

Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's consultation of January 2020 on the regulatory framework and financial issues for Heathrow Airport Limited ("HAL") (CAP1876). It sets out the views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus and LEVEL.
2. It does not seek to comment on every point raised in CAP1876 - rather, it focuses on key issues; however, we may subsequently comment on others.

Summary

3. In January 2020, the CAA published a further consultation on the regulatory framework and financial issues for HAL (CAP1876). Subsequently on Thursday 27th February, the Court of Appeal issued a judgement which found the designation of the Airports National Policy Statement unlawful. In the light of this judgement the risks to the scheme have substantially increased. **We call on the CAA to ensure that any spending by HAL from the judgement onwards is done so at their own risk.**
4. It should be noted that CAP1876 focusses primarily on expansion. There is now significant uncertainty over expansion. However, the views of IAG are provided for completeness and many comments are still highly relevant in a two-runway scenario.
5. IAG has commissioned a report from CEPA to update and comment on certain aspects of this consultation. The report has been appended to this document.

Regulatory timetable

6. Following the recent court of appeal decision on Heathrow Expansion and HAL's subsequent decision to mothball Expansion Plans, we urge the CAA to act quickly to put in place a revised H7 process that reflects the current situation.
7. IAG strongly believes that the start of H7 should be 1st January 2022 which should include a brand-new settlement including updated building blocks and the latest thinking on WACC, forecasts etc. There should be no continuation of Q6 assumptions, which have effectively been extended to 8 years already and are underpinned by assumptions that were made nearly a decade ago and are well out of date.

8. IAG and the airline community believe that the H7 regulatory settlement should revert to a more traditional length in the range of 4 to 5 years. Collectively we do not believe a longer settlement should be considered at this stage due to considerable uncertainty over expansion.
9. IAG believes that the CAA's framework for H7, HAL's business plan and the resultant settlement should be for a two-runway world with, if appropriate, a three-runway overlay.
10. IAG is concerned about the lack of near-term planning and detail in HAL's current Initial Business Plan (IBP) and would strongly urge HAL to spend some time coming up with a 4-5 year two-runway IBP that can be reviewed before the Final Business Plan (FBP) is released. It is hard to see how meaningful Constructive Engagement can take place by jumping to a two-runway FBP without the community having had a chance to review the building blocks of a two runway IBP first.
11. We request that HAL review and amend their Constructive Engagement plan so that near term engagement only focuses on those aspects that are pertinent to a revised 4-5 year two-runway plan. This should free up some time for HAL to develop a revised 4-5 year plan.
12. Given the need to review and re-plan large elements of the IBP, IAG proposes the following high-level timetable:
 - HAL to release Two-runway IBP by end April
 - Constructive Engagement through to September/October
 - Final Business plan in November

Allowed return

13. We agree with the CAA's approach to roll-forward the 'as-is' WACC and then make an adjustment for expansion as doing so is transparent and makes use of existing analysis. However, we would caution that it is more appropriate to think in terms of an 'adjustment' rather than an 'uplift' to WACC. Thinking of an uplift prejudices the answer to the question of whether HAL's exposure to risk will increase, which is a function of the regulatory regime as well as any inherent volatility in cash flows. To be clear, HAL have not increased their exposure to risk.
14. Contemplation of the need for an adjustment should start from an appropriate base. The Q6 roll-forward analysis appended represents the WACC for a private airport with significant market power in a regulatory framework. Despite the size of the proposed expansion project it is not clear that the fundamental proposition for HAL's investors will be materially different from this. The evidence for individual parameters will of

course continue to change. Irrespective of that our Q6 roll-forward presents a view that is similar to that put forward by the CAA's own advisors, PwC. It also demonstrates the wide gap between HAL's proposals and the evidence.

15. Any adjustment should be grounded in an assessment of how risk exposure has changed, and should recognise that without a dramatic shift in the single till approach, exposure to volume risk or cost incentives, HAL's risk exposure is likely to remain below that of typical private airports. The experience of the Thames Tideway Tunnel (TTT) shows that risk exposure for large, complex projects can be tightly controlled. If required, an adjustment ought also to be computed within the common regulatory language of the CAPM not added arbitrarily as is the case in HAL's IBP.
16. Evidence from HAL's actual debt costs (at a gearing materially above notional) indicates standard cost of debt indices are sufficient to remunerate HAL's notional debt costs. Provided that the CAA sets a cost of debt allowance commensurate with the target credit rating it should set a high bar for any adjustments to notional indices. Both the CAA and HAL have adopted an assumption of an A- credit rating; if retained this should be reflected in the cost of debt benchmarks applied.
17. The appended CEPA report provides a detailed analysis and evidence-based approach to estimating the current 'as-is' WACC range and commentary around an appropriate 'adjustment' if expansion goes ahead. We estimate an 'as-is' WACC range of [REDACTED]

Incentives for capital efficiency

18. IAG agrees with the CAA that HAL should have a package of measures applied that allows for efficient financing but also strongly incentivises HAL to deliver expansion on budget. Whilst the CAA places significant concern on allocating risks to HAL that may be 'disproportionately burdensome', IAG believes that HAL requires strong incentives on capital spend to ensure that they act in a commercial way.
19. Given the high level of information asymmetry, a strict governance protocol should be put in place around any incentive arrangements that do not just incentivise delivering on budget, but also on time and to the scope required to achieve the benefits agreed.
20. IAG believes that in order to give the greatest protection to consumers, there must be a mixture of ex-ante and ex-post incentive mechanisms.

Regulatory framework and financeability

21. There is a case for ensuring the regulatory approach to financeability is clear before seeking to assess the allowed return. It is important that the CAA considers

financeability early in its decision-making process and considers the target financing structure carefully.

22. Construction projects can proceed at a sub-A- rating (e.g. TTT) though we acknowledge the logic of targeting a strong rating in order to facilitate access to diverse markets. However, the current notional gearing assumption of 60% is relatively debt-focused for a privately financed construction project and may be more appropriate for a steady-state network business than one that is expanding. An A- rating may require either significant de-risking or unwarranted cash flow adjustments to be feasible. As demonstrated in our analysis of the Q6 roll-forward, the regulatory regime for HAL warrants an equity return that is close to the overall market return, significantly lower than HAL has assumed. This presents a challenge to quantitative credit metrics under a relatively debt-focused financing approach.
23. Options for equity investors then are twofold:
 - Manage weak metrics during the construction period. This may be reasonable – credit ratings are not only based on quantitative cash flows; they will draw on visibility of future returns.
 - Invest sufficient equity to generate quantitative metrics consistent with an A- rating.
24. The CAA should consider both options carefully, noting that the latter helps minimise debt interest costs and is more consistent with the role of equity finance in a project such as this.
25. The CAA has specifically asked whether a stronger long-term commitment to the price control package would be required to support financeability. We consider that the perceived stability of economic regulation in the UK combined with merit-based appeal rights for airports to an independent body provide considerable comfort for investors that future decisions will be taken in a consistent manner. Credit rating agencies, for example, generally view the UK regulatory regime as credit positive. In this context a longer-term commitment on specific price control parameters from the CAA may add relatively little value. If such commitments would require longer-term forecasts or pre-judgement price control parameters they may even add to the risk of a mismatch between regulatory allowances, economic variables and the allocation of risk.
26. The CEPA report appended to this document provides more detailed commentary on this subject.

Other considerations

27. We agree with the CAA that there should be a tax clawback mechanism in the H7 settlement. HAL have benefitted significantly in recent years from the tax shield created through higher gearing. The cash generated through this has not been taken into account in past regulatory periods, hence flowing to shareholders to the disbenefit of consumers. The tax shield also incentivises HAL to gear-up relative to the notional gearing, which may not be in the interests of consumers.
28. We note that other regulators have already implemented clawback mechanisms, ensuring that the debt tax shield benefit from leverage is largely allocated to consumers.
29. We do not agree that a 'dead band' should be considered in H7. As has been stated many times in the past, HAL's financing is the responsibility of HAL. It is their choice to gear-up above the notional level, and they have benefitted from their tax shield. Consumers should not have to bear the cost of unwinding HAL's financing decisions.

Incentives for capital efficiency

30. IAG agrees with the CAA that HAL should have a package of measures applied that allows for efficient financing but also strongly incentivises HAL to deliver expansion on budget. Whilst the CAA places significant concern on allocating risks to HAL that may be 'disproportionately burdensome', IAG believes that HAL requires strong incentives on capital spend to ensure that they act in a commercial way.
31. IAG welcomes the retrospective reviews of Q6 capital expenditure and the outcome of these will inform our view of the overall effectiveness of the current process.
32. The behaviour of HAL in its mismanagement and subsequent inflation of Category B and early Category C costs demonstrate that the current mechanisms in place to promote efficient capital expenditure are not fit for purpose and are not taken seriously by HAL. The fact that HAL has been willing to continue spending above their original forecasts and without a definitive early Category C cost policy in place is indicative of the ongoing issues with management of early costs since the expansion programme started, as we have raised in response to previous early costs reviews.
33. Given the significant amount of risk budgeted in the capital plans for expansion, HAL already have a large buffer to outperform the current budget. The CAA should be careful not to double count the risk exposure on HAL, especially given the information asymmetry experienced today.

34. Whilst we note the CAA's desire to place incentives on the costs and timely provision of expansion, this needs to be balanced with achieving an efficient overall cost that does not inflate ultimate costs too far.
35. IAG agree that HAL should be incentivised to outperform baseline cost allowances. However, given the immaturity of the capital plan today and the asymmetry of information, a high level of diligence must be applied to the baseline cost allowance. To date, IAG do not believe the current evaluation and testing of HAL's costs is robust enough to be used in the H7 regulatory framework. It should also be noted that HAL's ability to significantly grow the RAB will provide substantial reward to its owners. Given the recent judgement by the Court of Appeal, it is inappropriate to consider a cost baseline at this stage, given the significantly increased uncertainties around expansion.
36. Incentives and penalties relative to a cost baseline would also need strong rules and guidelines around them to ensure that HAL does not cut back on scope if they believe that costs will exceed the baseline.
37. The CAA should carefully consider how incentive arrangements feed through to HAL's revenues. Given the potential scale of incentive payments, these should be amortized over a suitable time period.
38. The CAA notes that any new incentives must be viewed as part of the overall package of regulation at Heathrow, and that varying levels of risk exposure may impact other parts of the regulatory building blocks. However, the CAA should recognise that without a significant shift in the single till approach, exposure to volume risk or cost incentives, HAL's risk exposure is likely to remain below that of typical private airports. The experience of the TTT demonstrates that risk exposure for large, complex projects can be tightly controlled.
39. In principle, we do not disagree with the CAA's view that a 'one size fits all' approach is not appropriate. However, where there is subjectivity in the categorisation of costs, there is potential for HAL to game the system, particularly where different incentive regimes apply. This can be seen in practice with the treatment of Category B and early Category C costs, where HAL have moved costs between the two categories. If the CAA is to adopt this approach, it should tighten the governance protocols around these costs to avoid any ambiguity.