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Re: Response to – CAP2098: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment

Thank you for the opportunity to respond to the CAA's consultation CAP2098. This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address.

Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

Summary

As the CAA will be aware, the overwhelming view from the Airline Community has been that HAL's request is not in the consumer interest, justified or reasonable and should be rejected in full.

We agree with the CAA's own analysis presented in CAP 2098 that increasing the RAB by £2.8bn does not improve HAL's financeability (and some key credit metrics will be worse) and will increase charges and is therefore not in the consumer interest. We also note that the CAA is only obliged to consider the "notional" finances of the regulated company and that HAL have not demonstrated that these are affected to the extent of reducing the notional companies financeability.

We also firmly believe and agree with the CAA's assessment contained within CAP 2098 that service quality standards will not be impacted in 2021 if the CAA reject the request for a £2.8bn increase in the RAB. With the significantly reduced passenger levels forecast for 2021 and the whole H7 period the need for additional Capex is very limited and completely covered by the existing Capex governance process.

We would also highlight HAL's management approach and lack of prudence, with what appears to be an expectation that they can always lean on regulation and the consumer to bail them out, is not acceptable. A small group of investors are sitting on healthy dividends and no expectation to inject funds. There clearly should be a significant injection of true equity to the HAL business from these shareholders.

Reasoning behind our views:

1. A RAB adjustment is incompatible with the Q6 Regulatory settlement

Firstly, it is important to reemphasise that there is no regulatory justification for reopening the Q6 settlement. There is nothing explicit within the CAA Licence that obliges the CAA to re-open the regulatory settlement for Q6. We also fully support the CAA's statement that there is no obligation for the CAA to grant HAL's request and that its main duty is towards furthering the interests of consumers.

The Q6 settlement is a package in which risks and rewards assigned to HAL are carefully balanced among the different building blocks that underpin a price control. HAL was assigned passenger volume risk throughout the period and this included a downward adjustment to passenger forecasts ("a shock factor") at HAL's insistence.

Statements by HAL in its November 2019 Debt Prospectus that passenger numbers at LHR are subject to risk from **"Health scares, epidemics or pandemics across the globe"** (Nov_19_Heathrow_Finance_plc_Final_Prospectus.pdf) clearly illustrate that HAL's cost of capital already includes assessments by investors and debt holders as to the impact of a pandemic on passenger volumes.

Therefore, HAL's assertion that their cost of finance will increase significantly without a RAB re-opener as investors did not take a pandemic such as Covid-19 into account is simply untrue.

We also would stress that if the CAA did approve a RAB adjustment, then HAL would have taken the upside of increased profits in Q6 due to higher than forecast passenger volumes and due to a WACC that was increased to account for HAL taking traffic risk but would have been protected from any downside. This is clearly not in the consumers interest and goes against the better regulation principles of being "accountable and consistent" across the Q6 period.

2. HAL's proposal to reopen the RAB is harmful to consumers

HAL were paid to hold all passenger volume risk during the whole of the Q6 price control in the form of a WACC that incorporated that risk. If the RAB is inflated by any increment, then this will result in the consumer paying twice for a risk that was already incorporated in determining the underlying Q6 WACC since 2014. As per our evidence submitted in response to CAP1966, HAL have used a significant increase in debt to remove equity from the business and fund dividends to the amount of £3.85bn during this period and the application is totally inappropriate. HAL have stated in their press release of February 23rd 2021 for their end of year results: *"We ended the year with £3.9bn of liquidity, enough to see us through until 2023"*. Shareholders should provide a true equity injection before consumers are asked to pay further. The RAB adjustment figure is not relevant to liquidity and will not improve HAL's financeability.

We would also highlight the UK Government's response to airlines request for intervention was that additional support to individual companies "would only be possible if all commercial avenues have been fully explored, including raising further capital from existing investors and discussing arrangements with financial stakeholders". This was reiterated by the Transport Secretary who insisted that current shareholders "must be part of the solution. (See separate report by CEPA attached).

It must also be highlighted that HAL is stating it no longer wants the volume risk it agreed to (hence, its request for the RAB adjustment), but HAL is happy to continue applying the current framework on the items that are in its favour (i.e. HAL was happy to increase the ORC charges to recover the GBP 150m under-recovery). Airlines are honouring the risks they faced as their part of the regulatory decision (ORC increases), HAL should do the same.

3. The CAA's proposal to consider other actions

The CAA Notice granting the 2014 HAL licence (CAP 1151 Economic Regulation of Heathrow from April 2014: Notice Granting the licence) notes in Appendix I para A12 that the CAA would consider a request from HAL to reopen its price control *"in the light of its statutory duties under the circumstances prevailing at the time"*. The Notice does not state that the CAA is obliged to reopen the price control in *"exceptional circumstances"*. The CAA has considered HAL's request for a RAB adjustment and found in CAP 1966 and CAP 2098 that it is not justified in that it does not improve HAL's financing metrics (under the CAA's secondary duties).

In CAP 2098 para 15. the CAA states that the Q6 price control appears to give little weight to the circumstances created by the pandemic. However, in the Q6 price control HAL was paid a premium on the WACC for taking volume risk and additionally benefitted from the downward shock factor to passenger forecasts. In HAL's own debt prospectus from Nov 2019, HAL state that it is subject to passenger numbers being affected by *"Health scares, epidemics or pandemics across the globe"* (see earlier ref). We therefore argue that HAL's investors and bond holders were clearly aware of the risk and that HAL was compensated for all volume-related risk in the WACC applied to the Q6 period. We therefore do not agree with the CAA's statement that it is necessary or appropriate to reopen the price control on the basis of changes in volumes related to Covid-19.

4. The CAA's proposal for an assessment Framework

We note from the Civil Aviation Act 2012 that the CAA's primary duties are: to protect the consumer (passengers and cargo users) and specifically the availability, continuity, cost and quality of the airport's operation. We also note that the CAA must carry out these functions in a manner that promotes competition in the provision of airport services. We also note that the CAA's secondary duties are only in support of these primary duties and include ensuring that HAL is able to finance its provision of airport services and to promote economy and efficiency in HAL's provision of airport services.

It is clear from the act that the CAA's primary consideration is to the consumer and that its secondary duty is ensuring that ensure that a notional entity can be financed ex-ante by the proposed price control. However, it is also clear that in conducting its secondary duties of financability, the CAA should pay equal attention to ensuring that HAL is operating in an economical and efficient manner and that the regulatory regime is promoting competition. We will review the CAA's assessment framework in the light of these duties.

We note CAP 2098 para 19. details the key objectives in developing the assessment framework and we strongly request that ensuring HAL operates in an economical and efficient manner is included. This should be as equally important as ensuring that the notional company is financeable on an ex-ante basis.

We note further that CAP 2098 para 1.23, fig 2 summarizes the key objectives when assessing any regulatory interventions with an assessment framework. These objectives should also include promoting competition in the provision of airport services and promoting economy and efficiency in HAL's provision of services. If the CAA chose any of the 4 options stated then there could be an impact on competition in that other airports simply do not have any similar facility to recover Covid-19 losses and a competitive market would be less likely to emerge if any intervention disrupted emerging competition.

Framework a) – Compensating HAL for the reduction in revenues via a RAB increase:

We agree with the CAA that framework a) presents too narrow an approach as it does not address the key issues of HAL's financeability, the impact on the consumer and ensuring HAL operates in an economical and efficient manner. We also note that HAL's approach (as outlined below) is complex, not transparent, and certainly not proportionate. It also – as stated previously does not take any account of the substantial cost savings HAL have made in 2020 and 2021 or the increased WACC and passenger volume upside HAL received over Q6.

- Requesting a depreciation holiday in 2020 and 2021
- In combination with a RAB adjustment at the start of 2022 and a final adjustment at the end of 2022,
- With no depreciation allowed on the RAB adjustment itself during H7
- With allowed returns to be made on the RAB adjustment to be included in the H7 maximum yield calculations.

Framework b) – Assess a broad range of issues due to the pandemic and an appropriate package:

If the CAA is to intervene (and note we do not agree that it should – see above) then this framework is better than Framework a).

Framework c) – No intervention, the Q6 allocation of risks covered the impact of Covid:

Our overall view is that there should be no intervention, as HAL have repeatedly demonstrated that they do not have any issues relating to liquidity or financeability. To intervene would increase costs to the consumer and reduce the incentive for HAL to ensure that it is operating in an efficient and economical manner – both in 2021 and forward into the H7 period.

If however, the CAA do go ahead and intervene, and can clearly demonstrate that it results in better outcomes for consumers, then we would support Framework b) over Framework a) for the reasons stated above.

We note the summary of assessment framework and objectives (CAP 2098 - para 1.23, Fig2) and agree with the Primary and Secondary duties and objectives listed by the CAA. We do not agree that the CAA should discount the need to promote competition in the provision of airport services (as stated by the CAA in CAP 2098 para 1.19 and appendix J). This should be included in the assessment framework. If the CAA chose any of the 4 options stated then there could be an impact on competition both since other airports do not have any facility to recover Covid-19 losses, and a competitive market would be less likely to emerge if any intervention disrupted emerging competition.

5. The CAA's options for assessment

5.1 Package 1: Adjust 2022-2026 H7 price control package to account for Covid-19 risk in some form

Of the 4 options proposed by the CAA this is the only option we could support. It is clearly appropriate to consider the impact of the pandemic on risk and also on the ability to reliably forecast passenger numbers over the H7 period. If volume risk is removed in H7 then the agreed WACC must fall substantially to reflect that. It is important in order to ensure clarity to all stakeholders, that the CAA detail what the WACC would be with and without HAL bearing traffic risk.

5.2 Package 2: Re-open the current (Q6/iH7) price control now, then also adjust the H7 price control package

We do not support this option given both our earlier comments on adjusting the existing settlement, but it is also clear from the assessments that there is no immediate issue to address that would require the CAA to intervene within 2021. HAL has shown it has strong liquidity and has repeatedly stated to investors that is not at risk of breaching covenants (see earlier comments). There is a 2021 Capital Plan in place and it does not constrain HAL from reopening T4 if required. The SQRB performance measures demonstrated by HAL during 2020 and January 2021 have been good and largely to agreed standards. This illustrates that HAL can maintain service levels without the need for intervention by the CAA.

In addition to the above, even from a timeline point of view, there is no point in making an adjustment now when the CAA's H7 Initial proposals (which would already consider this item "in the round") will be published just around 3 months after the CAA's decision on CAP 2098.

5.3 Package 3: Re-open the current price control to implement (as yet unspecified) traffic risk sharing retrospectively to 2020 & 2021

We agree with the CAA that this is unworkable, complex and not transparent. In addition, we do not support this option for the same reasons we do not support package 2 (see above). There is no need for the CAA to intervene retrospectively in 2020 and 2021, and this would be contrary to the ex-ante incentives of the price cap.

5.4 Package 4: Heathrow's plan to adjust the RAB upwards by £2.8bn now, inflated further by adjusting depreciation in H7 2022-2026

The Airline Community have been clear on our views through previous responses, these remain unchanged and we particularly note the CAA's own analysis set out within CAP 2098 which shows that this will neither assist HAL's credit rating, nor support any financing metrics, the basis of which formed HAL's original application. This option is therefore clearly not in the consumer's interest.

6. HAL’s comments that “Pressure to cut costs could jeopardise quality of service and future investment” are unfounded:

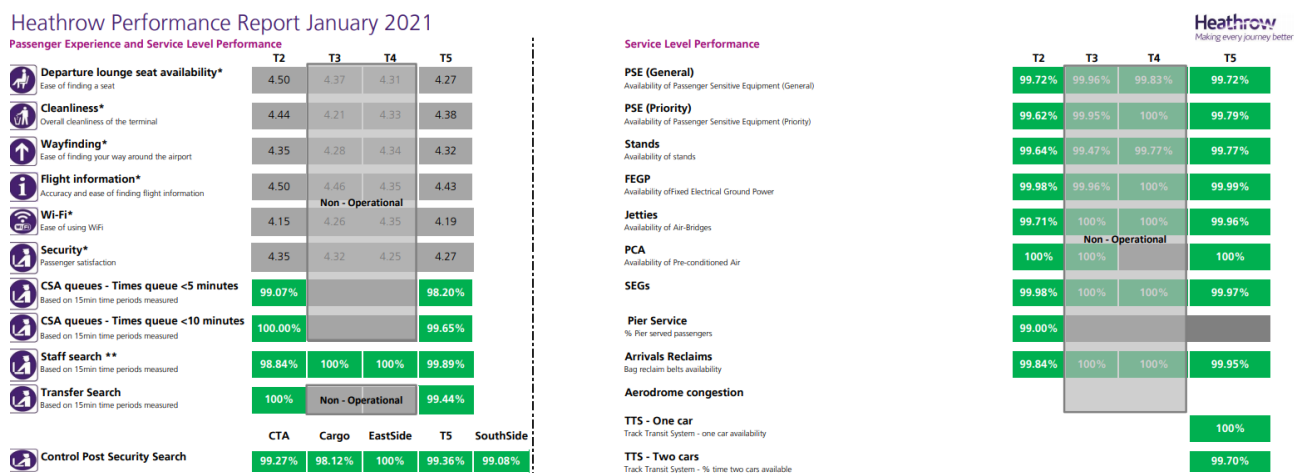
a) Service quality in 2020 and Jan 2021

The SQRB scheme is the key incentive that ensures service quality is maintained under the price cap and operates as a powerful mechanism to support those services levels. We have seen this as remaining effective as an incentive for Heathrow to deliver high levels of services quality.

To date in 2020 and 2021 service levels have been maintained by HAL (see below the SQRB summary report for January 2021) – except for Control Posts and Security queue times - where standards have been breached on a number of occasions. Investigation by HAL has concluded this has not been due to lack of resources. HAL have stated that service breaches have been due to lack of staff training, impact of Covid-19 on passenger demographics and service delivery and un-forecast peaks in the schedule. Management focus by HAL since early October has resulted in significant service improvements. HAL security management have stated that they have not been constrained by costs in delivering the required service levels and that they expect performance to continue to improve.

Punctuality performance with the reduced levels of movements seen in 2020 and 2021 has been very good and significantly better on average than that experienced over the whole of Q6. (For the month of December 2020 Scheduled Flight departures punctuality was 75% (source: CAA website)).

1. SQRB January 2021 Published Report



b) Service quality in 2021

HAL’s statement that punctuality may drop to 60% and security queue times may increase by 5 minutes due to the need to cut costs further in 2021 does not seem logical and we have seen no evidence from HAL to support this claim.

The SQRB scheme incentivises HAL to deliver to a set level of standards across a range of measures that have been agreed between the airlines and the airport. HAL have stated that they have £3.9bn of liquidity with

debt covenants not at risk under the most adverse passenger forecast scenarios, and are adequately funded in the unlikely scenario of receiving no revenue income in 2021. HAL therefore have abundant resources to fund Opex in 2021.

Should HAL choose to not meet the standards agreed in the SQRB it would result in up to 7% of charges being at risk. It simply is not logical for HAL to forego this revenue.

c) Investment to maintain service quality in 2021

HAL have stated that without intervention on the RAB they will not be able to continue essential investment to maintain ongoing and efficient operations. HAL's own forecast for 2021 is for 37m passengers a 54% reduction in traffic in 2021 versus 2019 levels. It seems nonsensical to suggest that a lack of investment for 1 year in the existing infrastructure which has been designed for 54% greater volumes than that forecast for that year will result in reduced service quality levels in 2021. HAL's argument just does not make sense and we would request specific detail of which pieces of infrastructure require investment to maintain service levels in 2021 before being persuaded further on this argument.

Investment in Capital Expenditure should only be in the consumers interest and the RAB is increased for efficient investment only. Airlines support efficient capital expenditure that delivers demonstratable consumers outcomes (subject to the agreed governance processes).

Heathrow's proposal to increase the RAB for no consumer benefit is an abuse of the norms of the RAB. If Heathrow has excessive debt and insufficient equity to fund future capital investments, the correct solution is an injection of real cash equity to replace the equity that has been stripped out of the business through excessive dividends.

Yours sincerely,



Gavin Molloy
Chair
London (Heathrow) Airline Consultative Committee



Nigel Wicking
Chief Executive
Heathrow AOC Limited

Inclusions:

Evidence in support of the CAA's conclusions in CAP 2098A- Appendix K- Regulatory Precedent:
CEPA Paper: Covid Support to the Transport Sector – LACC