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Response to CAP1966: Heathrow RAB adjustment – Aer Lingus

Aer Lingus welcomes the opportunity to respond to your latest consultation on the application for an upward RAB adjustment made to you by Heathrow Airport (HAL). Aer Lingus considers the proposal made by HAL to be wholly inappropriate in the context of the purpose of economic regulation of Heathrow and the structure of the Q6 licence. In addition, we wish to fully endorse and support the submissions made to this consultation process by both British Airways and the International Air Transport Association (IATA).

Purpose of Regulation

The purpose of regulation is to protect consumer interests by replicating, in so far as is possible, the conditions of a perfectly competitive market. In a competitive market, organisations will, in the long-run, earn an average return which compensates for the level of risk undertaken – however, there is no guarantee that this level of return, or indeed any return, will be earned in the short-term. Organisations that are unable to earn the necessary level of return to compensate for risk (through inefficiency or otherwise) are ultimately expected to exit the market and be replaced by more efficient operators. A competitive market does not provide any guaranteed level of return or even less so a guaranteed level of revenues for an individual organisation in the market. Moreover, a competitive market will carry a very real risk that an individual investment loses its entire value.

It is clear therefore that economic regulation should not seek to create a guarantee of returns, and no such guarantee is contained within the Q6 settlement nor the HAL licence. Yet this is in effect what HAL is seeking through the proposed RAB adjustment. While it is not disputed that there has been a significant impact to both traffic and revenues at Heathrow arising from Covid-19, Heathrow is not unique in this situation – airlines and other airports face similar impacts. Airlines (and ultimately consumers), whose own financial positions have weakened considerably from Covid-19, cannot be expected to insulate HAL from the very real risk it took on, and is being compensated for, in the Q6 settlement and licence.

Volume Risk

It is clear that Heathrow holds passenger volume risk in the Q6 settlement and the WACC of 5.35% set for the period reflects this fact. For the entire period 2014-2019, Heathrow has benefited from holding the volume risk, with traffic volumes above forecast in all years. If HAL now contend that they wish not to hold the volume risk for 2020 (which is implied through their application for "compensation" through RAB adjustment for the reduction in passenger volumes) then it would logically follow that they would also have to give up the revenues earned through out-performance to volume forecasts in the earlier years of the regulatory period. A lower WACC would also need to be applied across the full Q6 period as volume risk would not longer need to be priced in.

Lost Revenues

In their RAB adjustment application, Heathrow has made repeated reference to "lost revenues" arising from traffic collapse in the face of Covid-19. However, the regulatory settlement for HAL is a maximum yield per passenger not a maximum or guaranteed revenue. Other forms of regulation do allow for guaranteed revenues, but in those cases, there is no potential upside available to the regulated entity. A concept of "loss of revenue" therefore does not exist in the present regulatory framework. While HAL may contend there are revenues they have failed to earn, this would only be against their own internal forecasts and not derived from the regulatory settlement.

Financial Risk

In the Q6 setting you set a pre-tax, real Weighted Average Cost of Capital (WACC) of 5.35%, assessed upon a notional capital structure comprising 60% debt and 40% equity, and informed by passenger forecasts over that same period. With cost of equity significantly above cost of debt, this notional gearing level gave rise to a WACC higher than would have been the case if the actual gearing level of Heathrow had been used. However, Heathrow continued to increase its gearing ratio throughout the regulatory period – with proportions of cash flow dedicated to debt service increasing, and almost all equity value having been stripped from the business by year end 2019. The current "cash crunch" is therefore a result of decisions taken by HAL's management for their financial structure and not a function of the underlying financeability of the business or regulatory settlement. Under the Q6 settlement it is open to Heathrow to optimise financing, however this has to be at the risk of Heathrow's equity shareholders. Having determined on a gearing ratio far higher than the notional gearing on which the WACC was based, HAL has earned return on equity above that expected when the Q6 settlement was made. Only now has that equity risk moved into negative territory and once again regulation intervention cannot be used as a backstop to financial risks undertaken completely voluntarily and independently by Heathrow.

Alternatives to proposed RAB adjustment

Despite the high level of gearing already utilised by Heathrow this has not impeded the raising of further debt financing even in the current Covid-19 crisis. It has not been clearly demonstrated therefore that there is no further appetite for investors to finance Heathrow's operating business, as an alternative to having recourse to consumers to provide a bail out Heathrow.

In preference though, an equity injection from Heathrow's shareholders could also restore and also bring their actual return more in line with the WACC set for the period. Heathrow has not demonstrated that their equity owners will not or indeed cannot provide further equity to the business. Moreover, before there is any recourse to consumers (through higher costs to airlines) Heathrow must be able to demonstrate that there is no appetite from any potential equity investor to provide additional equity to the business given the regulatory settlement WACC of 5.35%.

Possible Future Consequences of granting the requested RAB adjustment

A major attraction regulated entities hold for investors is the relatively high level of certainty on the conditions which will prevail over the medium/long term. Permitting a mid-period adjustment, effectively re-opening the price control, will undermine this stability for investors who rely on ex-ante incentives to plan business investment. We therefore support the CAA's in its stated position to uphold the present regulation and deal with issues arising at the periodic review for H7. Any change from this position could have significant and long-lasting implications for the perception of certainty provided by regulated entities and the appetite for investors to participate in economically regulated industries.

Conclusion

Heathrow's proposal for RAB adjustment represents an asymmetrical approach to risk in the Q6 period – with Heathrow taking any upside (and it has been substantial) whilst seeking to transfer the downside to airlines and ultimately consumers. The supposed "necessity" for regulatory intervention is driven by the high level of financial risk Heathrow's equity investors have taken on, and not by any flaw or lack in the regulatory settlement. Finally, there is no evidence that this "crunch" could not be overcome through either further debt financing or equity inject from current shareholders or from an entirely new equity provider (change of ownership). For these reasons Aer Lingus therefore supports the CAA in its rejection of Heathrow's proposal.

Yours sincerely,

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