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British Airways Response to CAP1966: Heathrow RAB adjustment

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on Heathrow's proposals and implications for the wider policy environment.

Executive Summary

Heathrow has proposed an upward adjustment to its Regulatory Asset Base ("RAB") to insulate itself against traffic volume risk, claiming that the Civil Aviation Authority ("CAA") must act now to protect what they refer to as "lost revenues" due to the pandemic.

However, Heathrow's proposal is fundamentally wrong on the facts, the mechanism and its justification. The proposal attempts to pressurise the CAA into making a decision, but the reality is that it is neither an appropriate course of action in the context of the existing regulatory framework, nor is it in the consumer interest to raise airport charges for years, and our response sets out our reasoning why this is the case.

The key points in our assessment of Heathrow's proposal are follows:

1. **The current Q6 licence already compensates Heathrow to hold all passenger volume risk;**
2. **Heathrow has used excessive debt to strip almost all equity value from the business; Heathrow's debt profile is a consequence of management decisions and is not a function of the financeability of the business;**
3. **It would be inappropriate therefore, for the CAA to permit Heathrow to adjust the Regulated Asset Base, as consumers would be <u>double charged</u> for a risk Heathrow has already been compensated to bear. Further, the effect on airport charges would impact consumers for 20 years;**
4. **Having stripped the business of almost all equity, it is now time for Heathrow's investors to reinject equity to replace the capital that has been removed;**
5. **We believe that it is entirely appropriate for the parties to discuss, and come to a reasonable agreement on, the future allocation of risk during the negotiations relating to the next regulatory period.**

Heathrow is heavily in debt, having removed almost all equity to pay nearly £4bn of dividends to owners during Q6 (including a £100m dividend payment paid out to owners in April 2020), and even admits this extreme leverage has "increase[d] the Group's vulnerability to **any** economic downturn in its business or to adverse industry conditions"[1]. Equity exists to absorb downside risks and needs to be replaced if it is inadequate to support the impact of any such risks.

It is our view that an analogy with Railtrack is entirely appropriate; a company that, having paid dividends to investors and pared back critical maintenance spending, was unwilling and unable to raise new equity to support required essential maintenance.

Heathrow has publicly declared that it is unwilling and unable to seek additional equity investment from its investors, and instead insists that the CAA approve a bail out of its business by consumers. It would be entirely inappropriate to adjust the RAB for what is essentially an equity shock driven by the Covid-19 crisis. If Heathrow's current equity investors are unwilling, or unable, to provide the required equity to support the business, it may be appropriate for another party to ultimately assume that equity risk.

The supposed urgency of Heathrow's proposal is undermined by its repeated insistence in media statements that "we are very well-funded", and "we are in a very strong position, and Heathrow will survive this"[2], with new funds of £2.15bn raised[3]. Heathrow continues to adjust its public statements to suit the audience and the proposal, its rationale, and its supposed urgency are inconsistent with statements made to investors and the press. Consumers should not be Heathrow's recourse for its unwillingness to seek additional equity from investors (or its current shareholders being unwilling to inject additional equity), or to bail it out for its poor management decisions.

Heathrow's claim that, should the CAA not approve an adjustment to the RAB, it would damage current and future investment by international investors in UK regulated businesses is, quite frankly, a falsehood. It is stability of UK regulation that encourages foreign investment in UK regulated assets; lack of political interference, setting ex-ante incentives, and not intervening mid-period of a price control, which offers the possibility of earning oversized returns on capital investment, are exactly why foreign investors are attracted to regulated entities such as Heathrow. We see no connection between CAA's rejection of Heathrow's proposal, and future foreign investment in Heathrow or other UK regulated companies.

Permitting a mid-period adjustment will ultimately create instability for investors who rely on ex-ante incentives to plan business investment. While investors in regulated businesses such as Heathrow might earn oversized returns on investment, the fact that an entity is regulated does not create a guarantee of returns – neither the Q6 settlement nor the license provide any such guarantee. In any event, the CAA's obligation is to protect the consumer interest

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[1] Heathrow Funding Ltd prospectus dated 24th September 2020, p28 accessible at https://www.rns-pdf.londonstockexchange.com/rns/0638A_1-2020-9-24.pdf

[2] John Holland-Kaye, Heathrow CEO, BBC Radio 4 Today 28th October 1:20:15 2020 https://www.bbc.co.uk/sounds/play/m000nt9k

[3] Heathrow (SP) Ltd: results for the 9 months ended 30th September 2020, p8, accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-SP-Limited-Q3-2020-results-release-final.pdf

and not to protect the returns of Heathrow's investors. Lastly, re-opening price controls would be the very definition of instability, and we support the CAA's minded to position to uphold the present regulation and deal with issues arising at the periodic review for H7.

It is abundantly, and unmistakably, clear that Heathrow holds passenger volume risk in the Q6 settlement. Heathrow has benefited from holding such passenger volume risk for the entirety of the Q6 settlement period, and consumers have compensated Heathrow for such risk through the WACC. **Heathrow's proposal would therefore require consumers to pay twice for Heathrow's holding of such risk.**

Heathrow's attempt to redefine the nature of the volume risk for which it has been already compensated by consumers is highly inappropriate. It argues that it should now only be responsible for "normal" volume risk, despite having enjoyed the benefits of assuming passenger volume risk in its entirety for the settlement period.

It cannot now be permitted to (i) unilaterally redefine the definition of volume risk in the Q6 settlement in its favour with the sole aim to protect its equity investors; or (ii) cherry-pick the parts of the settlement that it likes or dislikes depending on the tide of macroeconomic conditions. Heathrow is regulated by licence, and such licence is based on most efficiently pursuing the consumer interest – not the interests of Heathrow's equity investors.

Heathrow's behaviour; by (i) strong-arming the CAA into making a rapid, unprecedented, and candidly unnecessary decision with broad implications across every UK regulated sector in the middle of the H7 price review process; and (ii) publicly threatening the CAA with legal action in the media are nothing more than bully tactics, that place the CAA at risk of consumer challenge; is unconscionable.

We fully support the CAA in ensuring a robust process remains in place for the negotiation of the H7 settlement period, that assesses the regulatory building blocks in their entirety, at the appropriate time, based upon clear evidence and facts. We further note that a far lower utility cost of capital would be required for consumers to assume some or even all volume risk.

The current licence establishes a package of clear regulatory incentives

1. Heathrow is currently subject to a regulatory price control known as Q6, which provides a package of **incentives based upon "single-till" building blocks to establish a maximum allowable per passenger yield** that can be recovered from consumers through airlines.[4]

2. This yield follows a price path of RPI -1.5%, informed by a pre-tax, real Weighted Average Cost of Capital ("WACC") of 5.35%, assessed upon a notional capital

[4] Heathrow's current licence and price control are set out on the CAA website at https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/

structure comprising 60% debt and 40% equity, and informed by passenger forecasts over that same period.

3. We agree with the CAA that this **longstanding regulatory framework allocates all traffic risk to Heathrow**, a risk that Heathrow is, and has been for the entirety of the Q6 settlement, compensated for in assessing the WACC that derives its return and has repeatedly acknowledged in Q6 and H7 Constructive Engagement. There exists no concept in regulation of the concept of "normal" traffic risk that Heathrow now attempts to portray.

4. Since existing regulation provides for a maximum allowable per passenger yield, **Heathrow's proposal is a significant deviation from existing principles** towards a form of revenue guarantee that does not form part of the present licence arrangements, being price cap regulation on the upside and rate of return regulation on the downside. The regulatory framework is designed to promote efficiency of Heathrow to the benefit of consumers. Further, the regulatory framework is not designed to guarantee revenues and earnings, nor insulate investors from economic shocks, such as Covid-19.

5. A concept of "loss of revenue" does not exist in the present regulatory framework and should be properly described as **revenue neither earned nor achieved** against internal forecasts that Heathrow may have set itself.

6. Incentive regulation practised in the UK **is designed to set a calibrated package of incentives, ex-ante** (before the fact) as far as possible, based upon various building block inputs considered at the periodic review. This assessment at the periodic review prices the whole incentive package with a WACC that reflects risks incorporated within the settlement.

7. **Incentive-based regulation has at its heart a concept of non-interference**, largely to ensure productivity growth is delivered by profit maximisation, reducing costs efficiently to mimic the effects of a competitive market.

8. Heathrow's characterisation of this WACC as a "CAA target"[5] is therefore an **inappropriate interpretation of incentive-based regulation**. If this WACC were indeed a target, it would suggest that Heathrow not only had no equity risk but should in fact be compensated at a far lower cost of debt, suggesting **consumers have been significantly overcharged for a risk Heathrow is supposed to have held**.

9. Whilst an extreme proposition, it merely reinforces the fact that a reassessment of the present regulatory package from 2014 in any form would imply a balancing **reassessment of each and every aspect of the Q6 price control package to account for prior outperformance**. Alongside this, a significant decrease in returns from the WACC of 5.35% would need to be applied retrospectively to 2014, since removing traffic risk clearly **requires a sharp downward WACC adjustment** to reflect the fact that this risk is no longer borne.

[5] Heathrow RAB Adjustment Submission, p9, Table 4

10. For good reason therefore, **regulation does not characterise the WACC as a target** or seek to compensate investors for under-achievement against that target. We note that Heathrow seeks to portray a sustained asymmetry of risk by selective portrayal of returns since 2003[6], but without calculation or assessment of performance on other factors throughout the settlement, including debt and tax. This is neither how regulatory settlements are assessed nor implemented.

11. We should all be mindful that **re-opening regulatory settlements ex-post (after the fact) is the very definition of regulatory risk**. Price control periods are purposefully standalone packages, and interference in their mechanics has implications across that package. Heathrow should be aware that given the strong outperformance from 2014 to 2019 on so many aspects of the settlement, a reopening of the settlement would require a reassessment of the entire settlement period, and not just the parts of the settlement that Heathrow tries to cherry pick in its favour. A re-opening of the Q6 settlement will introduce significant regulatory risk for investors in future settlement periods, which will ultimately increase costs for consumers.

12. Regulatory risk is minimised by allowing the business to operate to ex-ante incentives without regulatory interference, regardless of whether performance exceeds or does not meet assumptions in setting the price control. **It is this very stability in the UK that attracts investment capital**, as there remains the opportunity to out-perform regulatory settlements, profiting from doing so without appropriation. **Risk is in fact increased by re-opening price controls**, and matters raised are **best dealt with instead at periodic reviews for the subsequent price control.**

13. **It is not therefore appropriate to modify a single aspect of the price control**, since it can only be assessed alongside all the other risks and incentives within the package set at the periodic review. The CAA should assess any changes to the Q6 settlement in that context, ensuring that Heathrow's total incentive package is appropriate in the context of any modification request.

14. Heathrow's outperformance in Q6 and Q6+1 to date requires closer scrutiny to consider underlying performance, and **we concur with the CAA's analysis**[7] that builds on work presented by the airline community. This additionally accounts for outperformance on cost of debt and taxation assumptions, and adjusts to 2018 prices, rather than the nominal basis of the original airline analysis.

<u>Table 1: Heathrow volume outperformance</u>

15. This **clearly demonstrates an outperformance in the present regulatory period** that not only needs to be considered alongside any proposed Covid-19 adjustment but would be even greater if the WACC is correctly adjusted down, both to reflect removal of traffic risk in any mechanism applied, and adjust for outdated elements

[6] Heathrow RAB Adjustment Submission, p9, Figure 3
[7] CAP1966A, Table E2

that make 5.35% higher than it would otherwise be, had it been reassessed for market conditions in the latter years of the Q6 settlement.

16. The RAB is as well-developed concept that is used a tool to ensure that airport charges reflect efficient capital expenditure incurred and not paid for in whole by current consumers. **Heathrow's proposal contravenes regulatory norms and would make future consumers pay for a volume risk that relates to the present** and was assigned to Heathrow in return for a higher cost of capital. It is also depreciated to reflect the real expense that physical assets will eventually become worthless and require replacement. The RAB should not be used as a discretionary cashflow management tool in any scenario, and the RAB has nothing to do with in-period issues of a price control.

17. **Heathrow's proposal to apply a depreciation holiday[8] ignores the fact that depreciation has already been charged to consumers in 2020 and 2021**, informing airport charges calculated in these years, and that the price cap is on a per passenger rather than total revenue basis. RAB depreciation also has nothing to do with in-period issues of a price control.

18. **The proposal therefore attempts to, again, double-charge consumers** by introducing a notion that depreciation of assets has not occurred in years of lower passenger volume, when depreciation has already been considered in building the charge for today's consumers. Loss of business due to Covid-19 has nothing to do with depreciation on the RAB, and depreciation should not be considered an optional cost of business.

19. **Depreciation is a real cost to a business that must continue whilst an asset remains on the balance sheet**, and as the investor Warren Buffett notes, "Any management that doesn't regard depreciation as an expense is living in a dream world".[9]

20. Heathrow's proposed method of adjustment is an **asymmetric attempt to extract additional value from the existing Q6 price control** by claiming that it is not being re-opened. This is clearly incorrect. We urge the CAA to judge this as a re-opening of the entire Q6 price control back to 2014 or reject the proposal out of hand.

21. Furthermore, it should be noted that in accounting standards, **IAS16 specifically prohibits a usage-based treatment of depreciation**, stating "a depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate"[10], and furthermore that "depreciation begins when the asset is available for use and continues until the asset is derecognised, even if it is idle"[11].

22. Heathrow's accounting policies follow that standard in statutory accounts, and state that "depreciation is charged by equal instalments over…expected useful lives [of

[8] Heathrow RAB Adjustment Submission, p4
[9] Berkshire Hathaway, Annual Shareholder Meeting 2003 as reported at https://buffett.cnbc.com/
[10] IAS16.62A from IAS16 Property, Plant & Equipment, issued by IFRS Foundation
[11] IAS16.55 from IAS16 Property, Plant & Equipment, issued by IFRS Foundation

assets]"[12], **demonstrating continued depreciation of the RAB also remains appropriate**. Whilst the RAB is not based on International Financial Reporting Standards ("IFRS"), economic regulation should not radically depart from those internationally recognised accounting norms, which would be the sole financial performance metric in a competitive marketplace.

23. It would also seem appropriate at this time to consider whether assets that have been written off in statutory accounts should remain on the RAB earning a return in future periods. If an asset no longer meets the recognition criteria of IAS16 or fails to deliver the economic benefits that were supposed, **perhaps the RAB might be re-stated downward at the outset of the next price control to reflect the reality that these assets are not delivering any benefit to future consumers?**

24. Heathrow's proposal also suggests compensation through a recovery mechanism based upon revenue outturn in 2020 and forecast revenue in 2021, graciously charging consumers for just 95% after deducting the first 8% of the **risk that they are already paid to bear, and that has already been priced into the current prices** that have be charged in 2020 and will be charged in 2021.[13]

25. This mechanism yet again fails to consider all the building blocks that provide inputs when constructing the price control. The notion of **revenue "loss" further omits to consider associated costs and cost reductions that have been achieved**. Heathrow's Q3 results clearly state cost-cutting actions that include "cutting at least £300 million of operating costs"[14], all whilst the business remains EBITDA[15] earnings positive.

26. Basing any adjustment on revenue, and more so on Heathrow's own revenue forecasts is simply an invitation to provide a bailout to Heathrow's equity investors at a 100%+ margin, thus **revenue cannot be the basis for any reasonable discussion** of any proposed adjustment mechanism.

A highly leveraged capital structure has amplified risks held by Heathrow

27. BAA plc was originally acquired by Ferrovial S.A. in consortium with Caisse de dépôt et placement du Québec ("CDPQ") and GIC, the Singaporean sovereign wealth fund, at what was described by Marcus Agius, BAA plc's then Chairman, as a "**premium of more than 49%** to the 30 day average pre-bid share price"[16].

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[12] Heathrow Airport Holdings Ltd, Annual Report & Accounts 2019, Accounting Policies p132 accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts
[13] Heathrow RAB Adjustment Submission, p5
[14] Heathrow (SP) Ltd Results for the 9 months ended 30th September 2020, accessible at https://www.londonstockexchange.com/news-article/market-news/3rd-quarter-results/14734509
[15] Earning before Interest, Tax, Depreciation and Amortisation, or EBITDA, the preferred non-standard profit metric of highly-leveraged private equity investors, used to determine the maximum debt load under which a company can be burdened to extract maximum equity value from an asset
[16] Ferrovial recommended final offer for BAA plc, accessible at https://www.ft.com/content/ed0af4ce-f53b-11da-bcae-0000779e2340

28. This valued BAA plc at an enterprise value of £16.3bn[17], **reducing £10.1bn of pre-acquisition equity to just £4.3bn and elevating the debt burden to £11.9bn** by introducing additional debt facilities that included the most aggressive form of acquisition financing: Payment in Kind ("PIK") notes, described as an indicator of market excesses in a recent FT article[18].

29. Furthermore, **Ferrovial's equity was itself funded by just £456m of real equity exposure to its own balance sheet**, with the balance of its £2.6bn shareholding funded by a £1.85bn facility secured against its ownership interest in its other airports and Cintra subsidiaries, alongside a further £168m secured against FGP Topco Ltd shares (the acquisition vehicle itself)[19].

30. This started a **history of imprudent financing under ownership of the Ferrovial-led consortium**, starting with a highly leveraged acquisition, and leading shortly afterward to a failed re-financing of acquisition debt facilities through a proposed whole business securitisation.

31. In attempting to raise £11bn in 2007 through this securitisation[20], **it transpired that investment risk had been mis-assessed**. As the securitisation timetable slipped further, the FT reported that "BAA appeared to be running out of cash" with "cash flows…insufficient to service a total of £1.8bn of estimated annual interest payments and capital expenditure" [21].

32. This ultimately **led to the loss of investment grade credit rating**, as Standard & Poor's "lowered BAA's credit rating to speculative grade" [22], colloquially known as junk, and nearly resulted in the downgrade of its bonds[23]. Heathrow claims its proposed RAB adjustment will lead to "helping to restore Heathrow's A- credit rating"[24] yet the events of 2006 to 2008 demonstrate its already imprudent stewardship of capital.

33. The present approach to financial engineering therefore existed long before Covid-19 and the present economic environment, and merely demonstrates that Heathrow operates **an aggressive financial structure that has proven repeatedly incapable of**

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[17] Ferrovial presentation on BAA plc acquisition, p7, accessible at https://static.ferrovial.com/wp-content/uploads/2019/11/22171034/baa-acquisition-presentation.pdf

[18] Financial Times, "Risky PIK deals pitched by private equity to yield-hungry investors" dated 23rd October 2020, accessible at https://www.ft.com/content/83954fe0-2e81-451c-b94d-688d92270e87

[19] Ferrovial presentation on BAA plc acquisition, p9, accessible at https://static.ferrovial.com/wp-content/uploads/2019/11/22171034/baa-acquisition-presentation.pdf

[20] Financial Times, "BAA and securitisation" 30th January 2007, accessible at https://www.ft.com/content/b5204f38-b05b-11db-8a62-0000779e2340

[21] Financial Times, "Refinancing BAA", 11th February 2008 https://www.ft.com/content/49acb074-d80b-11dc-98f7-0000779fd2ac

[22] Financial Times, "Refinancing BAA", 11th February 2008 https://www.ft.com/content/49acb074-d80b-11dc-98f7-0000779fd2ac

[23] Financial Times, "Fears for Ferrovial over burden of debt at BAA", 25th March 2008 https://www.ft.com/content/e9f142a4-faa0-11dc-aa46-000077b07658

[24] Heathrow RAB Adjustment Submission, p4

dealing with any market downturn, the risks of which Heathrow's equity shareholders are already paid to bear.

34. At the time of the post-buyout securitisation issues, Heathrow attempted to point blame at the CAA, as the episode coincided with the Q5 periodic review. However, this was never the cause of BAA's financing difficulties. Instead**, a combination of poor financial performance, aggressive financing, and a failure to understand the regulatory environment** combined to create a reckoning that only reducing the debt burden could solve.

35. The problem was clearly identified at the time: **BAA was over-indebted**. The obvious solution to the problem was the injection of real cash to restore more appropriate levels of debt to equity in the business. A **£500m injection of equity resulted on November 13th 2009**[25], which allowed Fitch to raise BAA's outlook from negative to stable, and Standard & Poor's to reaffirm BAA's investment grade credit rating[26].

36. The solution to Heathrow's present position is therefore clear, and we agree with Heathrow's proposal only so far as the fact that "this level of debt would need to be addressed".[27] If Heathrow wishes to ensure its finances remain within its covenants, **equity investors must follow precedent and inject cash as new equity** to change Heathrow's financial structure.

37. **Heathrow's present position is therefore a recurring, self-induced problem that has been created by excessive borrowing**, with group nominal borrowings rising at a compound rate of 4.6% from £12.9bn in 2014 to £16.1bn at the end of 2019, supported by a RAB that has only grown at a compound rate of 2.2% from £14.9bn to £16.6bn over the same period[28].

38. This has resulted in outstanding year-end borrowings at Group level in Heathrow Airport Holdings Ltd rising from 86.5% of the closing RAB in 2014 to 97.2% in 2019, with **75% of available cashflows in the same period spent on debt service, repayments and dividends**.

39. Heathrow themselves admit their over-indebtedness, stating in the risk factors of their recent debt prospectus that "The Group has been able to raise more debt than would typically be the case for an unsecured borrower. As a result, a greater portion of the Group's cash flow from operations is dedicated to payments on its debt obligations, thus reducing its flexibility to deal with significant financial underperformance. **This may increase the Group's vulnerability to any economic downturn in its business or**

[25] Reuters: "BAA's bond acquisition refinancing takes off", 27th November 2009, accessible at https://lta.reuters.com/article/bonds-baa-idUKLI26194420091127

[26] "BAA Funding's Ratings Unaffected After Equity Injection", 13th November 2009, accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/credit-ratings/sp/2009-BAA_Funding.pdf

[27] Heathrow RAB Adjustment Submission, p12

[28] Figures from Annual Report & Accounts, Heathrow Airport Holdings Ltd 2014-2019 accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts

to adverse industry conditions, which in turn could have a material adverse effect on the Group's business, financial condition and results of operations"[29]

40. Since the Q6 WACC is determined by reference to a notional capital structure comprising 60% debt and 40% equity, and with debt being lower cost than equity (and decreasing over time), **Heathrow has been emboldened to arbitrage their cost of capital**, being lulled by a previously benign traffic environment to replace more expensive equity financing with lower-cost debt financing, and raising debt far above that 60% level whilst underappreciating the risks of doing so.

41. This **arbitrage has been a one-way bet**, which reached its limit as a result of the failure of expansion: inflation of the RAB under Heathrow's proposals will only allow this to continue again in future, undermining any real resilience of the business.

42. The effect of this arbitrage has been to boost equity returns, allowing Heathrow's **shareholders to benefit from £4bn in dividends in the Q6 period alone**[30], including a payment of £100m that was approved and paid from Heathrow (SP) Ltd to Heathrow Finance in February 2020, **but only paid out from FGP Topco Ltd to shareholders after Covid-19 had started to bite**. We understand this was in April 2020, which airlines raised as a concern to Heathrow at Joint Steering Board at the time.

43. **The scale of dividend extraction is demonstrated by deeply <u>negative</u> retained earnings of £1.86bn** in Heathrow Airport Holdings Ltd's latest accounts[31], indicating dividends paid out have even exceeded total profits earned. This compares to a positive balance of £5.46bn in 2007[32], a dramatic reversal that demonstrates the scale of the value that has been extracted and paid to shareholders over time.

44. There is **no justification for paying out dividends in the midst of a crisis**, particularly where the board can always rescind its resolution to pay an interim dividend at any time up to the time of actual payment, and payment is not legally binding. This is exactly the action taken by the Board of IAG, which cancelled dividend payments due in 2020 as a result of the Covid-19 crisis.

45. Whilst entirely permissible in the Q6 settlement to optimise financing, this can only be at the risk of Heathrow's equity shareholders. Having benefitted from this outperformance of the settlement, **the equity risk has now materialised**, and Heathrow's shareholders **need to restore financial resilience by replacing the equity capital that has been removed**.

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[29] Heathrow Funding Ltd prospectus dated 24th September 2020, p28 accessible at https://www.rns-pdf.londonstockexchange.com/rns/0638A_1-2020-9-24.pdf
[30] Companies House filings for FGP Topco Ltd (#05723961) https://find-and-update.company-information.service.gov.uk/company/05723961
[31] Consolidated Statement of Financial Position, Heathrow Airport Holdings Ltd, accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts
[32] Note 30, Annual Report & Accounts, BAA Limited accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts

46. To be clear, the risk incorporated within the cost of equity calculation is not return that will be delivered. It is an average return that might be expected for taking onboard a basket of similar risks, incorporating the very real risk that an individual investment loses its entire value. **Equity risk is the risk of losing your investment on the downside and earning outsized returns on the upside.**

47. If the WACC were instead intended to be a target around which returns might moderately fluctuate, that would **imply little real equity risk and a sharply lower cost of capital to reflect some guarantee of returns**. This does not exist in the present Q6 regulatory settlement.

48. Therefore, if Heathrow were correct, there should be no equity risk in the business, which is at odds with the now greatly inflated WACC at which Heathrow's investors are presently compensated. **Having misunderstood equity risk, and compounded it with the risk of financial leverage, on what basis can Heathrow begin to justify an adjustment to the RAB?**

49. As **the RAB indicates the future earning potential of the business**, Heathrow manages debt by reference to the ratio of debt to the RAB, and debt covenants using RAB metrics have been incorporated into Heathrow's financing platform through the Common Terms Agreement ("CTA") with debt investors[33].

50. The stark reality of Heathrow's request is that, having breached forecast debt covenants based upon ratios against the RAB set out in the CTA, their proposal seeks to provide headroom to those covenants not by injection of real cash to reduce net debt, but to use **creative regulatory accounting to inflate the RAB**.

51. This inflation of RAB value for no consumer benefit would allow Heathrow to claim to debt investors that Heathrow's overall financial structure would have greater headroom to its covenants, **giving false assurance as to the integrity of its finances**.

52. **Even more egregiously, consumers would be double charged twice.** Not only would consumers be charged for an equity risk that Heathrow is already compensated, they would be charged a second time for depreciation that has already flowed through the present charging formula (which Heathrow proposes to adjust). Future consumers would then be charged both as Heathrow is further remunerated through an incremental return on the RAB of the value of any adjustment, and for an equity risk (that would not exist) on that increment.

53. We therefore welcome the news that Heathrow has found commercial solutions and agreed to fund a £750m subordinated debt facility[34] from its immediate parent company alongside raising £1.4bn from a bond placement (for refinancing 2021

[33] Annual Report & Accounts, Heathrow Airport Holdings Ltd, p79, accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts

[34] Disclosed as subordinated debt in Ferrovial S.A. January – September 2020 results, p2, accessible at https://www.ferrovial.com/en/ir-shareholders/financial-information/quarterly-financial-information/

maturities), totalling new funds of £2.15bn[35], removing the forecast covenant breach in the process[36]. Therefore, **it is demonstrably possible for investors to finance Heathrow's operating business**, though noting that this is not in the form of permanent equity.

54. This **prompts serious questions over the reluctance of Heathrow to inject permanent, real cash equity into its capital structure**, and it is worth considering the other effect of financial engineering: the creation of a "tax shield" in minimising profits chargeable to corporation tax.

55. **Independent analysis has suggested just £15m was paid in UK Corporation Tax by FGP Topco** in the period 2007 to 2014[37], a figure that if correct, demonstrates the asymmetry of this financial structure for consumers and taxpayers. It would be reassuring for consumers to know exactly how and where Heathrow applies exemptions such as the Public Infrastructure Exemption and the Group Ratio Rule to ensure best value is being incorporated into future regulatory settlements.

56. This all appears to be a clear repeat of the issues of 2006 to 2008, suggesting the Ferrovial-led consortium have not learnt from previous missteps. This **history of imprudence has led to a recurrence of financial difficulties**, and consumers cannot be expected to be the ultimate backstop to solve for financing decisions made by equity investors, which require a solution during every downturn.

57. Financeability of Heathrow's core business is therefore not in question, and it is clear that a **combination of financial engineering and insufficient equity** have exacerbated the effect of an exogenous shock.

58. **Heathrow must therefore bear the consequences of its management decisions**, and the Civil Aviation Act 2012 is clear in its explanatory notes that "the **<u>CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions</u>**".[38]

59. As ratings agencies themselves note in revising Heathrow Funding's outlook to negative in April 2020, **Fitch "expect[s] equity contributions sized to maintain**

[35] Heathrow (SP) Ltd: results for the 9 months ended 30th December 2020, p8, accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-SP-Limited-Q3-2020-results-release-final.pdf

[36] Heathrow Q3 2020 results presentation, statement by CFO Javier Echave at 31:30, accessible at https://www.londonstockexchange.com/news-article/market-news/3rd-quarter-results/14734509

[37] Tax Watch "For years Heathrow made billions in operating profit, but paid nothing in tax" accessible at https://www.taxwatchuk.org/reports/2-2/

[38] Civil Aviation Act 2012, Explanatory Notes, Section 36(a) accessible at https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

Heathrow Funding's investment-grade ratings"[39]. This is the only appropriate route to restoring credit ratings to pre-pandemic levels, and **consumers should not expect to pay an inflated WACC resulting only from Heathrow's chosen capital structure**. Heathrow's assertions that an inflated cost of debt is unrelated to these capital structure decisions contradict of the reports of their own credit ratings agencies.

60. However, S&P comments in their latest assessment of Class A and Class B credit ratings that "The regulation also allows the price cap to reopen during the regulatory period if modifications are requested by stakeholders due to extreme circumstances. We understand Heathrow has requested such a modification."[40] **This appears to mischaracterise the CAA's position as set out in CAP1966 and is misunderstood again by Ferrovial in its Q3 investor presentation as "enforce[ment of] regulatory framework mechanism"[41]**. It concerns us that investors have incorrect information.

61. Fitch's ratings criteria for airports assesses revenue price risk on the degree of the "contractual agreement/regulatory framework to recover revenue reductions or increased costs through the tariff mechanism (irrespective of volumes)"[42], **a clear incentive for Heathrow to attempt to recover "revenue reductions" by demanding a change in the basis of its regulatory settlement**, as Heathrow does in its proposal.

62. Ferrovial has further demonstrated in other UK investments its **inability to control finances within established regulatory incentives** through a £1.35bn shortfall that developed at the TubeLines PPP in 2010[43], operated by its Amey subsidiary in partnership with Bechtel.

63. "A damning decision by Alex Charlton QC, an independent arbiter, found no basis for Tube Lines' claims"[44], which suggests **a pervasive inability to understand risks within Ferrovial-owned businesses, and a history of seeking bailouts** to address its own failure to operate within financial incentives.

64. Whatever the solution, the CAA might consider that Heathrow has demonstrated an inability to fully assess the investment risks that they hold, reducing financial resilience

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[39] "Fitch Revises Heathrow's Funding's Outlook to Negative on Coronavirus Disruptions", 21st April 2020 accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/credit-ratings/fitch/Fitch-Revises-Heathrow-Funding-Outlook-to-Negative.pdf

[40] S&P Global Ratings "Heathrow Funding Ltd Debt remains on CreditWatch" 1st October 2020 https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/credit-ratings/sp/Heathrow-Funding-Ltd-Remains-on-CreditWatch-Oct-01-2020.pdf

[41] Ferrovial S.A. January – September 2020 Results Presentation, p14, accessible at https://www.ferrovial.com/en/ir-shareholders/financial-information/quarterly-financial-information/

[42] Fitch "Airports Rating Criteria — Effective March 24, 2020–Oct. 22, 2020", p3-4, accessible at https://www.fitchratings.com/research/infrastructure-project-finance/airports-rating-criteria-24-03-2020

[43] Financial Times, "Tube Lines faces £1.35bn shortfall", 17th December 2009, accessible at https://www.ft.com/content/b808fb82-eae1-11de-a0e1-00144feab49a

[44] Financial Times, "Tube Lines considers claim loss action", 1st February 2010, accessible at https://www.ft.com/content/d249e3aa-0e9d-11df-bd79-00144feabdc0

to a minimum in order to pay out dividends. **The Heathrow proposal does not provide a permanent solution to the gaming of the financing structure** that is at the heart of present problems, but perpetuates it further, burdening future consumers.

65. It also implies that Heathrow has set up its highly geared financing structure in a way that is **unable to accommodate a normal decline of the RAB** in periods when lower capital investment is required. There is no obligation on the CAA to sanction price settlements with ever-increasing RAB values to solve Heathrow's capital structure conundrum, and especially not where it does not represent efficient capital expenditure for consumer benefit.

66. It seems that Heathrow may have embraced Modern Monetary Theory ("MMT") in assuming the RAB represents a magic money tree. As HSBC's Chief Economist, Stephen King, notes, "a company making a severe loss cannot reduce that loss by imposing taxes on everyone else"[45]. **The RAB is a well-developed and well-understood concept to act as tool to appropriately reward investment in capital expenditure, not to be abused to solve current issues in future regulatory periods**.

67. This demonstrates the fallacy at the heart of Heathrow's proposal, namely, that the RAB adjustment is required to "allow additional future investment"[46]. Efficiently incurred future investment would be added to the RAB in the normal way, compensating investors for the sunk cost of their investments through the charging structure. It is **illogical to suggest that the RAB needs to be inflated to allow further rises in the RAB to occur**, and only demonstrates a complete lack of equity reserves available as retained earnings or otherwise to finance an investment programme.

68. Heathrow should therefore clarify how a subordinated £750m debt facility provided by ADI Finance 2 Ltd[47], the immediate parent company of Heathrow Airport Holdings Ltd, can remedy the lack of real equity in the business, and **set out how it intends to provide ongoing, permanent equity support for Heathrow with an appropriate equity cushion in place**. Given the recurring history of Heathrow's financing issues, we should ensure that this cannot occur yet again in future, particularly as the source and permanence of subordinated funds is unclear.

69. **Clarity over the identity of subordinated debt investors and the source of their funds is particularly important**, as were equity shareholders structuring their investment as subordinated debt, **this creates a further avenue for value extraction** that adds to the opacity of Heathrow's holding structure, and perpetuates the tax shield that deprives the UK Treasury of corporation tax revenue. This further calls into question Heathrow's claims of longstanding low returns and exposes the extensive nature of the debt-fuelled leveraged buyout structure.

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[45] Financial Times, "MMT: The case against Modern Monetary Theory", 22nd October 2020, accessible at https://www.ft.com/content/bcb523c3-7448-4cd6-a2d2-69b8f13be8f3
[46] Heathrow RAB Adjustment Submission, p42
[47] Ferrovial S.A. January - September 2020 results, p2 accessible at https://www.ferrovial.com/en/ir-shareholders/financial-information/quarterly-financial-information/

70. Perhaps the CAA should **consider an explicit future requirement to inject equity cash into ailing businesses,** as Ofgem is able to require of regulated businesses under its regulation. Alternatively, bank regulation under Basel III seeks to strengthen the resilience of individual banks by introducing **minimum capital requirements, which might be considered as a sustainable solution** in this case?

71. In addition, **Heathrow's treatment of its capital structure raises pertinent questions regarding the regulatory ringfence conditions in Q6**[48], both those considered and those implemented. The CAA might consider the effectiveness of the licence condition in ensuring financial stability when assessing H7 alongside the possible requirement of a special administration regime for future price controls.

72. Fundamentally, **Heathrow's equity investors hold equity risk**. This is the basis of the regulatory settlement, is reflected in the traffic risk held, and has been compensated through a higher regulatory WACC paid by consumers than would be the case if Heathrow did not hold that traffic risk.

73. Heathrow is **owned by a consortium of seven wealthy shareholders** who own stakes in FGP Topco Ltd (UK Company 5723961), the ultimate parent company into which Heathrow is consolidated. Their shareholdings are set out in Heathrow Airport Holdings Ltd Annual Report and Accounts[49].

74. These **shareholders sit behind substantial funds**, with the size of the Qatar Investment Authority estimated at $335bn in 2017[50], CDPQ with CAD333bn under management[51], GIC with US$100bn in assets under management[52], Ferrovial with a market capitalisation of €14.35bn[53] (owned through Hubco Netherlands B.V. a Dutch Cooperative that offers advantageous tax treatment), Alinda with $5.4bn under management[54], USS with £67.4bn in assets[55], and CIC with $940bn under management[56].

75. Heathrow is **held by investors through a complex corporate structure** that makes it hard to determine the exact nature of its finances above Heathrow Airports Holdings Ltd, complicated by financing flows related to the whole business securitisation: this includes **Heathrow Funding Ltd, a company domiciled offshore in Jersey**. The

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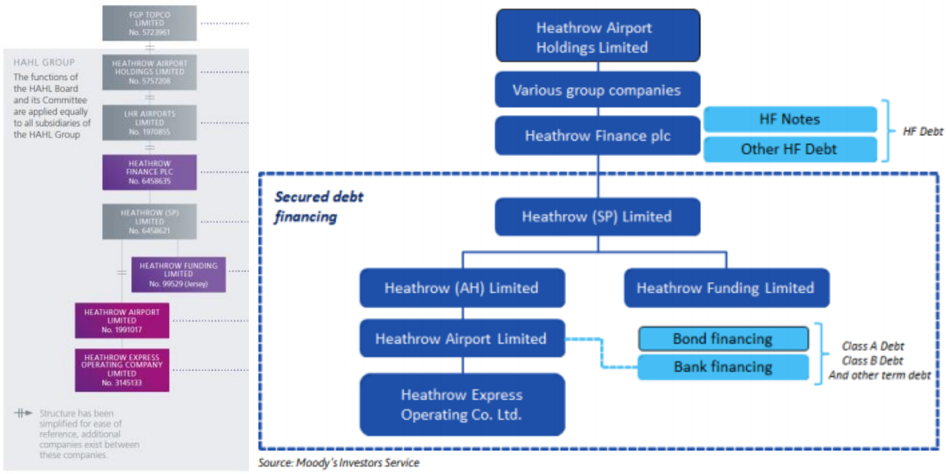
48 CAP1151 Economic regulation at Heathrow from April 2014: Notice granting the licence, para 2.127 to 2.134 https://publicapps.caa.co.uk/docs/33/CAP1151.pdf
49 Annual Report & Accounts, Heathrow Airport Holdings Ltd, p79 accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts
50 "The Tiny Gulf Country With a $335 Billion Global Empire" 11th January 2017 accessible at https://www.bloomberg.com/news/articles/2017-01-11/qatar-sovereign-wealth-fund-s-335-global-empire
51 CDPQ funds under management 30th June 2020 (https://www.cdpq.com/en/about-us/snapshot)
52 GIC funds under management https://www.gic.com.sg/about-gic/
53 Market capitalisation calculated as at 1200hrs CET on 29th October 2020 at €19.35 per share
54 Alinda 13F filings aggregated at https://aum13f.com/firm/alinda-capital-partners-ltd
55 USS funding update at 31 March 2019 https://www.uss.co.uk/about-us/valuation-and-funding/summary-funding-statement
56 CIC 2018 Annual Report http://www.china-inv.cn/chinainven/xhtml/Media/2018EN.pdf

structure is reminiscent of that utilised by Thames Water Utilities in previous years[57], and even summary versions set out below omit key entities that play crucial roles such as ADI Finance 1 & 2 Ltd.

Table 2: Heathrow Corporate Structure[58][59]



76. It is therefore **incumbent on Heathrow to provide complete transparency** of its financing and taxation arrangements, alongside their evolution from buyout, in order to provide the consumer of assurance as to where the money has gone over that time period.

77. The financing flows within this complex corporate structure, combined with the near total removal of equity from the business simply go to demonstrate that – contrary to Heathrow's proposal – **there is no requirement for urgent amendment of the regulatory settlement, but a requirement for real cash equity to be permanently re-injected**.

78. **Heathrow has repeatedly stated that their funding position is sound**, with CEO John Holland-Kaye stating on BBC Radio 4's Today programme that "we are very well-funded", and "we are in a very strong position and Heathrow will survive this"[60]

79. **Financeability is not therefore in question as Heathrow themselves have repeatedly stated to the markets**, with Heathrow's CFO stating that "despite these records losses, we continue to benefit from a robust balance sheet, and a strong liquidity

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[57] Financial Times, "Thames Water: the murky structure of a utility company", 4th May 2017, accessible at https://www.ft.com/content/5413ebf8-24f1-11e7-8691-d5f7e0cd0a16
[58] Annual Report & Accounts, Heathrow Airport Holdings Ltd, p78 accessible at https://www.heathrow.com/company/investor-centre/reports/annual-accounts
[59] Moody's Investor Services, "Heathrow Finance plc Update following ratings affirmation with negative outlook", 16th July 2020, accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/credit-ratings/moodys/Moodys-Credit%20Opinion-Heathrow-Finance-plc-6Jul20.pdf
[60] BBC Radio 4 Today 28th October 1:20:15 2020 https://www.bbc.co.uk/sounds/play/m000nt9k

position, which ensures we are able to overcome this crisis when the market recovers".[61]

80. Heathrow's CFO continues with a reminder that Heathrow has access to **"£4.5bn of liquidity taking into account the additional fundraising in October and the capital injection from ADI Finance 2**. As a reminder, we have c.£400m of cash held at Heathrow Finance **which will cover four years of debt service and the next debt maturity in 2024**."[62]

81. This continues with assurances that "on top of that, the capital injection from ADI Finance 2 helps to provide further headroom to our group covenant levels and when you add all these features together, **we can meet all our forecast needs…these forecast needs include all our projected operational costs, as well as capital investment, debt service and debt repayment**"[63].

82. This directly contradicts Heathrow's assertion that service quality might be impacted if they were not permitted an adjustment to the RAB. **It is clear that Heathrow has the resources in place to fund the high levels of service quality that consumers expect to be in place**. At British Airways, we pride ourselves on providing service standards that exceed customer expectations and delivering a world class experience to consumers who travel through Heathrow.

83. It should also be noted that a number of non-cash, exceptional items contribute to Heathrow's £1.376bn reported loss after tax in the 9 months to 30th September 2020, demonstrated by the fact that Heathrow has remained EBITDA positive to the tune of £259m over the same period, with a **net cashflow increase over the period even before October's financing activities**.

84. **Near-term and medium-term financing are not therefore in question**, particularly when considering that Heathrow has exacerbated the situation through management decisions to remove near all the equity from the business.

85. It is particularly **important to consider what financeability means** in the context of a regulatory settlement. **A notional company** is considered comprising 60% debt and 40% equity when establishing the price control, and we note that CAA12 states that "**the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements** or put the interests of users at risk by making them pay for an inefficient operator's financing decisions."[64].

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[61] Heathrow Q3 2020 results presentation, statement by CFO Javier Echave at 19:30, accessible at https://www.londonstockexchange.com/news-article/market-news/3rd-quarter-results/14734509
[62] Heathrow Q3 2020 results presentation, statement by CFO Javier Echave at 20:30, accessible at https://www.londonstockexchange.com/news-article/market-news/3rd-quarter-results/14734509
[63] Heathrow Q3 2020 results presentation, statement by CFO Javier Echave at 27:45, accessible at https://www.londonstockexchange.com/news-article/market-news/3rd-quarter-results/14734509
[64] Civil Aviation Act 2012, Explanatory Notes, Section 36(a) accessible at https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

86. It is therefore **clear that there are no near-term issues with Heathrow's finances in 2020 and 2021** as evidenced by statements made to financial markets, and that the Q6 framework provides incentives to ensure appropriate service standards and investment until the reset of the price control for H7 in 2022.

The licence and supporting legislation do not oblige regulatory action

87. The legislative background to the regulatory environment in CAA12 grants the CAA powers to act as **independent economic regulator** of airport operation services ("AOS"), as set out in CAP1966A. We support the CAA in ensuring that an assessment of any request to re-open a determination is based upon evidence.

88. We **further agree with the CAA that Heathrow has not presented evidence that is persuasive, balanced or considers all options available** to itself in submitting the RAB application, and consider that the timing of this during Constructive Engagement ("CE") for H7 has been highly disruptive.

89. There appears a **contradiction in Heathrow's approach to the RAB adjustment** in simultaneously suggesting its immediate necessity in order to secure debt financing (then successfully placing new debt financing without the adjustment), whilst also asking that it should apply from the start of H7 (before the H7 consultation process has been completed).

90. Heathrow's CEO, John Holland-Kaye, has stated that in setting the Q6 price control that "if there were exceptional circumstances…then they [the CAA] would re-open the settlement and make sure that shareholders were fairly compensated for the risks that they are taking, that's all that we are asking for"[65]. **This mischaracterises the adjustment mechanism present in CAA12 legislation, however we note that this statement recognises that the whole of the Q6 price control would need to be re-opened and a fair allocation of all risks established if such a route were followed**.

91. Heathrow's CEO also appears misinformed on the facts of the Q6 regulatory settlement. **There is no general "shipwreck" clause in the Q6 licence** (as updated for Q6+1 and iH7) in existence. CAA12 provides a power to modify a licence[66], which is restricted unless it is clear that "[consumer] benefits of the modification are likely to outweigh any adverse effects"[67].

92. Consumers have already been charged for the volume risk borne by Heathrow along with depreciation Heathrow proposed to adjust for: **there are no consumer benefits whatsoever in raising future charges to consumers**, with Heathrow having already benefitted from the existing incentive-based settlement.

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[65] BBC Radio 4 Today 28th October 2020 1:21:10 https://www.bbc.co.uk/sounds/play/m000nt9k
[66] CAA12, Section 22 accessible at https://www.legislation.gov.uk/ukpga/2012/19/section/22
[67] CAA12, Section 23 accessible at https://www.legislation.gov.uk/ukpga/2012/19/section/23

93. If Heathrow is unable to fund future capital expenditure as **a result of the excesses of their financial engineering, the appropriate solution lies in a restructuring** of the business to result in a more appropriate capital structure, **not in charging consumers for the privilege of perpetuating the current structure** and **<u>invite future value extraction through dividend recapitalisations in future</u>**.

94. However, we fully agree with Heathrow's CEO that shareholders should be fairly compensated for the risks they are taking. **If Heathrow's investors are unable to bear volume risk, they should be appropriately compensated with sharply lower WACC**, as it would be inappropriate for investors to be compensated for a risk they had not really been prepared to bear.

95. We note that CAA12 provides guidance notes on the "financeability" duty that is repeatedly referred to by Heathrow in its proposal. This states that "the financing duty does not require the CAA to ensure the financing of regulated airports in all circumstances, for example **the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions**"[68].

96. Ticket pricing is a highly competitive market, with multiple options between city pairs existing on competing airlines operating through competing hubs and airports. In **competitive markets, pricing reflects the costs of providing a service**, and the effect of raising costs to is to render marginally profitable routes unprofitable for airlines.

97. **Heathrow's proposal would therefore reduce consumer choice** as routes that would become loss-making as a result of elevated charged would be withdrawn, reducing possible routings between several city pairs as a result. As Greg Mankiw states in his Economics 101 textbook, Principles of Economics, "rational people think at the margin"[69].

98. Heathrow also asserts that service quality might be impacted if they were not permitted an adjustment to the RAB, however, **as we have previously made clear, Heathrow's own statements on its finances demonstrate that they have sufficient resources to maintain service standards for consumers**.

99. We do not believe there should be any degradation in service quality and note that Heathrow is already fully compensated to deliver consumer outcomes incentivised through the service quality rebate and bonuses scheme ("SQRB"). At British Airways, **we are passionate in ensuring that we always deliver a world class experience to consumers who travel through Heathrow**, and have been encouraging Heathrow to place appropriate resources in place to meet the quality requirements of the SQRB scheme and **see no reason why this should change in light of Heathrow's abundant liquidity**.

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[68] CAA12, Explanatory Notes, Section 36(a) accessible at https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

[69] Principles of Economics, N. Gregory Mankiw, Part 1, Section 1, "How People Make Decisions" p6

100. Heathrow attempts to portray the effect of any price rise as insignificant in the context of a £400 ticket, "having little impact upon what consumers pay for travel"[70], but **Heathrow's contention is economic nonsense**. We care about all our customers, and on our lowest priced shorthaul destinations, the marginal impact of any rise in costs is far from insignificant.

101. Heathrow is regulated as it fulfils the Market Power Test set out in CAA12 and **Heathrow does not operate in a competitive market** due to the limited available airport infrastructure, whilst being favourably situated in West London.

102. Competition should also be considered in relation to the development of competition at other airports. Economic regulation, whilst not in force at other airports, has still resulted in charges that are the highest in the world[71]. **There are no options available to unregulated airports – at which competition might develop in future – to seek recovery of revenues not earned** as a result of Covid-19. Regulation is not intended to insulate companies from what would result in a competitive marketplace

103. We therefore note further in CAA12 guidance notes, that "one would expect both of those needs [fulfilling demand and promoting efficiency] to be met in a competitive airports market **where airport operators provide the services demanded by passengers at minimum cost**. The requirement to have regard to those needs reflects the fact that **the ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market**."[72]

104. **Heathrow continue to misinterpret CAA12 in public statements**, with Javier Echave, their CFO, stating "if the CAA fail to adjust for this, they will be simply failing their duties to enforce something that is already in the settlement"[73], followed by "if the CAA does not change its decision this could require us to launch a legal challenge"[74].

105. Neither the Q6 settlement or CAA12 include any provisions that *require* the CAA to grant Heathrow's request, contrary to these many egregious statements made by Heathrow to the media, and apparently also investors. As previously mentioned, **Ferrovial refers in its Q3 investor presentation to "enforce[ment of] regulatory framework mechanism"[75]**, a deep misunderstanding of the situation.

106. The threat to launch legal action demonstrates Heathrow's complete disregard for the regulatory processes of CAA12, comprising consultation and assessment against

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70 Heathrow RAB Adjustment Submission, p5
71 Leigh Fisher Annual Review of Airport Charges
72 Civil Aviation Act 2012, Explanatory Notes, Section 36(b) accessible at https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1
73 Sunday Telegraph, "Heathrow holds course on £1.7bn hike in airport charges", 25th October 2020 accessible at https://www.telegraph.co.uk/business/2020/10/25/heathrow-holds-course-17bn-hike-airline-charges/
74 Ibid.
75 Ferrovial S.A. January – September 2020 Results Presentation, p14, accessible at https://www.ferrovial.com/en/ir-shareholders/financial-information/quarterly-financial-information/

consumer interest. **There are high hurdles to amending the licence under CAA12, designed to protect consumers from avaricious monopolies**.

107. Issuing threats of legal action is **particularly inappropriate whilst we remain in the middle of an H7 price control consultation process** that has not yet concluded.

108. Heathrow presents a range of "evidence" from other regulated businesses – selectively and **without fully assessing context of such re-opening mechanisms**. A more appropriate analogy would be Thames Water's mid-period attempt to raise consumer prices by 8%[76], ultimately rebuffed by Ofwat as not being in the consumer interest[77]. Examples from other jurisdictions can only be assessed in the context of those overseas legal and regulatory environments, and cherry-picking favourable aspects does Heathrow no favours.

109. **Instead, lessons need to be drawn from the experience of other UK regulators** in dealing with regulatory gaming, financial engineering and dividend recapitalisations to ensure that incentives are set that do not place the consumer at risk.

<u>**Consumers and airlines have been deeply impacted and cannot insulate Heathrow**</u>

110. **Covid-19 has had a devastating impact on the global airline and travel sectors**, with routes and frequencies cut drastically cut, aircraft grounded, fleets scrapped, and consumer demand remaining extremely weak. Airlines' network plans are highly uncertain, and international travel remains subject to a patchwork of restrictions that have sharply reduced consumer confidence[78].

111. The **impact of this on airline finances has been overwhelming**, with IATA estimates of total industry revenue decline being $419bn, based on a 66% decline in passengers and 51% fewer flights than in 2019[79].

112. This is estimated to result in $84.3bn in total losses in 2020 alone, with the airline industry as a whole not expected to turn cashflow positive until 2022 at the earliest[80],

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[76] Financial Times "Thames Water makes waves with price rise proposal", 12th August 2013 accessible at https://www.ft.com/content/c417d70a-0346-11e3-9a46-00144feab7de
[77] Financial Times "Ofwat rules against Thames Water's 8% bill increase", 8th November 2013 accessible at https://www.ft.com/content/71db97a4-4853-11e3-8237-00144feabdc0
[78] IATA Economics "Covid-19: Downgrade for global air travel outlook" 29th September 2020, accessible at https://www.iata.org/en/iata-repository/publications/economic-reports/downgrade-for-global-air-travel-outlook/
[79] Latest IATA Economics industry analysis at https://www.iata.org/en/publications/economics/
[80] IATA Economics "Airline industry will continue to burn through cash until 2022" 9th October 2020, accessible at https://www.iata.org/en/iata-repository/publications/economic-reports/airline-industry-will-continue-to-burn-through-cash-until-2022/

in stark contrast to Heathrow's positive EBITDA results highlighted above for the 9 months ended 30th September 2020[81].

113. Balance sheets have been devastated, leaving businesses to **seek additional cash equity financing or restructure balance sheets to support business and ensure survival**.

114. These equity support measures include a €2.75bn rights issue at IAG, a €400m equity issue at Ryanair, a $1bn share sale by United, $1.75bn at American Airlines, £450m equity placing at easyJet, a AUD 1.86bn equity raise by Qantas, a NOK 12.7bn debt for equity restructuring at Norwegian, €6bn of state equity capital via KfW at Lufthansa, and a £2bn rights issue at Rolls Royce[82].

115. The UK has experienced its deepest ever slump as a result of Covid-19[83], and with travel behaviours likely to change significantly, **consumers and airlines cannot afford to fund anything above a minimum, efficient level of airport charges**, a position supported by CAA12[84]. Allowing airport charges to rise would **extinguish nascent consumer spending on travel and jeopardise the recovery of the UK economy.**

<u>Alternative solutions are more appropriate and provide real financial resilience</u>

116. As we demonstrate above, in light of the enormous levels of value extraction from the business through dividends, and removal of almost all equity from the business, the only appropriate solution is for **Heathrow to replace the equity they have removed**, reflecting the risk they have been paid to bear, and restoring the equity buffer that the was envisaged in the Q6 settlement.

117. **We recognise that the regulatory model needs to develop at each periodic review** and are **open to considering issues during the consultation for the new price control from 2022** to set the most appropriate balances of risks and incentives that deliver the best value consumer outcomes. We are happy to explore the relationship between volume risk and cost of capital based upon concrete analysis, market-based data and facts.

118. As previously raised, explicit requirements to inject cash as equity might be considered, along with minimum equity capital requirements, stronger regulatory ringfence conditions, and the possibility of a special administration regime to deal with extreme scenarios. A licence is required that **thoroughly considers the post-tax**

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[81] Heathrow results for the 9 months ended 30th September 2020, accessible at https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-SP-Limited-Q3-2020-results-release-final.pdf
[82] Per individual airline investor relations sites, and financial media reports at the time
[83] Financial Times "UK economy suffers worst slump in Europe in second quarter ", 12th August 2020, accessible at https://www.ft.com/content/c8b172e2-8f70-4118-9e81-423e9a4b6839
[84] Civil Aviation Act 2012, Explanatory Notes, Section 36(b) accessible at https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

financial structure to ensure consumers benefit from lower cost of debt, appropriate gearing, and any tax allowances that might be applicable.

119. Having removed almost all equity from the business, if Heathrow is unprepared to assume equity risk, **other parties should be approached** to discuss terms to **assume the equity risk.** We do not believe this is a necessary step and that Heathrow's shareholders have proven capable of providing the necessary equity financing.

120. However, it is not appropriate for consumers to be charged through a RAB-based mechanism, and **highly inappropriate for consumers to act as a financial backstop** for the equity returns of Heathrow's shareholders.

121. Whereby Heathrow's shareholders have benefited from significant cash dividend pay-outs, and are some of the world's largest infrastructure investors, and further whereby Heathrow has demonstrated its ability to raise further debt capital from markets without a RAB adjustment, it is **only appropriate that Heathrow's proposal is rejected by CAA as it has failed to demonstrate any immediate urgency or actual financeability issue within the core business**.

122. **Heathrow remains fundamentally financeable** with an appropriate capital structure and equity reserves in place. A sustainable and conservative balance sheet is the required solution to provide resilience against economic shocks.

123. **We therefore support the CAA in its rejection of Heathrow's proposal and commit to fully engage in consultations for the H7 price control, where we can properly assess the risks and rewards of an appropriate incentive package for the future.**

Yours sincerely,

…………………………………

Alexander Dawe
Head of Economic Regulation
Networks & Alliances
British Airways Plc