary.

The RAB Model means that customers pay financing costs (debt service and return on shareholder equity - dividend payments to investors) to Heathrow during the lengthy construction period. Hence, there is little incentive for Heathrow and their contractors to build the new facilities to time and cost.

Such a concept is contrary to the conventional principles underpinning the privatisation of public services, where the risk of, and responsibility for, investment and service delivery should reside solely with the private owner of the assets.

The effect is to allow HAL to create a quasi-private sector monopoly to the disadvantage of customers.

Views on the Consultation

- **Gearing Cap**

Heathrow as a company has debt of £13.7bn and a £15.8bn asset base — giving it a leverage ratio of 87%.

Financing the construction of a third runway would almost double the size of Heathrow's £15.8bn asset base. This would also require stretching its balance sheet further, taking the leverage ratio up to 93%.

By way of comparison, the highly geared utility Thames Water has ratio of 81.5%, and is under pressure to reduce it.

In 2012, the CAA imposed a gearing ceiling on the air-traffic company NATS of 65%. If debt climbs above this level, NATS is banned from paying dividends.

A similar cap on Heathrow's gearing — a measure of its debt as a proportion of the value of its assets — would ban dividends if borrowings climb above a certain level. Such a cap should be imposed by the CAA on Heathrow and this could affect their ability to raise funds for the runway.

Given that HAL is already highly leveraged, a cap on debt-asset ratio is essential. In our view it is a mistake that this consultation chooses to ignore this option, particularly when it already exists within the aviation sector (NATS).

- **Disposal of Assets**

Heathrow have sold off assets since 2009, this is how they've been able to make dividend payments to shareholders. It is not evident what other asserts remain available to sell.

- **Credit Rating Obligation – which company in HAL group – what obligation**

The proposal to create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the investment grade credit rating is lost makes sense.

This trigger needs to be set at an appropriate level to reflect any downgrading in Heathrow's credit worthiness.

Such an obligation should be placed on the parent company and any company with significant assets and reserves that may need to be leveraged to secure the finance for construction of a third runway.

- **Sufficiency of Resources**

It makes absolute sense to create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the certificate given is not "clean". The lack of financial transparency around expansion plans is of significant concern to the markets and HAL should be limited in their freedom to make dividend payments, particularly if their investment grade credit rating is downgraded.

The current structure allows Heathrow to raise debt but the repayments of this are ultimately passed on to consumers. The construction of a third runway will make these repayments significantly more expensive.

The Airports Commission's base case financial model for Heathrow forecasts capital costs of £80 billion. This comprised £25 billion for the Northwest runway expansion scheme, £22 billion for core capital expenditure and £33 billion for replacement capital expenditure, all through to 2050.

However, the recent statutory consultation from Heathrow revelaed that the costs for the third runway are likely to be over £31 billion. This means that Heathrow's peak debt will need to rise from £11 billion in 2014 to at least £40 billion in 2028, which with re-financing needs will be a huge challenge for debt markets.

PwC estimates that Heathrow would have to issue £3bn to £6bn of bonds a year for most of the 2020s in to finance the third runway. That would swamp the market for sterling bonds.

- **Use and design of a targeted curtailment of HAL's ability to make dividend and other payments**

We agree that new rules creating a targeted restriction on HAL's ability to pass funds to its shareholders should be established, particularly where their investment grade credit rating is under review.

- **New requirements on HAL to provide information.**

Welcome proposal for more onerous obligations to apply in the event of financial distress.

It is worth noting S&P's concerns in their August 2019 ratings assessment out lack of transparency of financing for third runway in Heathrow's plans. Indeed, they stated that there was insufficient information about exactly how the project would be financed in terms of levels of debt and equity and how this would be balanced with objective of keeping landing charges close to 2016 levels.

The S&P report also highlighted as a risk the aggressive leveraging and relatively weak credit metrics of HAL.