Economic Regulation of Heathrow Airport:
CAP1966: Response to HAL's request for a Covid-19 related RAB adjustment

5th November 2020

1.0 Introduction

1.1 This response to the consultation is submitted by Heathrow Hub Ltd/Runway Innovations Ltd. (HHL/RIL), promoters of the Heathrow Extended Northern Runway (ENR) scheme.

2.0 Response to consultation

2.1 Heathrow Airport Ltd.'s (HAL) submission notes *"passenger numbers reduced by 52% in March, by 97% in April and May, and by 95% in June,"* states *"the RAB has no value because we cannot earn on it"* and concludes that, without an upward adjustment to the RAB, *"these consequences would be genuinely calamitous for Heathrow and most importantly for consumers and passengers, airlines, Heathrow's community and the UK's post-COVID economy."* [1]

2.2 For comparison, Gatwick's passenger numbers fell 66% in the six months to June 2020, [2] and Manchester Airport Group's by 99% in the same period. [3] HAL is therefore not unique in suffering the severe and unprecedented commercial impacts of Covid-19. It is however the only airport that is theoretically able to seek regulatory relief by asking consumers to bear the vast majority of its losses.

2.3 HAL's *"illustration of recovery through proposed mechanism"* shows an estimated revenue loss of £2.2bn (in 2018 prices) under a *"Delayed Recovery"* scenario. Of this £1.7bn is assumed to be recovered through the RAB and £0.5bn would be *"borne by HAL."* [4] The consultation clarifies this assumes *"HAL would bear the first 8% of revenue losses in 2020 and 2021"* and *"it would recover 95% of revenue losses beyond that 8% threshold through RAB adjustments."* [5]

---

[1] Executive Summary, Application for Covid - related RAB adjustments, HAL July 2020
[2] Results for the six month period to 30th June 2020, Gatwick Airport Ltd. August 2020 https://www.gatwickairport.com/globalassets/business--community/investors/june-2020--mid-year/investor-presentation---results-for-the-period-ended-30-june-2020.pdf
[3] Results for the year to 31st March 2020, Manchester Airports Group July 2020 https://www.magairports.com/media/1660/mag-investor-presentation-fy20.pdf
[4] Table 9, Application for Covid - related RAB adjustments, HAL July 2020 https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/Heathrow%20Airport%20Limited%20-%20RAB%20Adjustment%20Submission.pdf
[5] Para. 1.7, CAP1966, CAA October 2020

2.4 It is not clear whether the amount *"borne by HAL"* is intended to be a proposed equity injection or if HAL envisage some other form, perhaps arguing for hypothecation by foregoing the regulated return on investment cancelled [6] as a result of the *"cost savings it has made and those it plans to make."* [7]

2.5 It appears that, since HAL's July application, there has been at least one capital injection of £750m from ADIF2 into Heathrow Finance group. [8] However, there is little clarity as to its form or terms.

2.6 The *"illustration"* in HAL's application includes an alternative demand recovery scenario which has been redacted. However, the consultation suggests this may be intended to project a higher revenue loss of as much as £2.9bn for the same years 2020 and 2021. [9]

2.7 These scenarios, and the CAA's analysis, presumably relate to demand forecasts from July 2020, the date of HAL's application. For the unredacted *"Delayed Recovery"* scenario, the consultation states *"passenger numbers are forecast to be 29 million in 2020 and 63 million in 2021 (compared with the 'commercial deal' baseline forecast of 81 million in each year)."* [10]

2.8 This appears broadly consistent with HAL's June 2020 Investor Report which assumed *"a staged recovery in traffic over the course of H2 2020 and 2021"* [11] and that *"overall in 2020, passenger traffic is expected to decline 63.9% compared to 2019."* Revenues were estimated at £1,261m in 2020 and £2,401m in 2021 compared to 2019 actual revenues of £3,070m. [12] When adjusted for Other Regulated Charges (ORC's), which are excluded from HAL's submission, this yields the correct basis of comparison of c.£2,660m as the portion of overall revenues which HAL suggest is eligible for consideration in the remedies sought.

2.9 However, traffic forecasts are now substantially lower than those from June and July. HAL's most recent results state *"passenger numbers are now forecast to be 22.6m in 2020 and 37.1m in 2021, compared to our June forecast of 29.2m in 2020 and 62.8m in 2021, and 2019 actuals of 81m."* [13] It is not known if this or a similar forecast was assumed in the redacted

---

[6] Including a £1.455bn reduction in the 2020 capital programme - Page 10, Application for Covid- related RAB adjustments, HAL July 2020

[7] Para. 2.10, CAP1966, CAA October 2020

[8] Page 4, Heathrow (SP) Ltd, Results for the 9 months ended 30th September 2020 https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-SP-Limited-%20Q3%202020%20final.pdf

[9] *"HAL's current forecasting scenarios predict that passenger numbers will remain low during 2020 and 2021 and, as a result of this, it expects to lose between £2.2 and £2.9 billion of revenue in these two years"* – Para. 1.2, CAP1966, CAA October 2020

[10] Footnote 6, Application for Covid - related RAB adjustments, HAL July 2020

[11] Forecast financial performance, page 13, Heathrow (SP) Ltd. and Heathrow Finance PLC Investor Report June 2020 https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_SP_investor_report_June_2020.pdf

[12] Page 5, *ibid*

[13] Page 1, Heathrow (SP) Ltd. Results for the 9 months to 30th September 2020, HAL 28th October 2020 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

scenario, which the consultation states *"showed the impact on the RAB adjustment in a scenario where there was a much slower recovery in traffic, where the impact on charges was around double."* [14]

2.10 However, in any scenario, the effect of HAL's application is to transfer an as yet unknown and apparently unlimited financial liability to consumers, at least until (but most likely extend beyond) 1st January 2022 when the regulatory framework would be reset.

2.11 There are therefore compelling grounds for rejecting HAL's claim.

2.12 The consequence of rejection may or may not be "*calamitous"* for Heathrow Airport Ltd. However, HAL provides no evidence as to why the financial challenges facing a private company should be calamitous to the national interest or consumers. Instead, it simply serves to show HAL's apparent belief that regulation should render it immune from the consequences of its own financial mismanagement.

2.13 HAL rightly notes *"the Covid-19 epidemic is an exceptional occurrence."* However, as CAP1966 recognises, the dividend payments paid by HAL's ultimate parent company [15] have also been exceptional.[16]

2.14 The scale of such payments is entirely incompatible with HAL's demand that consumers should effectively bear downside risk, while HAL retain upside benefits. As the CAA note, it was also HAL's own decision to increase and maintain gearing beyond the 60% assumed in setting its price controls, to an estimated 93.3% by the end of 2020. [17]

2.15 HAL also suggest that its financial challenges have been *"compounded by two decades of failing to consistently achieve the cost of capital."* [18] If this were indeed the case, the level of dividends, even without taking into account airlines claim of HAL's consistent regulatory outperformance of the regulatory settlements, [19] would appear to more than compensate.

2.16 In addition, HAL consistently assume pre-tax figures. Given its very low levels of corporate taxation, the picture is likely to look different on a post-tax basis.

[14] Para. 1.8, CAP1966, CAA October 2020

[15] "*FGP Topco is the ultimate parent company of the Heathrow group of companies" – page 78, Annual Report & Accounts,*

[16] *"Dividends paid to Heathrow's ultimate shareholders"* (e.g.; page 56, ibid)

£m	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**Total**
Dividends	240	555	1,075	300	325	525	500	500	100	4,120

[17] Para. D.19, CAP1966A, CAA October 2020

[18] Page 42, Application for Covid - related RAB adjustments, HAL July 2020

[19] Para. 1.10, CAP1966A, CAA October 2020

2.17 In October 2013 USS paid Ferrovial £392m for 8.65% of HAL. [20] Ignoring control premia and other such distortions, this valued the company – absent any market quote – at £4.53bn. In the following six years 2014-19 inclusive, the aggregate dividend distribution to shareholders was £3.225bn. The running average yield over this time on these years, assuming no dividend-related distortions in the USS purchase price, has therefore been just below 12%.

2.18 During the same period HAL's net debt rose by £1,801m. Subtracting this from the actual dividends paid would have adjusted the yield to 5.2% - a much more recognisable yield in publicly-quoted equity markets, which in turn might support the argument that HAL has been borrowing money to pay unwarrantedly high dividends for a regulated utility – privately held or not.

2.19 HAL state *"current market parameters for debt and equity for Heathrow suggest that its cost of capital today is around 3% higher than the level before the pandemic."* [21] This is difficult to analyse without sight of the workings but given HAL's balance sheet is overwhelmingly debt-based and its bond yields have moved from 2-2.5% to 3% at the time of writing, it is difficult to see how the WACC has risen by 3% using common and conventional parlance. The use of equity market betas on p.13 of HAL's submission is of course arguable, although previous commentary in submissions and reports on this subject have rightly focused on the debt beta.

2.20 HAL refers to investment of *"over £10bn,"* but this should of course be considered in the context of historically supportive regulation and the gross inefficiency in capital expenditure which CAP1964 and CAP1964A describe. We suggest that the avoidance even of a capital inefficiency of 10% would have rectified the shortfall in the pre-tax return on RAB, subject to timing, and would have provided an extra amount of debt headroom to the same amount of £1bn.

2.21 HAL appears to confuse Heathrow as an, admittedly important, national infrastructure asset with the responsibilities that accompany private ownership. The consultation's reference to the then Secretary of State's comments on Railtrack [22] is welcome in demonstrating the CAA's determination to safeguard the interests of consumers.

2.22 It is also entirely and demonstrably wrong for HAL to threaten that a refusal to accede to its request for a minimum £1.7bn increase in the RAB would mean *"the viability of expansion will be at stake."* [23] Our previous consultation responses show its North West Runway (NWR)

---

[20] https://www.cliffordchance.com/news/news/2013/10/clifford_chance_advisesussonp392minvestmentinheathrowairporthold.html

[21] Page 41, Application for Covid - related RAB adjustments, HAL July 2020

[22] *"The Government stands behind the rail system but not individual rail companies and their shareholders who need to be fully aware of the projected liabilities of the companies in which they invest and the performance risks they face"* - Statement to Parliament**,** The Secretary of State for Transport, Local Government and the Regions, Column 955 Hansard 15th October 2001 https://hansard.parliament.uk/Commons/2001-10-15/debates/c5701c3b-c3ca-4313-af39-4926d12c376f/Railtrack

[23] Page 10, Application for Covid - related RAB adjustments, HAL July 2020

scheme was fundamentally unviable long before the pandemic. The c.£1.75bn increase in HAL's estimated early Category C costs in a period of just over a year clearly signalled a project that was effectively out of control. [24]

2.23 As the consultation notes, HAL has provided very limited evidence to support its claim, relying in large part on attempts to monetise the threat of increasing delays. This uses a Systra '*Willingness to Pay'* survey, which HAL's Initial Business Plan (IBP) suggests was commissioned in 2018. [25] The survey does not appear to have been published and the very limited detail in the IBP has been redacted.

2.24 Apart from references to its own finances, which appear fundamentally at odds with the most recent public statements as to liquidity, [26] this monetisation is the only detailed evidence which HAL put forward to support its claim. It is therefore important that this is carefully assessed, and we share the CAA's *"specific concern"* over HAL's use of the survey for the following reasons.

2.25 HAL claims *"increasing security queue time by 5 minutes for 40m departing passengers would result in a loss of £150m pa of consumer welfare."* [27] This equates to £45/hr (£0.75/min) average Value of Time (VoT).

2.26 This is used to value the improvement of on-time departure punctuality from 80 to 85%. The IBP has only limited information on how the research was performed and the exact questions that were asked of the passengers. [28] It would seem difficult for an ordinary passenger to accurately assess the benefit of such a change and how it might impact their journey.

2.27 Nevertheless, HAL normalise the figure per one percentage point of On Time Performance (OTP) and multiply by 20 to value the decline in OTP drop 80% to 60%. To put this in perspective, an improvement from 80 to 85% equates to c.5 minutes per flight, whilst a deterioration from 80 to 60% is c.9-11 minutes on average per flight. Although passenger

[24] *"In the April 2018 Consultation … HAL's latest estimate was that it would spend approximately £650 million (in 2014 prices) on early Category C costs. In the Autumn of 2018 … HAL's forecasts of these costs had, by then, increased significantly, suggesting total spending might reach £1.6 billion. HAL has now provided more detailed information on its forecasts for these costs and its latest estimate for early Category C costs has increased further to £2.4 billion (in 2014 prices)"* – Paras. 2.2-2.3, Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable CAP1819, CAA July 2019

[25] *"Systra, Heathrow Airport Customer Valuation Research, November 2018",* Footnote 80, Initial Business Plan, HAL December 2019
https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/Heathrow-intial-business-plan-detailed.pdf

[26] *"Heathrow finances remain robust – Liquidity at the end of September has been boosted further in October to £4.5bn. Cash reserves are sufficient for the next 12 months even under an extreme scenario with no revenue, and well into 2023 under our current forecast"* – Press release, Heathrow Airport Ltd. 28th October 2020
https://mediacentre.heathrow.com/pressrelease/details/81/News-1/12582

[27] Page 11, Application for Covid - related RAB adjustments, HAL July 2020

[28] Page 36, Initial Business Plan, HAL December 2019

sensitivity may well increase with the length of any delay, the methodology does seem to factor for this by accident and without any sensitivity.

2.28 Furthermore, using GDP deflator and Heathrow's relative business/leisure passenger mix, [29] we calculate a WebTAG databook VoT figure of £0.25/pax/minute. [30] This compares to the comparable figures used by the Airports Commission (£0.32) [31] and Eurocontrol (£0.31) [32] (all in 2020 prices). HAL's assumed passenger VoT is therefore two to three times higher, without any explanation or comparison.

2.29 More importantly, the very fact that HAL felt it appropriate to make its application, at a time when not only airlines but the entire aviation business community face existential challenges from the covid pandemic, provides further evidence of what appears to be HAL's sense of entitlement and confirmation that its market power does not serve the public or national interest.

2.30 HAL suggest that refusal to accede to its application could mean *"aeronautical charges will increase long term, most likely leading to direct increased costs for consumers."* This clearly shows the need for regulatory intervention in accordance with the CAA's primary duty. Any other course of action would confirm IAG's fear that *"HAL is absolved of responsibility for financeability, as the CAA is prepared to transfer risk and cost onto passengers, in order to protect dividends, whilst financing capacity expansion, irrespective of inefficiency, inappropriate capital structure or unwise dividend policies."* [33]

2.31 HAL state *"the reason the CAA has these statutory duties in respect of Heathrow is because the CAA understands Heathrow to have a critical role in the market – as the operator of the UK's only hub airport; and its importance for cargo, premium passengers and connecting passengers."* We take an opposing view – that Heathrow's market power largely reflects the legacy of its location, its role as the former national flag carrier's hub, long-standing state

---

[29] CAA Passenger Survey Report, 2018, UK business travellers: 10% (8.2 million), Foreign business travellers 15% (12.2 million), Leisure travellers: 75% (59.5 million) in 2018 - https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Data_and_analysis/Datasets/Passenger_survey/T02_2018.pdf

[30] TAG Databook, 2020, rail
https://www.gov.uk/government/publications/tag-data-book

[31] Airports Commission, Economy: Final Delay Impacts Assessment, November 2014 - note; the updated July 2015 version shows ranges rather than exact figures.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/372619/AC08_tagged.pdf

[32] Standard Inputs for EUROCONTROL Cost-Benefit Analyses, Edition number 8.0
https://www.eurocontrol.int/sites/default/files/publication/files/standard-input-for-eurocontrol-cost-benefit-analyses-2018-edition-8-version-2.6.pdf

[33] Para. 5, Response to CAA consultation on Economic regulation of capacity expansion at Heathrow: policy update, (CAP1782), IAG undated
https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/International%20Consolidated%20Airlines%20Group%20(IAG).pdf

ownership and BAA's historic emphasis on developing Heathrow at the expense of other London and SE airports. [34]

2.32 Providing the private owner of an airport with substantial market power with unquantified and unlimited relief that is not available to its competitors would appear fundamentally incompatible with the CAA's primary duty to, *inter alia*, further the interest of consumers and promote competition.

[34] *"Both Gatwick and Stansted, together with their respective owners, Global Infrastructure Partners (GIP) and Manchester Airports Holdings Limited (known as MAG), told us of the contrast between their operations when owned by BAA and their new freedom after the divestments. They described the period of BAA ownership as one where they felt they were not a priority compared with Heathrow"* – Para. 5.9, BAA Airports: Evaluation of the Competition Commission's 2009 markets investigation remedies, Competition and Markets Authority May 2016 https://assets.publishing.service.gov.uk/media/57399d43ed915d152d00000b/evaluation_of_baa__market_investigation_remedies.pdf