

Appendix E.ii.a – WACC – Views on CAA’s approach to Heathrow’s financeability

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1 Ringfencing licence conditions

This section assesses the CAA’s position in the H8 initial proposals in respect of hypothetical ringfencing licence conditions for the notional company, and the potential impact on the notional company’s rating under Fitch’s methodology.

1.1 Counterfactual ringfencing licence conditions

In the H8 initial proposals (appendix L.3), the CAA set out its view that “*the notional company, by virtue of not having whole business securitisation, would likely have a more comprehensive set of ringfence licence conditions*” (such as those imposed by Ofgem for energy networks), and sets out an assumption that the notional company would achieve the same rating uplift as actual HAL derives from its covenanted financing structure.

There are three fundamental questions that must be assessed to determine whether that is a reasonable conclusion:

1. Is it reasonable to assume that the notional company would be subject to similar ringfencing licence conditions as imposed on energy networks by Ofgem? In particular, would there be a strong customer justification for such conditions?
2. Could such conditions enhance credit quality to the same degree as covenanted financing structures?
3. Would such conditions satisfy Fitch’s criteria used to assess whether the notional company should be treated as a project finance issuer and therefore achieve a more favourable rating treatment than a corporate issuer?

1.1.1 Is it reasonable to assume that CAA would impose Ofgem-like regulatory conditions?

It is important first to recognise that HAL is already subject to licence conditions intended to strengthen financial resilience, including:

- The requirement to maintain sufficient financial resources and facilities on a forward-looking basis for service provision and to comply with licence obligations;
- The requirement to maintain sufficient operational resources, including assets, on a forward-looking basis for service provision and to comply with licence obligations;
- Restrictions on non-core business activities; and
- Ultimate controller undertakings.

Therefore, the relevant conditions to consider are those that apply to energy networks and that go beyond those that apply to HAL, including the cash lock-up (triggered for energy networks by a rating of Baa3/BBB- with negative outlook or gearing above 75%) and the requirement to maintain two investment grade credit ratings.

There is longstanding precedent that regulators do not generally specify which rating agencies UK regulated infrastructure assets should be rated by – not least because that

would represent a significant degree of intervention on financial policy and could give rise to the risk of higher debt costs, at the expense of customers, for example where one rating agency's methodology could give rise to structurally worse ratings. Consequently, it would be a significant departure from precedent for the CAA to impose additional licence conditions purely with the goal of achieving a re-rating of the notional company under Fitch's transportation criteria, and such measures would require a strong consumer welfare justification. That justification is not self-evident, not did the CAA advance one in its initial H8 proposals.

In H6, the CAA considered that setting a gearing cap "*holds significant challenges both generally and in HAL's particular circumstances...*"¹ and could dilute "*the CAA's policy that HAL's choices as to how it finances itself are the responsibility of HAL's directors and shareholders*". Moreover, it is not clear how a gearing cap would be consistent with the notional gearing assumption used in estimating the cost of capital. The CAA's previous position on the structure of the notional company is set out in more detail in section 1.3.

More recently, in an August 2019 working paper, the CAA considered the merits of requiring HAL to maintain an investment grade credit rating, imposing trigger events that could curtail HAL's ability to make dividend and other payments to shareholders, and more onerous reporting requirements.² The CAA determined that these interventions were not warranted.

1.1.2 Would Ofgem-like regulatory features enhance credit quality in a similar way to covenanted financing structures?

It can be observed that rating agencies do not assign the same benefit to ringfencing licence conditions as they do to covenanted financing structures, implicitly considering licence conditions do not enhance credit quality to the same degree. Among GB energy networks, only Wales & West Utilities has a highly covenanted financing structure comparable to HAL's. As set out in Figure E.ii.1, WWU's Class A debt receives a one-notch rating uplift for structural enhancements under its WBS structure from both S&P and Fitch³, demonstrating the incremental enhancement to credit quality provided by its covenants over and above the ringfencing licence conditions. Other gas and electricity networks, which do not operate highly covenanted structures but are subject to the same (or in the case of electricity, similar) licence conditions, do not receive the same uplift.

¹ CAP 1832, paragraph 2.5.

² CAP 1832, paragraph 11.

³ Fitch provides a one notch sector-specific uplift for regulated UK utilities and an additional notch only for Wales and West Utilities, reflecting structural benefits under its securitisation structure.

| Company | S&P | | Fitch | | |
|--|-------------------------------|------------------------------------|-----------------------|--------------------|--------|
| | Standalone credit profile | Uplift for structural enhancements | Issuer Default Rating | Senior debt rating | Uplift |
| Cadent Gas | bbb | Nil | BBB+ | A- | +1 |
| Electricity North West | bbb+ | Nil | BBB+ | A- | +1 |
| National Gas Transmission | NR | – | BBB+ | A- | +1 |
| National Grid Electricity Transmission | Not rated on standalone basis | – | BBB+ | A- | +1 |
| Northern Gas Networks | bbb+ | Nil | NR | – | – |
| Northern Powergrid operating companies | a | – | A- | A | +1 |
| Phoenix Energy Group | NR | – | BBB | BBB+ | +1 |
| Scottish Hydro Electric Power Distribution | Not rated on standalone basis | – | BBB+ | A- | +1 |
| Scottish Hydro Electric Transmission | Not rated on standalone basis | – | A- | A | +1 |
| SGN operating companies | NR | – | BBB | BBB+ | +1 |

| Company | S&P | | Fitch | | |
|--------------------------|---------------------------|------------------------------------|-----------------------|--------------------|--------|
| | Standalone credit profile | Uplift for structural enhancements | Issuer Default Rating | Senior debt rating | Uplift |
| UKPN operating companies | a- | Nil | BBB+ | A- | +1 |
| Wales & West Utilities | bbb+ | +1 | BBB | A- | +2 |

Figure E.ii.1 - Table showing S&P and Fitch ratings for selected energy networks analysis of operating company ratings. NR = ‘not rated’; purple denotes companies with covenanted structures, blue denotes those with corporate structures.

Following the recent acquisition of UKPN by ENGIE, Moody’s downgraded the ratings of UKPN’s operating companies (London Power Networks, Eastern Power Networks and Southern Power Networks) on the basis that they were not sufficiently insulated from the weaker credit quality of ENGIE⁴. Moody’s did not consider the energy ringfencing provisions to be sufficient to support the previous higher rating, noting:

“We do not believe that the regulatory restrictions and ring-fencing provisions in the licences of UKPN DNO’s protect their credit quality from that of the wider ENGIE group at the A3 rating level. This assessment takes into account the scheduled tightening of the regulatory ring fence, later in 2026, including the introduction of a dividend lock up at a lower leverage threshold of 75% net debt to regulatory asset value (RAV), which represents our maximum Baa1 leverage guidance for a Great Britain electricity network.”

The idea that stringent licence conditions are equivalent to covenanted financing structures is also disproven by the water sector, where all three rating agencies apply different rating thresholds to companies with such structures. Despite ringfencing licence conditions that are more stringent than in energy, rating agencies still consider covenanted structures to provide a quantifiable improvement in credit quality.

Both Ofgem and Ofwat have imposed more stringent ringfencing licence conditions in recent years. Ofgem has imposed a gearing cap as part of RIIO-3 and introduced a requirement to maintain two investment-grade ratings. Ofwat, with effect from April 2025, raised the cash lock-up threshold from Baa3/BBB- to Baa2/BBB (in each case with negative outlook). Neither change gave rise to an improvement in credit ratings for companies with corporate structures.

A key distinction between covenants and regulatory ringfencing conditions is that, even when they are superficially similar, the former are designed to protect creditors while the latter are intended primarily to protect customers and operations. To this end, covenants give creditors additional control over the regulated company in certain circumstances, whereas ringfence licence conditions give that control to regulators. For example, an event of default gives

⁴ Moody’s Ratings, 8 May 2026. ‘Moody’s Ratings downgrades UK Power Networks group companies to Baa1; stable outlook’, link available [here](#).

creditors the ability to take control of a regulated company, while the regulatory equivalent – a breach of a licence condition – deprives them of control.

Reflecting the difference in purpose, the regulator can choose to waive the breach of a minimum rating requirement if implemented as a licence condition, whereas if implemented as part of a covenanted financing structure, an equivalent covenant would allow creditors to enter negotiations with the company and seek certain credit-enhancing measures. More broadly, covenants typically require creditor consent for amendment or removal, whereas licence conditions do not. The CAA itself recognised, in its 2019 consultation, that the interest of customers and creditors may diverge.

The CAA refers to South Staffordshire Water as benefiting from “a degree of rating uplift by virtue of the regulatory ringfence” (appendix L.6). It is not clear why South Staffordshire Water is singled out as an example. However, S&P makes it clear, in a rating update following the 2021 implementation of a new financing structure, that the uplift given to the operating company’s stand-alone credit profile results from structural features of the financing structure:

“We assess the group credit quality at 'bbb', combining the cash flow generation from regulated and unregulated activities as well as the total consolidated debt (about £430 million)... Due to the separation created within the financing structure, we assess SSW's stand-alone credit profile (SACP) as being stronger than that of the group, at 'a-', and we therefore rate the regulated entity one notch above the group credit profile at 'BBB+'.”

1.1.3 Would such conditions satisfy Fitch’s characteristics of project finance issuers?

A related question is whether Ofgem-like regulatory features would satisfy the criteria that Fitch uses to assess whether a transportation project is a project finance issuer. In Figure E.ii.2 below, we assess whether Ofgem’s energy network licence conditions align with these characteristics, and find that that only on factor 2 and 3 is such a licence likely to be regarded as project-like. For comparison, HAL’s actual structure can be regarded as project-like in respect of factors 1, 2, 3, 4 and, in part, 5.

| Characteristics of project finance issuers | Alignment with Ofgem licence conditions | HAL’s actual structure |
|---|--|---|
| Factor 1 – Ability to re leverage | | |
| Covenant limiting additional indebtedness, for example, a leverage-based limit | No direct limits on indebtedness (but see discussion of dividend lock-ups) | Leverage covenants in respect of both senior and junior debt (if breached, cash lock-up and restrictions on new indebtedness – default in the case of more severe breaches) |
| Requirement for lender approval in order to issue additional debt/increase leverage | No | No, provided leverage covenants are met and subject to conditions on maturity concentration |

| Characteristics of project finance issuers | Alignment with Ofgem licence conditions | HAL's actual structure |
|---|--|---|
| Ratings test to issue additional debt/increase leverage | No ratings test to increase leverage, only to distribute dividends (SLC A38 (ET) and B10 (GD)) | Ratings tests in respect of both senior and junior debt (downgrade below BBB+ and BBB- respectively) |
| Default or dividend lock-up set at a meaningful level | SLC A39 (ET) and B9 (GD) provide for dividend lock-ups. Ofgem has recently introduced a 75% leverage trigger, but this is unlikely to be considered "meaningful" for notionally financed company given 15-20% headroom. No default thresholds. | Dividend lock-up occurs if certain conditions are met (financial covenants, ratings covenants or others). There are default thresholds, however HAL currently has a significant meaningful degree of headroom (c.30% against Senior RAR as of December 2025 – albeit that threshold is unlikely to be reached in practice given much lower trigger event thresholds). |
| Factor 2 – Ability to make acquisitions | | |
| Clear and stringent restrictions on acquisitions | Licence conditions restrict scope of operations, which achieves similar outcome. | May only acquire businesses engaged in owning, operating or developing a designated airport |
| Factor 3 – Ring-fencing | | |
| Comprehensive and strong ring fencing of assets | Ring-fencing conditions require licenced entity to be maintained as standalone entity insulated from holding companies. | Conditions prevent granting security or guaranteeing debts outside the security group, and limits disposals. Restricted to permitted business. |

| Characteristics of project finance issuers | Alignment with Ofgem licence conditions | HAL’s actual structure |
|--|---|---|
| Factor 4 – Security package | | |
| Comprehensive and strong security package | Licence conditions explicitly prevent granting of asset security. | Fixed and floating charges over HAL’s assets (subject to modest exclusions), share pledges, and a negative pledge covenant, enforced through a dedicated Security Trustee under a single intercreditor waterfall. |
| Factor 5 – Other structural features may act as an indicator of PF or infrastructure company debt structure | | |
| Fully amortising debt structure/no refinancing risk | No requirement for an amortising structure (or even limits on maturity concentration) | Non-amortising structure |
| Exhaustive and robust covenant package (e.g. such as reporting requirements, maintenance minimum requirements, hedging requirements) | <p>Strong alignment on reporting requirements: Licenced entities are subject to extensive regulatory reporting requirements that are more comprehensive than typical corporate disclosures.</p> <p>Other elements of the “exhaustive” covenant package are not present, in particular hedging requirements.</p> | Comprehensive covenant package, comprising financial and other restrictive covenants, hedging requirements, as well as information covenants including six-monthly reporting to creditors. |

| Characteristics of project finance issuers | Alignment with Ofgem licence conditions | HAL's actual structure |
|--|---|--|
| Dedicated debt service liquidity | No requirement for debt service liquidity | Requirement to maintain liquidity facilities to cover 12 months' of interest (not principal) and capex (net of any positive cashflow generated). |

Figure E.ii.2 – Table of assessment of energy network licence conditions and HAL's actual structure against Fitch's characteristics of project finance issuers red denotes factor very unlikely to meet Fitch's requirement, amber denotes factor unlikely to meet Fitch's requirement, green denotes factor likely to meet Fitch's requirement.

Two criteria are particularly worth noting:

- Regulators often strengthen financial resilience by tightening dividend lock-up triggers. However, despite the leverage and rating-related dividend lock-up triggers, energy networks' licence conditions fall well short of satisfying the criteria of factor 1. A dividend lock-up trigger with 15-20% headroom to expected leverage and the absence of any DSCR or other interest cover covenant would be regarded as very weak, as would the absence of incurrence covenants or a hard limit on total leverage.
- Ofgem's licence conditions not only fail to achieve factor 4, they make it impossible for networks to achieve this contractually by prohibited them from granting asset security.

1.2 Impact of a hypothetical project finance structure on cost of equity

1.2.1 Transfer of risk from lenders to shareholders

The core purpose of a covenanted financing structure is to reduce risk for lenders at a given level of leverage, compared to an equivalent corporate financing, thereby reducing borrowing costs. This is achieved not by reducing the company's risk in aggregate – covenants do not mitigate price, volume, or regulatory risks faced by the enterprise – but by transferring it from lenders to equity investors through a structured package of contractual protections.

For example, trigger events mean creditors can effectively acquire control over cash flow that would normally be reserved to equity, even while the business continues to operate normally. Other covenants constrain shareholders' valuable options to re-leverage, enter or divest businesses, or require them to fund liquidity reserves or facilities.

Any reduction in a company's cost of debt resulting from such a risk transfer should, in principle, be matched by an equivalent increase in the return required by the company's equity investors. Academic research provides empirical support for the relationship between covenants and required equity returns. For example, Liu and Nguyen found that the presence of loan covenants increased the discount required by private investors in public equity by 3.9% compared to companies without such covenants.⁵

1.2.2 Evidence from holding company ratings

The impact of covenanted financing structures on equity risk can also be inferred from their impact on holdco debt ratings, because holding company debt investors have a similar, subordinated position to equity investors in operating companies.

Fitch rates the Heathrow Finance (holdco) notes two notches below the BBB consolidated credit quality of the group because of the covenanted financing structure at the operating company, despite offsetting credit strength such as liquidity at holdco:

“The two-notch difference reflects structural subordination of the HY notes to the class A and B debt, and opco’s reliance on a single asset. The notching difference also reflects the ring-fencing structure at Heathrow SP Group, which may restrict distributions to holdco level, but also financial metrics well above lock-up covenants, as well as the security available to HY noteholders and the liquidity buffer available at Heathrow Finance Plc⁶”

Similarly, Moody's rated Anglian Water's holding company (Osprey) four notches below the consolidated credit quality of its operating company group, compared to a single notch between the operating and holding companies at Severn Trent and United Utilities, which are otherwise similar companies with no covenanted structure.

A 2-3 notch credit rating differential attributable to a covenanted financing structure reflects materially higher risk of default (in particular, due to the risk that the opco will be prevented from distributing dividends required to service holdco leverage) and lower recovery in a default scenario (in particular because opco creditors have first-ranking security over opco assets). These considerations are equally relevant to equity investors, who risk losing control of their company in downside scenarios. As set out in our previous report on the target credit rating, 2-3 rating notches is broadly equivalent to 50-75bps on the cost of debt. The impact on cost of equity is likely to be similarly large.

The impact on the cost of equity of either HAL's actual financing structure or the counterfactual ringfencing licence conditions has not been reflected in how the CAA estimates the cost of capital for the notional company.

⁵ [The role of financial covenants in pricing private investments in public equity - ScienceDirect](#)

⁶ Fitch Rating report

1.2.3 Fitch characteristics of a project finance structure

In Figure E.ii.3 below, we consider Fitch's criteria and whether, if met, they would affect the cost of equity. We find that these features would materially increase the cost of equity.

| Characteristics of project finance issuers | Relevance for the notional company | Implications of features for cost of equity |
|---|------------------------------------|--|
| Factor 1 – Ability to re leverage | | |
| Covenant limiting additional indebtedness, for example, a leverage-based limit | High | Equity loses option to optimise capital structure over time. Lenders gain rights that they would otherwise hold only in a default. |
| Requirement for lender approval in order to issue additional debt/increase leverage | High | |
| Ratings test to issue additional debt/increase leverage | High | Ties equity's financing flexibility to a third-party assessment out of its control. Introduces a cliff risk where a single-notch downgrade can create a hard constraint. |
| Default or dividend lock-up set at a meaningful level | High | "Meaningful level" means lock-up activates before economic distress. Equity's cash flow rights are contingent on meeting covenants while lenders' are not. |
| Factor 2 – Ability to make acquisitions | | |
| Clear and stringent restrictions on acquisitions | Medium | Eliminates a growth option that would otherwise be reflected in equity value. |

| Characteristics of project finance issuers | Relevance for the notional company | Implications of features for cost of equity |
|--|------------------------------------|--|
| Factor 3 – Ring-fencing | | |
| Comprehensive and strong ring fencing of assets | Medium | Increase recovery for senior creditors, and reduce it for equity, in an enforcement scenario. |
| Factor 4 – Security package | | |
| Comprehensive and strong security package | High | Increase recovery for senior creditors, and reduce it for equity, in an enforcement scenario. |
| Factor 5 – Other structural features may act as an indicator of PF or infrastructure company debt structure | | |
| Fully amortising debt structure/no refinancing risk | Medium | Reduces optionality for shareholders |
| Exhaustive and robust covenant package (e.g. such as reporting requirements, maintenance minimum requirements, hedging requirements) | High | Continuous monitoring regime creates compliance costs of a scale more typical of a distressed borrower under lender supervision. Hedging requirements reduce optionality. |
| Dedicated debt service liquidity | Medium | Serves as a mandatory, unremunerated equity commitment: shareholders must provide capital or fund |

Figure E.ii.3 – Table of assessment of the implications for the cost of equity of Fitch’s characteristics of project finance issuers, considering relevance for the notional company for relevance red denotes high relevance, yellow denotes medium relevance, green denotes low relevance; for implications for cost of equity, red denotes very likely to increase cost of equity, yellow denotes likely to increase cost of equity, green denotes unlikely to increase cost of equity.

If a hypothetical licence were somehow to achieve the characteristics of a project-like structure, it would significantly increase equity return requirements compared to an investor in a notionally-financed corporate airport. Equity in these structures is more constrained, more subordinated in recovery, and more exposed to cash flow interruption than in an equivalent corporate structure, each of which would lead investors to require a higher return.

The CAA does not assume the notional company operates under a project-finance structure for the purposes estimating the cost of equity, which would otherwise give rise to a higher cost of equity due to the additional risks borne by equity investors. It is therefore inconsistent to assume such a structure for the purpose of the financeability assessment. In effect, that would be arbitrage within the price review and weaken the value in undertaking such an assessment.

1.3 Inconsistency with past regulatory practice

UK economic regulators rely on the concept of a notional structure in setting allowed returns and testing financeability to ensure that investors, rather than customers, bear the risk of firms' financing choices and to provide a consistent basis for estimating the cost of capital and assessing financeability.

According to UKRN, there are two aspects to the notional structure: "*When setting prices most regulators use an assumed notional capital structure and a notional level of gearing.*"⁷ This is because companies' financing choices go beyond the level of total debt and include the choice of a secured or unsecured structure and one or more classes of debt. The use of a WBS structure, in particular, is a financing choice that regulators have been careful not to endorse. In a report on the water sector's financial resilience, Ofwat dismissed arguments by some companies that covenanted structures protect customers, saying that these structures are "designed to address the interests of investors... rather than to protect the customer interests"⁸.

Ofgem, Ofwat and CAA regulate companies with a mix of secured and unsecured financing structures and have taken a clear stance that highly covenanted arrangements represent a deviation from the notional structure. This is important because, if these regulators were to define the notional company on a senior secured basis, it would be necessary for their cost of debt allowances and financeability assessments to incorporate the costs and limitations imposed by these structures, including additional liquidity requirements and the requirement to meet financial covenants.

CAA's longstanding policy has been to avoid "*making judgements on, or allowances for, HAL's actual financial structure*" to ensure that "*the consequences of, the actual financial structure are the responsibility of HAL, its directors and shareholders.*"

⁷ UKRN, Cost of Capital – Annual Update Report, October 2024, link available [here](#).

⁸ Ofwat, Financial resilience in the water sector: a discussion paper, December 2021, link available [here](#).

CAA directly addressed the question of whether it should consider HAL's covenanted financing structure in the H6 methodology decision⁹, and found that it was inappropriate to do so:

“A high gearing assumption might only be achievable if the CAA also assumed that its notionally financed airport operator provided its creditors with credit enhancements such as granting creditors with security over assets and other contractual ring fence conditions. Assuming security over assets would be inconsistent with and could frustrate the Department for Transport's policy that it would want to see a movement to a regulatory ring fence over time (including the prohibition of granting security over assets).”

This was justified by the CAA's approach (maintained from Q5) of relying on a “simple” structure that does not reflect HAL's more “complex” arrangements:

“In the CAA's Q5 STAL decision, a split of 50/50 between historical fixed rate debt, and historical floating rate and new debt was assumed. Making a simplifying assumption such as this reflects the CAA's approach to set a simple notional capital structure rather than a complex structure such as those seen at HAL and GAL.”

CAA also acknowledged that its financeability assessment should be based on thresholds applicable to the notional HAL, and that these would differ from those relevant to the actual company because of the WBS:

“We note that in carrying out our financeability assessment we are trying to find a reasonable proxy for the rating thresholds that would apply to the notional entity. This involves a certain amount of complexity: i) the thresholds that are relevant for the notional entity may not be identical to those that apply to the actual entity / Heathrow Funding Limited given the complications created by the whole business securitisation and the different levels of gearing.”

⁹ CAA, Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014, CAP 1115, link available [here](#).

2 Rating thresholds and target rating

This section assesses the credit rating agency thresholds adopted by the CAA in the H8 initial proposals, including the assertion that the notional company would be financeable at BBB.

2.1 CAA's selection of credit rating agency thresholds

In the H8 Initial Proposals, the CAA set out its understanding that HAL would need to maintain metrics in line with the following thresholds to maintain a BBB+ rating on its Class A debt:

- S&P: FFO / net debt of at least 7-8%¹⁰
- Fitch: net debt / EBITDA no greater than 8-9x

It goes on to say that:

“Recognising that the notional company is not identical to the actual company, we cautiously make use of the lower end and the upper end of these ranges, respectively, in our financeability assessment.”

Those thresholds reflect the benefit of HAL's covenanted financing structure, in particular in respect of Fitch, where the thresholds for the notional company rated under as a corporate issuer would be materially tighter. As set out in section 1, it would be a significant departure from regulatory precedent and the CAA's historical reasoning to impose energy-like ringfencing licence conditions for the notional company in an attempt to see the notional company rated more like a project-finance issuer. Even if the CAA were to do so, as set out in section 1, ringfencing licence conditions like those imposed on energy networks would be insufficient to meet a sufficient number of Fitch's criteria for assessment as a project-finance issuer.

Consequently, the thresholds by the CAA have the effect of materially weakening the value of the financeability assessment, by assessing the notional company against thresholds far looser than would be applied. As set out in a report by KPMG¹¹, the appropriate thresholds for a notional HAL at a target credit rating of BBB+ would be as follows:

- S&P: FFO / net debt of at least 8%
- Fitch: net debt / EBITDA no greater than 5.2x

The CAA's usage of the thresholds for HAL to maintain a BBB+ on its Class A debt is also inconsistent with its position that a one notch differential would apply between the thresholds relevant for the notional and those applied to HAL. If a one notch differential applies, where the CAA acknowledges *“there was some merit in the argument that a whole business securitisation would produce a one notch uplift in rating but that other*

¹⁰ The CAA refers to 7.0-8.0x, but that is assumed to mean 7.0-8.0%

¹¹ KPMG, June 2025. An analysis of the target credit rating for the H8 price control.

factors were also relevant”, it would be more appropriate to assess financeability against the thresholds for an A- rating on HAL’s Class A debt. For S&P the threshold is the same as that proposed by KPMG for the notional company (FFO / net debt of at least 8%), whilst for Fitch, it would be in line with the lower bound of the range proposed by the CAA (recognising the credit enhancements under HAL’s covenanted structure).

In any case, even disregarding the issues with using thresholds relevant for a covenanted structure, it would be prudent to use the more cautious end of the threshold ranges, as the CAA itself recognises. From the CAA’s ranges set out in the Initial Proposals, that would be FFO / net debt of at least 8% and net debt / EBITDA no greater than 8x. The CAA uses the more generous (less stringent) end of the ranges in its finance-ability assessment (figure 11.4 and 11.5), but this would logically appear to be an error given the CAA’s stated position.

2.2 Finance-ability of the notional company at BBB

In Appendix L of the Initial Proposals, the CAA sets out its view that the notional company would be financeable at BBB:

“As noted above, HAL’s financing requirement for the H8 period is comparable to that for the H7 period and, therefore, we conclude that a BBB rating would still be likely to be sufficient for the notional company to be able to finance its activities.”

The assumption that a BBB target credit rating would be sufficient for the notional company is a significant departure from precedent in other UK regulated sectors and the CAA’s own target rating for H7. Regulators have generally targeted BBB+, being an investment-grade rating with headroom to absorb plausible downside risks and ensure larger issuers have sufficient market access at a reasonable cost of debt.

There are several reasons why a BBB rating would not be financeable for a large issuer like a notional HAL, with a capex programme expected to be materially larger than H7:

- Debt spreads are materially wider at BBB+ vs BBB – under typical conditions, KPMG found BBB-rated debt would be expected to be priced 25-35bps wider than BBB+-rated debt, likely as a result of significantly higher default rates of BBB-rated debt. This applies also to the cost of hedging and liquidity facilities with banks, where a BBB rating results in a higher funding cost for the bank than a BBB+ rating (and therefore higher cost to HAL), driven by capital requirements that increase as credit risk increases.
- At a BBB rating, the notional company would be expected to materially underperform the allowed cost of new debt, which is informed by HAL’s actual debt yields, not a BBB index. In that scenario, the structural underperformance on cost of debt would itself put greater pressure on credit ratings and finance-ability.
- It is incomplete to consider in-period financing requirements as the only relevant factor for finance-ability. Debt investors are exposed to risk in respect of the total value of outstanding issuance (not just that refinanced or raised new in-period) –

that risk is greater at BBB, where there is a single notch of headroom to lowest-investment grade, below which there is a structural break in investor appetite and pricing. In the case of notional HAL, the average total value of debt is likely to be significantly higher in H8 than H7, therefore the value that investors place on a stronger credit rating is greater. Companies with the same scale of total outstanding of issuance as notional HAL would typically be rated at least BBB+, but in many cases at single-A. It is also important to note that debt investors have counterparty limits in respect of total exposure to a single issuer and those counterparty limits are generally higher for stronger-rated issuers.

As set out above, there are several issues with the CAA's assertion that, absent HAL having a covenanted financing structure, the notional company would have energy-like ringfencing conditions. Setting that aside, there is an inconsistency between the CAA's position that such conditions would support a structural uplift in the notional company's debt rating and that the notional company could plausibly target a BBB rating.