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Re: Response to Economic Regulation of Heathrow – CAP1966: Response to Heathrow Airport Limited's request for a Covid-19 related RAB Adjustment

Thank you for the opportunity to respond to the CAA's consultation CAP1966. This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address.

Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

<u>Summary</u>

As the CAA will be aware, the overwhelming view from the Airline Community has been that HAL's request is not in the consumer interest, justified or reasonable and should be rejected in full.

Through the current settlement, from which HAL have already been significantly rewarded, consumers have already paid for HAL assuming risk. Asking consumers to pay again must not be allowed.

Covid-19 has had an unprecedented impact on aviation which has resulted in organisations needing to take drastic measures to deal with the initial impact, notably raising funding and cutting costs, whilst seeking to recover in the future. Despite the difficulties and challenges, there is no regulatory justification for re-opening the current settlement to shield HAL's investors' interests by double charging consumers.

As airlines are having to do, it must be incumbent on HAL to use all commercial levers to address the issues it faces whilst also working with the airlines to ensure the appropriate level of service and investment supports passenger recovery through 2021 and beyond.

With regards to the consultation itself we note in particular:

- We support the CAA's view that there is no evidence that there is a need to make an urgent intervention now. Not in full or partially.
    - HAL has been able to raise debt over the past weeks at an investment-grade level.
    - Any increase in HAL's cost of debt stems from its chosen, excessive level of gearing compared to other airports. CAA 12 (Explanatory notes Sec 36a) specifically notes that HAL's chosen financial structure should not prompt the re-opening of the existing regulatory structure. It should be HAL's shareholders that deal with this issue, and not consumers.
- Yet, we are concerned that CAA has not fully closed the door for any adjustments, which would set an inappropriate precedent with significant implications over the UK's regulated sectors.
- HAL signed up to a package of incentives at the start of Q6, containing all traffic volume risk, and have been richly compensated to hold that risk within this period, therefore any adjustment would result in consumers being double charged.
- In addition, HAL have paid out £4bn in dividends to investors since 2014 and removed almost all equity cushion from the business, leaving nothing to support traffic volume risk that it holds.
- Any changes that need to be made in the regulatory settlement need to consider the entire regulatory Q6 settlement as a package, be evidence based, consistent with the rest of industry and notably forward looking.
- We disagree with HAL's assertion that service levels may be jeopardised in 2020 and 2021 due to the pressure to reduce costs and investment.

<u>Reasoning behind our views:</u>

1. <u>A RAB adjustment is incompatible with the Q6 Regulatory settlement</u>

Firstly, it is important to reemphasise that there is no regulatory justification for reopening the Q6 settlement. Whilst HAL insisted in its application it was not intending to reopen the Q6 decision, it is, in fact requesting to reopen it- and HAL has made this clear in comments by the CEO and CFO (BBC Radio 4 Today programme 28th Oct. We also fully support the CAA's statement that there is no obligation for the CAA to grant HAL's request and that its main duty is towards furthering the interests of consumers.

The Q6 is a package in which risks and rewards assigned to HAL are carefully balanced among the different building blocks that underpin a charges decision. HAL was assigned the traffic risk throughout the period, and therefore it cannot attempt to re-assess one particular risk in isolation and solely for the years it pleases (2020 & 2021) without any consideration of the remaining parts of the settlement.

This can only be seen as package, and for the full period. As clearly detailed in its appendix, the CAA has calculated that HAL has outperformed its regulatory settlement by GBP 1.11 bn (in 2018 prices) between 2014 and 2019, so it appears to be unreasonable for HAL to seek any RAB adjustment when the airport bears the traffic risk with the Q6 period. On top of this HAL have significantly outperformed for most of the period. This is also before assessing the fact that the return derived from the WACC is now significantly higher that market assessment pre Covid and before also considering that a large part of that WACC renumerates HAL for covering traffic risk, all of which require downward reassessment if HAL does not want to hold traffic risk any longer.

In addition, if HAL knows that it will be "compensated" through a RAB adjustment, its incentive to achieve efficiencies will be significantly reduced. Furthermore any such a move would be against the incentive based nature of UK Regulation.

HAL's focus should be that of achieving further efficiencies. During the CE process, a consultancy report commissioned by the LACC/AOC and shared with both HAL and the CAA indicated substantial opportunities for operating cost savings. Airlines are undergoing substantial restructuring processes to adapt to the current circumstances, and it is expected that their business partners in the value chain behave in a similar manner and aim to stimulate demand rather than stifling it by adding costs to the system.

We are concerned at the ex-post nature of the adjustment proposed. Clawing back depreciation that was already allowed in the calculation of charges for Q6 would lead to a double counting of costs. The RAB and depreciation on the RAB are there to manage capital investment costs and have nothing to do with volume risk within a regulatory period. HAL's framing of the problem as it is not able to "earn on its RAB" is incorrect. This is about a risk that is assigned to HAL that happened to materialise in two years of the period.

In this regard, we are also concerned that while the CAA has rightfully concluded that no immediate action is necessary, it is still keeping the possibility open to apply this same mechanism during the H7 process (para D.26 of CAA consultation's appendix). We recognise that there may need to be "tweaks" to the regulatory framework at price control consultations, but this should be defined as regulatory evolution at each price control period, and not via ex-post adjustments.

2. HAL's comments that "Pressure to cut costs could jeopardise quality of service and future investment" appear to be unfounded

a) Service quality in 2020

To date in 2020 service levels have been maintained by HAL (see below the SQRB summary report for September 2020) – with the exception of Security queue times - where standards have been breached on a number of occasions. Investigation by HAL has concluded this has not been due to lack of resources. HAL have stated that service breaches have been due to lack of staff training, impact of Covid on passenger demographics and service delivery and un-forecast peaks in the schedule. Management focus by HAL since early October has resulted in significant service improvements. HAL security management have stated[1] that they have not been constrained by costs in delivering the required service levels and that they expect performance to continue to improve.

1. SQRB End month update-Sept, SQRB Mid month update- Oct

Punctuality performance with the reduced levels of movements seen in 2020 has been very good and significantly better on average than that experienced over the whole of Q6. (For the month of September 2020 departures punctuality was 91% and arrivals punctuality was 95%.)

Customer service levels are hugely important to all airlines at Heathrow. We would state again that HAL has £4.5bn in cash and is more than able to fund Opex to sustain the service levels agreed in the SQRB scheme.

(Note: T4 Stands availability is shown as not meeting standard due to winter resilience training)

Heathrow Performance Report September 2020

Passenger Experience and Service Level Performance

	T2	T3	T4	T5
Departure lounge seat availability* Ease of finding a seat	4.39	4.25	4.32	4.17
Cleanliness* Overall cleanliness of the terminal	4.40	4.19	4.32	4.33
Wayfinding* Ease of finding your way around the airport	4.34	4.27	4.33	4.27
Flight information* Accuracy and ease of finding flight information	4.43	4.41	4.43	4.40
Wi-Fi* Ease of using WiFi	4.19	4.20	4.35	4.23
Security* Passenger satisfaction	4.30	4.27	4.29	4.23
CSA queues - Times queue <5 minutes Based on 15min time periods measured	92.71%			94.71%
CSA queues - Times queue <10 minutes Based on 15min time periods measured	99.05%			99.36%
Staff search ** Based on 15min time periods measured	98.81%	99.95%	100%	99.89%
Transfer Search Based on 15min time periods measured	99.95%			99.40%

	CTA	Cargo	EastSide	T5	SouthSide
Control Post Security Search	97.63%	97.30%	100%	97.40%	94.28%

Service Level Performance

	T2	T3	T4	T5
PSE (General) Availability of Passenger Sensitive Equipment (General)	99.76%	99.90%	99.97%	99.62%
PSE (Priority) Availability of Passenger Sensitive Equipment (Priority)	99.59%	100%	100%	99.60%
Stands Availability of stands	99.88%	99.80%	95.21%	99.77%
FEGP Availability ofFixed Electrical Ground Power	99.99%	99.99%	100%	99.71%
Jetties Availability of Air-Bridges	100%	100%	100%	99.98%
PCA Availability of Pre-conditioned Air	99.97%	100%		100%
SEGs	99.99%	100%	100%	99.98%
Pier Service % Pier served passengers	99.99%			93.60%
Arrivals Reclaims Bag reclaim belts availability	99.60%	100%	100%	99.96%
Aerodrome congestion				
TTS - One car Track Transit System - one car availability				100%
TTS - Two cars Track Transit System - % time two cars available				97.73%

b) Service quality in 2021

HAL's statement that punctuality may drop to 60% and security queue times may increase by 5 minutes due to the need to cut costs further in 2021 does not seem logical and we have seen no evidence from HAL to support this claim.

The SQRB scheme is there to protect consumers by incentivising HAL to deliver to a set level of standards across a range of measures that have been agreed between the airlines and the airport. HAL have stated that they have £4.5b of liquidity and are adequately funded in the unlikely scenario of receiving no revenue income in 2021. HAL therefore have abundant resources to fund Opex in 2021.

Should HAL choose to not meet the standards agreed in the SQRB it would result in up to 7% of charges being at risk. It simply is not logical for HAL to forego this revenue.

HAL's own business case for 2021 ("BBU Low no RAB adjustment (CAA PCM).xls") forecasts the below key stats:

2021 Costs are forecast to reduce by only 10% vs 2019 levels, even though traffic is forecast to be 42% down vs 2019. With a 42% reduction in traffic levels forecast it seems very unlikely that service levels will fall significantly as a result of a 10% reduction in costs as is claimed.

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[redacted]	[redacted]	[redacted]	

(Source: HAL doc BBU Low no RAB adjustment (CAA PCM).xls)

c) Investment to maintain service quality in 2021

HAL have stated that without intervention on the RAB they will not be able to continue essential investment to maintain ongoing and efficient operations. HAL's own business case for 2021 ("BBU Low no RAB adjustment (CAA PCM).xls") forecasts a 42% reduction in traffic in 2021 versus 2019 levels. It seems nonsensical to suggest that a lack of investment for 1 year in the existing infrastructure which has been designed for 42% greater volumes than that forecast for that year will result in reduced service quality levels in 2021. HAL's argument just does not make sense and we would request specific detail of which pieces of infrastructure require investment to maintain service levels in 2021 before being persuaded further on this argument.

Investment in Capital Expenditure should only be in the consumers interest and the RAB increased naturally as a result of the capital investment delivered in return for real, physical, efficient investments. Airlines support efficient capital expenditure that delivers demonstratable consumers outcomes (subject to the agreed governance processes).

HAL's proposal to increase the RAB for no consumer benefit is an abuse of the norms of the RAB. If HAL has excessive debt and insufficient equity to fund future capital investments, the correct solution is an injection of real cash equity to replace the equity that has been stripped out of the business through excessive dividends.

3. Higher financing costs are self-inflicted rather than a consequence of COVID or the regulatory settlement

Firstly, it is unclear to what extent HAL is having the financing problems it claims. For instance, HAL was able to raise GBP 1.4 billion in early October 2020. Its bonds are still rated investment-grade and its yields on bonds barely moved when the CAA's consultation document came out (which means that markets are not expecting any adjustments from the CAA). Moreover, HAL has £4.5bn of liquidity that will cover all forecast Opex, Capex, debt interest and debt repayment according to their CFO's statements at the Q3 results presentation.

The forecast levels of capex for 2020 and 2021 have been appropriately reduced, via airline engagement through the governance process, to essential maintenance of assets and existing service quality and are the lowest in the Q. There therefore doesn't seem to be much pressure from an investment perspective that would require any immediate action.

In any case, if HAL were to be experiencing any problems, these would have been due to HAL's high gearing practices rather than because of the pandemic (or the regulatory settlement). Clearly, HAL's high gearing strategy (with gearing levels of c.90% vs. the 60% assumed by the CAA) has been designed to allow it to earn substantially higher returns on equity than that assumed by the CAA. This strategy has allowed HAL to pay some GBP 3.9 billion in dividends over the Q6 period.

However, this gaming of the regulatory system carries risks, since these extreme levels of gearing are dependent on stable cash flows. Risks that have now materialised, as the stable cash flows have been interrupted due to the pandemic, will put pressure on the airport bond yields. And it is this financial engineering going wrong that is causing the wedge between HAL's yields on bonds and those of other airports, not because of other reasons.

The solution is not to pass on this risk to consumers, but for HAL to assume that its gamble has not worked as expected and amend it itself, as is required in CAA 12. The most logical solution, as highlighted by the CAA, is that HAL should look for permanent cash injection from its shareholders. If shareholders have so readily received such significant amounts of dividends during the "good times" in the Q, then they should be prepared to inject funds back when needed.

On the basis of HAL's 3rd Quarter update where HAL states that – "*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. Investor confidence remains strong with 94% of creditors agreeing a waiver on financial covenants until the end of 2021. We have maintained our Investment Grade credit rating status*" We would strongly argue that there is no need for the CAA to intervene and accept HAL's request.

We close in reiterating the strong Airline Community feeling on this matter. Should you have any questions on this response please do not hesitate to contact us.

Yours sincerely,

Simon Laver
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