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British Airways response to CAP3044a
FTI WACC report for H8 and other financial issues

Dear Stewart

Further to our response of 13 December 2024 to the CAA's draft method statement for the H8 price control and business plan guidance to Heathrow Airport Limited (HAL) (CAP3044), we provide our response to the CAA's guidance on HAL's cost of capital. The CAA has based this guidance on a report produced by FTI Consulting (FTI) reviewing the methodology for determining the weighted average cost of capital (WACC) for H8. Our response below should be read in conjunction with our response to CAP3044.

British Airways supports the report produced by CEPA for IATA, on behalf of the airline community, responding to FTI's findings. We refer to CEPA's report for the detailed findings and recommendations.

Specifically, we are concerned that both the CAA and FTI have not considered several issues that are central to the estimation of HAL's WACC. Despite estimating a potential increase of 140 basis points to the WACC (from 3.16% to 4.56% RPI-real[1]) using updated market data to 31 July 2024, the CAA and FTI have not addressed key elements which would demonstrate an overestimation of certain WACC parameters. We also note that there was no engagement with stakeholders in the lead-up to FTI's report (such as on the draft report) which could have helped in identifying and addressing some of those issues early in the process.

The potential increase put forward by the CAA and FTI would have a material impact on charges, adding more than £3 per passenger using H7 assumptions, and almost £300 million in additional unjustified returns for HAL. Coupled with a potentially significant investment programme, this could lead to step increases in the level of the charge for H8 and beyond, resulting **in long-term ramifications for consumer affordability, the ability of consumers to**

[1] FTI has also estimated a vanilla CPI/CPIH-real WACC of 4.64% (range of 3.97%-5.30%).

fly – such as to visit friends and family – and Heathrow's role in as a global hub, including connecting the UK regions to the world and promoting world trade.

Key elements left unaddressed include moving to CPI/CPIH indexation, the impact of capacity constraints on the beta, the removal of pandemic-linked liquidity costs and the relative risk of comparators for the asset beta in recent years. For instance, comparators ADP and Fraport have lower asset betas than at the Q6 decision, when Heathrow's asset beta was assumed to be 0.42-0.52 (i.e. well below FTI's range of 0.52-0.71[2]). In addition, both ADP and Fraport have extensive international activities in riskier non-hub airports, including outside Europe, which do not correspond to HAL's regulated risk. In relation to AENA, the report does not delve in issues such as the operation of 47 airports in Spain which have higher traffic volatility as well as AENA's appetite in riskier international investments.

We moreover note inconsistencies in the calculation of certain parameters, for instance FTI's finding that HAL's asset beta with minimal demand risk is higher than the CAA's Q6 and H7 pre-pandemic beta where HAL faced all demand risk.

Our firm position throughout H7, our response to the H7 lessons learned (CAP2618), and our response to the draft H8 method statement is that HAL should not be over-rewarded and that insulating it from all eventualities is inconsistent with the risk faced by the airport, the risk of a regulated business and the cost paid by consumers. Indeed, ensuring efficient costs, including that HAL is efficiently financed, is a duty for the CAA under the Civil Aviation Act 2012. However, through adjustments applied to the WACC, HAL is currently compensated with around £150-275 million a year for facing partial demand risk (given the existence of the Traffic Risk Sharing mechanism) while pandemic-like reductions to passenger volumes would be required each year for the HAL not to achieve those financial benefits. We do not consider this to be a fair balance.

For the final method statement expected in February 2025, and in line with CEPA's recommendations, we request that the CAA makes the following commitments in relation to the cost of capital:

1. To undertake a full and thorough assessment of relative risk for comparator airports and estimating what is driving differences in estimates between comparators, including whether investment in non-core international airports by those airport groups is likely to be riskier than their core hub airports.

2. To provide a workbook (on a confidential basis if needed) to the airlines covering Heathrow's cost of debt, including all relevant debt instruments and derivatives.

3. To estimate an asset beta (and other revenue allowances) if all traffic risk was allocated to airlines. This should include justification for why the CAA considers that Heathrow with no traffic risk would be up to 0.18 higher (i.e. equivalent to its estimation of the compensation for traffic risk) for a regulated utility network with no demand risk, if this continues to be its assessment.

[2] Pre-Traffic Risk Sharing Mechanism.

4. Improve the quality of the price control financial model for H8, ensuring that the resultant workbook is transparent, can be used to project potential charges for future price controls and can be understood by stakeholders.

5. Moving into H8, new evidence and changes to relative risk mean a H7 roll-over should not be assumed to be the right approach. We agree with FTI's sentiment that H7 should not be seen to be the appropriate approach for H8 without review. While the CAA may have considered that the 'nascent' nature of the H8 price control is a reason to not fully engage with specific issues at this stage, we highlight the importance of discussions early in the process to avoid timing issues such as those experienced in H7. High quality regulatory decisions are more complicated with less time to engage on key topics, greater difficulty in moving away from reference points, and reduced transparency.[3] This is all the more relevant in view of the H8 Constructive Engagement process aiming to reach consensus between users and HAL on key building blocks of the price control.

6. To assess whether the balance of incentives is skewed in favour of HAL and conduct an appropriate evaluation recognising that insulating HAL from all eventualities is inconsistent with the risk faced by the airport or a regulated business.

7. In estimating the cost of capital, the CAA should set out explicitly how the estimation of the different parameters ensures efficient costs in line with its statutory duties.

We moreover support CEPA's recommendation that the CAA considers the impact of its policies on depreciation, inflation and affordability. The CAA ought to have regard to long-term consumer affordability, such as the knock-on impact on the ability to fly and connectivity out of Heathrow.

We welcome further engagement and are available for any questions on our response as the CAA develops its final method statement.

Yours sincerely,

Michael Petrides

Head of Economic Regulation
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[3] We re-iterate our response from the H7 lessons learned, where we stated that: "*[A]n early and comprehensive review of beta estimation is a necessary step in the H8 process. This should include a proper relative risk assessment and an adaptation of some of the policy decisions made at H7 to reflect precedent and evolving market evidence, which will demonstrate that the return allowed by the CAA for H7 is inconsistent with the level of risk faced by HAL.*"