Consumers and Markets Group

Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment

CAP 1966

Published by the Civil Aviation Authority, 2020

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First published October 2020

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The latest version of this document is available in electronic format at www.caa.co.uk

Contents

About this document

This document is published in response to the request made by Heathrow Airport Limited ("HAL") in July 2020 for the CAA to change its approach to the calculation of HAL's regulatory asset base ("RAB") to take account of the actual and expected impact of the covid-19 pandemic on its revenues in 2020 and 2021. It provides our initial views on HAL's request and proposes next steps for consultation.

The document sets out:

- the background to HAL's request and the initial views of airlines in response to it;
- our approach to assessing HAL's request;
- our initial assessment of HAL's request; and
- proposals for our next steps and timetable for dealing with the issues raised by the request.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in chapters 1 to 3.

Please e-mail responses to economicregulation@caa.co.uk by no later than 5th November 2020. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Stewart Carter (stewart.carter@caa.co.uk).

Summary and introduction

Introduction

1. HAL[1] is subject to a price control that sets the maximum revenue (or "yield") that it can recover from the per passenger airport charges it can levy on airlines. In setting the last main price control covering the period 2014 to 2018 ("Q6"),[2] we noted that we could reopen these arrangements to deal with exceptional circumstances (although we did not include in HAL's licence a specific mechanism to reopen the price control, or any specific criteria by which any request for such reopening would be assessed).

2. The entire aviation sector has experienced a severe and unprecedented downturn in passenger demand and revenues as the spread of covid-19 developed into a pandemic. Passenger numbers fell 97% at Heathrow airport in April 2020 when compared to April 2019. While there has been a modest recovery in passenger numbers since then (in August 2020 passenger numbers were 82% lower than the previous year), it is clear that the sector is facing a severe and prolonged downturn, and the path of any further recovery is highly uncertain. The financial impact is being felt by all companies within the aviation sector, including airports, airlines and their suppliers, and these companies' employees and investors.

3. Across the aviation sector companies and their investors have taken, and are continuing to take, significant and often difficult steps to support the liquidity of their businesses during these challenging times. HAL has taken steps to negotiate waivers on certain aspects of its debt financing arrangements, suspend dividends, reduce its operating costs (including cutting staff numbers and salaries) and reduce its capital expenditure programme.

[1] Definitions of terms and abbreviations used in this consultation as well as references to previous CAA consultations are set out in the glossary at Appendix B.

[2] The approach adopted for Q6 was subsequently extended to 2019 and then by a commercial deal between HAL and airlines for 2020 and 2021.

4. In addition to the steps set out above, on 27 July 2020 HAL made a request to the CAA for a significant upward adjustment to its regulatory asset base ("RAB") from 2022 to help protect it from the consequences of the covid-19 pandemic. The RAB is a key parameter that we use in setting HAL's price control. In broad terms, it represents the value of the investments that HAL has made in its regulated business that have not yet been recovered through aeronautical revenues. We use it as the basis for setting the allowances for regulatory depreciation and returns in HAL's price controls. In simple terms, increasing HAL's RAB at the start of 2022 would allow it to increase charges to airlines in future years.

5. HAL has said that making this RAB adjustment would be consistent with our primary duty to consumers, as it would allow for more spending in the short term and reduce HAL's financing costs in the longer term (which would put downward pressure on its prices).

6. HAL has also shared its request with airlines and a number of airlines have made representations to the CAA and suggested that such an adjustment would not be in the interests of consumers and that we should reject HAL's request.

7. This document sets out for consultation our initial assessment of HAL's request, taking into account the evidence provided by HAL and the initial responses from airlines.

HAL's request and the initial views of airlines

8. HAL has suggested that the impact of the covid-19 pandemic has created urgent short term and longer term issues for its business, including:

   - pressure to cut costs that could jeopardise not only the quality of service experienced by passengers and airlines, but also future investment in the airport; and
   - higher financing costs that could threaten HAL's future financeability and the affordability of its charges.

9. To help deal with these difficulties, HAL has suggested that the CAA should make an adjustment to its RAB. HAL has proposed a mechanism that would compensate it for the majority of the revenue it expects to lose in 2020 and 2021

from the downturn in passenger traffic levels. HAL has estimated this lost revenue would be about £2.2 billion[3] and its proposal would lead to an upward adjustment to the RAB to apply from 2022 of around £1.7 billion. HAL has said it would bear around £0.5 billion of the estimated revenue loss of £2.2 billion. This would increase airport charges by around £1.20 per passenger, or about 5% on the expected level of charges from 2022, and more in the longer term. HAL has also said that consumers would gain from the RAB adjustment as its cost of capital would be lower in the future and so, in its view, airport charges would be lower in the future than would otherwise be the case.

10. HAL has said that this intervention would help it to avoid the difficulties summarised in paragraph 8 above and would:

- be consistent with the CAA's statutory duties (including to further the interests of consumers), the Q6 price control settlement and the approaches taken at both other European airports and in other sectors subject to economic regulation in the United Kingdom; and
- also recognise the importance and value of an appropriately balanced approach to risk sharing.

11. HAL requested that we should take action quickly and commit to the RAB adjustment to help protect its quality of service, capital expenditure programmes and financeability, as well as to prevent significant increases in its cost of capital.

12. In contrast, airlines have objected to HAL's proposal and suggested that:

- HAL has been too slow to introduce efficiency savings;
- HAL should seek additional support from its shareholders given that its problems, in part, arise from the high level of gearing it has adopted;
- the returns made by HAL's shareholders during the Q6 price control period have been excessive and no further assistance is warranted;

[3] This is an estimate based on a forecast of passenger numbers during 2020 and 2021. HAL is proposing that the final amount is calculated based on actual passenger numbers in 2020 and 2021.

- HAL's comparisons with the adjustments made at other regulated airports for the impact of the covid-19 pandemic are misleading;
- regulatory intervention would be inconsistent with the Q6 regulatory framework, which was based on the assumption that HAL would be responsible for managing volume risks; and
- no other major airport (or airline) in the UK is seeking to compensate its shareholders for loss of revenue by increasing its prices to consumers and it would not be appropriate of the only airport subject to full price control regulation to be allowed to do so.

Our approach to assessing HAL's request

13. We have assessed HAL's request in accordance with our statutory duties. These include our primary duty to further the interests of consumers, where appropriate by promoting competition and our other duties, including to have regard to HAL's financeability. This has involved considering whether intervention is warranted given the regulatory settlement for the Q6 price control and the commercial deal between HAL and airlines for 2020 and 2021. It is very clear that the impact of the covid-19 pandemic has created exceptional circumstances, and we should consider whether the regulatory framework for HAL is fit for purpose as a result. We have already recognised that we will need to consider how the regulatory framework should change in response to these challenges, and are starting to address issues in our work on the review of HAL's H7 price control, which we expect to implement from January 2022.[4]

14. Nonetheless, in considering changes in respect of 2020 and 2021, we should recognise that the starting point for our assessment is a long standing system of economic regulation that allocates managing traffic risk to HAL in the period to December 2021, and that HAL accepted the continuation of these arrangements as part of a licence modification in 2019. We would need to be clear that any changes to this approach must be consistent with our statutory duties and

4 We provided a programme update in CAP 1914 (April 2020) and a policy update and consultation in CAP 1940 (June 2020).

supported by clear evidence. Careful thought and a strong justification would be needed to support adjusting the price control settlement mid-period, particularly where there is no predetermined threshold and/or mechanism within the licence to allow for such an adjustment.

15. Our assessment has mainly focused on whether urgent intervention is justified as we will, in any case, undertake a wider review of HAL's price control arrangements for the H7 period in 2021. We have considered:

- whether there is evidence of significant short term issues in relation to the incentives provided by the existing regulatory framework in respect of quality of service and investment for 2020, and particularly 2021;
- to what extent there is evidence of material financeability issues either now or to an increasing extent during the rest of 2021 and into 2022. In considering whether there is evidence of material financeability issues, we also consider whether there is evidence as to:
  - (i) whether financeability issues have been exacerbated by the decisions made by shareholders to increase and maintain the level of gearing of HAL beyond that we have assumed in setting HAL's price controls;
  - (ii) the role of shareholders and whether they should take further steps to help HAL deal with the difficulties it faces, and/or whether further regulatory intervention might be warranted; and
  - (iii) whether financeability issues (including the likely impact of regulatory action on HAL's cost of capital) should be dealt with now or at the H7 price control review. We recognise that financial markets and investor expectations regarding returns will have changed as a result of the impact of the covid-19 pandemic on aviation, but more evidence is likely to emerge over time that will allow us to better estimate the longer term impact of these factors robustly.
- where there are issues that might warrant regulatory intervention, whether an appropriate range of options has been assessed and whether there is evidence to support the identification of a proportionate and appropriate remedy. HAL's request focuses on one possible remedy for the issues that

it has identified, and does not consider or evaluate in detail alternative options; and

- whether there are other issues and measures we should consider to protect consumers better.

Our initial assessment of HAL's request

16. While HAL's request identifies a range of issues consistent with the assessment framework set out above (such as the incentives created by its regulatory framework and the financeability of its activities), the evidence that HAL has provided so far falls short of that required robustly to justify its claims that "urgent support/action is necessary" and that any such support should be in the form and of the scale in HAL's request (i.e. a £1.7 billion upward adjustment to HAL's RAB).

17. Firstly, we consider that, at this stage, HAL has not provided comprehensive evidence as to why existing regulatory arrangements are not sufficient to protect quality of service and investment. HAL's request does not set out what the additional requirements and service level impacts would be likely to be in 2020 and 2021 and why additional regulatory support is needed now. If further evidence is forthcoming that robustly demonstrates an urgent need for regulatory action to further the interests of consumers, we would consider an appropriate, targeted and proportionate response to address that need. It is also not clear that HAL has considered a range of possible options or that the remedy that HAL has put forward is an appropriate and proportionate approach to deal with any issues that warrant regulatory intervention.

18. Secondly, we do not consider that, at this stage, HAL has fully explored issues around financeability and whether shareholders should provide additional funds given their previous decisions to increase and maintain HAL's gearing significantly above the assumptions used in setting its price controls. On the cost of capital, HAL has not explained why it is better to deal with these issues now rather than at the next (H7) price control review, which will, by its very nature, need to consider the appropriate risk and reward package for HAL for the next control period, and how this relates to HAL's financeability and the affordability of its charges.

19. While HAL has not, at this stage, provided sufficient information to warrant short term regulatory intervention, we are also of the view that:

- if, in response to this consultation, HAL provides further evidence of short term difficulties, including in relation to its incentives to invest or financeability, we will assess this evidence carefully;
- more broadly, we acknowledge that HAL has experienced a very significant fall in its revenues as a result of the impact of the covid-19 pandemic and that there is significant uncertainty about the recovery. If circumstances turn out to be particularly difficult, there could be intense pressure on its financeability and continued ability to provide investment and reasonable levels of service. If these difficulties looked likely to emerge, it would be important for us to adopt a suitable process that would allow us not only to consult stakeholders, but also to be able to react quickly to protect consumers' interests and consider what changes to the regulatory framework might be appropriate either in 2021 or 2022 and beyond;
- issues that relate to 2022 and beyond will probably be best dealt with in our review of HAL's H7 price control that we are already consulting on and intend to finalise in 2021. This should provide the best opportunity to consider a full range of issues in a balanced and coordinated way, including HAL's financeability, the most appropriate risk and reward package (including whether action should be taken to provide HAL's investors with a degree of protection from the impact of the covid-19 pandemic), the cost of capital and the affordability of HAL's airport charges.

Next steps and views invited

20. Views are invited in the matters discussed in this consultation by 5th November 2020.

21. We will consider the views of respondents and any further evidence that is provided and intend to issue a further statement of these matters no later than the end of January 2021.

22. Where there are issues that warrant consideration as part of HAL’s next main H7 price control review, we will do so as part of the work we are planning for the remainder of 2021.

23. To the extent any regulatory intervention appears to be warranted, either ahead of, or as part of, the H7 price review, we will consider a range of options for intervention and seek to identify an approach that is proportionate to the underlying issues and difficulties.

Our duties

24. In developing this consultation, we have had full regard to our statutory duties under the Civil Aviation Act 2012 (“CAA12”), which are set out more fully in Appendix A.

Structure of this document

25. The structure of this consultation document is as follows:

- chapter 1 summarises HAL’s request and responses from airlines, and sets out our broad approach to assessing the request;
- chapter 2 sets out our initial assessment of HAL’s request;
- chapter 3 sets out next steps and timetable; and
- the appendices cover further information on HAL’s request, airline responses and our initial assessment of them. They also provide information on our duties and a glossary of the terms used in this consultation.

Chapter 1

HAL's request and our approach to assessment

Introduction

1.1 This chapter summarises HAL's request for a RAB adjustment to take account of the impact on it of the covid-19 pandemic, the initial views of airlines on HAL's request and our broad approach to assessing these matters.

Summary of HAL's request

1.2 The impact of the covid-19 pandemic has had serious consequences for the aviation industry generally. For HAL, this has resulted in passenger numbers between April and August 2020 being down by between 82% and 97% on 2019 levels. 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.

1.3 On 27 July 2020, HAL submitted a request to the CAA to publish a policy decision in 2020 that would set out an approach to adjusting HAL's RAB that would compensate HAL for a proportion of the revenue that it will under recover when compared against the forecasts made at the time of the "commercial deal" it entered into with airlines for 2020 and 2021.

1.4 HAL has said that changing the approach to calculating the RAB, and subsequently making an adjustment in the manner proposed, would be consistent with the CAA's primary duty under CAA12 to further the interests of consumers by mitigating the impacts of the covid-19 pandemic on its staffing levels, quality of service, operations, investment, financeability and cost of capital. HAL also stated that a RAB adjustment is needed to maintain its status as a hub airport and ensure the viability of the expansion of Heathrow airport should it recommence.

1.5 HAL also set out that a RAB adjustment is the best mechanism for consumers in both the short and long term because it would:

- deal with financeability issues, reduce financial markets' perceptions of risks, help to restore HAL's A- credit rating and mitigate increases in the cost of capital;
- enable continued investment in 2021 and during H7;
- smooth the recovery of lost revenues over a long period, preventing short term price rises; and
- be consistent with the principle of regulatory certainty.

1.6 It has benchmarked this approach against:

- certain traffic risk sharing approaches that have been adopted at other large European airports; and
- the traffic risk sharing mechanism that applies to NERL.

1.7 HAL has proposed that the RAB adjustment would be calculated as follows:

- HAL would bear the first 8%[5] of revenue losses in 2020 and 2021 (measured as the difference between forecast revenue in the commercial deal with airlines and the actual revenues recovered, but excluding revenue from Other Regulated Charges ("ORCs"));
- it would recover 95% of revenue losses beyond that 8% threshold through RAB adjustments effected by implementing a "depreciation holiday" for 2020 and 2021, with such adjustment to the RAB being made at the start of H7 (2022) with a final adjustment at the end of 2022; and

[5] HAL states this is based on a review of traffic-risk sharing mechanisms applied at other regulated airports and an 8% threshold with a 95% recovery rate provides the same balance of risk as applying a 10% threshold with a 100% recovery rate.

- depreciation would not be applied to these RAB adjustments during H7, but allowed returns on them would be included in the calculation of HAL's maximum allowed yield from 2022.

1.8 HAL has been discussing traffic scenarios with airlines through the H7 constructive engagement process. HAL's request is based on a "Delayed Recovery" scenario with a relatively rapid recovery in traffic.[6] The impact of the RAB adjustment is summarised in Table 1.1 below. HAL also 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 that shown in Table 1.1. We also note that HAL's proposal would lead to further price increases (across all scenarios) in the next price control period (H8) when it would start to recover regulatory depreciation on the RAB adjustment.

Table 1.1 – Impact of HAL's proposed RAB adjustments

Total for 2020 and 2021 £m figures are in 2018 prices	HAL's Delayed Recovery scenario
Traffic (percentage below forecast)	-43%
Revenue losses below forecast	£2,196 million
Amount recovered through RAB adjustments	£1,803 million
Impact on per passenger charges in H7	£1.2

Source: HAL's request.

Notes. Revenue losses excludes ORCs.

Amounts recovered through RAB includes allowances for the cost of capital and so the £1.8bn in the "Delayed recovery" scenario shown above is larger than the base adjustment for revenue losses of £1.7bn described in paragraph 9 of the summary and introduction.

[6] In the scenario, 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).

Airlines' views

1.9 HAL informed airline stakeholders of its request after sending it to the CAA. In response, a number of airlines have written both to HAL (as part of the constructive engagement process for H7) and direct to the CAA.[7]

1.10 The representations from airlines to HAL and the CAA set out in strong terms express the view that we should reject HAL's request. They raised a number of concerns with HAL's approach, including that:

- it is not in consumers' interests for HAL on the one hand to retain the upside from the Q6 settlement (which airlines estimate to be around £840 million of outperformance between 2014-2019) while making dividend payments of £3.8 billion, but on the other hand pass on the downside risk to consumers and protect its owners. Airlines noted that HAL proceeded to pay a group dividend of £100m in April 2020[8] against the advice of airlines and with the backdrop of the covid-19 pandemic already emerging;
- many airlines are facing financial hardship and are taking steps to cut costs, raising new debt and equity to secure their finances, so HAL should do the same. In addition, airlines have raised concerns that (i) HAL was slow to act to contain costs, (ii) the £1.20 increase in the per passenger yield estimated by HAL would stymie traffic recovery, and (iii) the RAB adjustments would add an estimated £155 million in costs and £2.21 to the airport charge per passenger per year over the next 20 years;
- the regulatory framework places passenger volume risk on HAL and the CAA should not ensure equity investor returns after the event. In addition, the RAB adjustment is an attempt to reopen the Q6/iH7 price

[7] These were: five letters to HAL between 4 and 12 August 2020 from AOC/LACC, BA, Star Alliance, United and Virgin; letters to the CAA from AOC/LACC (18 August and 10 September 2020); and a letter to the CAA from BA (14 September 2020).

[8] We note from the Heathrow (SP) Limited H1 2020 results (page 7) that this payment was made in February 2020.

control on a single aspect that benefits HAL, while, if a reopener were to be appropriate, there are other aspects that should be adjusted in favour of consumers such as the underlying allowed cost of capital (which airlines argue is too high). There are also concerns that this would be an inappropriate use of the RAB to manage cash and ensure dividends, and that reopening the price control settlement would drive significant investor uncertainty and destroy the regulatory model;

- HAL’s debt includes significant amounts that sit outside the regulated business and that it is not in the interests of airlines and consumers for them to fund HAL’s excess leverage and past financial decisions and the appropriate solution to the current situation should be an injection of additional equity from shareholders;
- it is not in consumers’ interests for them to incur additional costs without receiving tangible benefits in return, and HAL must consider and exhaust all other sources of funding, including equity injections;
- HAL’s analysis is based on an unfounded assumption that the allowed cost of capital would be significantly higher without the RAB adjustment and airlines see significant downward pressure on the cost of capital for H7;
- no other major airport (or airline) in the UK is seeking to compensate its shareholders for loss of revenue by increasing its prices to consumers and it would not be appropriate for the only airport subject to full price control regulation to be allowed to do so; and
- it is not appropriate to rely on comparisons with other European airports as justification for HAL’s request. There are numerous factors and differences to consider between the positions of each airport and making such comparisons is not credible in times of financial difficulty when no such comparison was made when HAL was outperforming the regulatory settlement. Furthermore, HAL’s assessment has missed important details, including that the other airports identified by it have not sought to reopen their regulatory settlements at this time.

1.11 The letters to HAL also called on HAL to withdraw its request for the RAB adjustment and for HAL to provide a scenario for the H7 constructive engagement process that did not include the impact of the RAB adjustment. HAL has responded saying that it would not withdraw its request, but it would attempt to provide further information to airlines on the impact of not making the RAB adjustment.

Our approach to assessing HAL's request

1.12 We fully recognise the exceptional circumstances created by the impact of the covid-19 pandemic and we understand the difficult situation HAL is facing.

1.13 While the price control arrangements in HAL's licence that support the commercial deal for 2020 and 2021 broadly leave the risks of traffic underperformance with HAL, we have said previously that we would be open to representations on the reopening of the price control arrangements in exceptional circumstances.[9] We consider that we could reasonably consider adjustments to the regulatory framework in exceptional circumstances, provided that we act consistently with our statutory duties under CAA12.

1.14 While we note the concerns raised by airlines, we do not necessarily consider that the possibility of reopening the price control goes against the regulatory model, provided there is clear evidence that suggests regulatory intervention would support the appropriate discharge of our statutory duties. However, neither the statements made at the time the Q6 price control was set, nor those made more recently, can be taken as indicating that we will automatically make changes to HAL's regulatory arrangements. We will

[9] When in the final proposals for Q6 (CAP1138), the CAA explicitly stated (at paragraph A12) that:

> "*HAL may request that its price control be reopened at any time. The CAA would consider such a request in the light of its statutory duties under the circumstances prevailing at the time.*"

We reiterated this point in the CAP1940 (at paragraph 17) by stating, in the context of a possible request for the price control to be reopened, that:

> "*if we receive detailed representations from HAL on these matters, we will consider them in the light of our statutory duties and consult stakeholders on the most appropriate way forward.*"

consider HAL's request fully and decide whether action is appropriate in the light of our duties under CAA12. We also recognise that careful thought and robust justification is needed before adjusting the price control settlement mid-period, where there is no predetermined threshold and mechanism within the licence to support such an adjustment.

1.15 HAL has raised a number of important issues in its request around the consistency of the current regulatory arrangements with the CAA's statutory duties under CAA12. It is appropriate that we seek to ensure that the incentives created by the regulatory framework further the interests of consumers in these difficult circumstances, as required by our statutory duties, with appropriate consideration of the matters that we are required to consider (or "have regard to") by our duties.

1.16 In considering HAL's request, we have conducted an evidence-based assessment of the issues raised by HAL and other stakeholders in the round and given the challenges facing the whole sector. While HAL has considered a specific regulatory intervention, given the importance of the issues raised by HAL, we consider that there would also be advantages in considering a range of options in deciding on the appropriate way forward.

1.17 We have approached our assessment by taking into account a broad set of considerations, including:

- whether there is a potential issue to be addressed to further the interests of consumers, including through avoiding consumer detriment;
- whether HAL's proposals are appropriately targeted to address any such issues we have identified and whether its approach would be proportionate to the issue in question; and
- whether any action is needed either now, or as part of the next price control, to address those issues. We have already recognised in our recent consultations CAP 1914 and CAP 1940 that we will need to consider how the regulatory framework should change from January

2022 to take account of the lessons being learnt from the impact of the covid-19 pandemic.

1.18 Airlines have raised the issue that any additional costs should result in tangible benefits for consumers. We agree with this point to the extent that it requires us to consider whether any potential benefits for consumers arising from action that we might take would outweigh the costs to consumers. Matters relevant to this consideration include:

- the need for HAL to provide an appropriate quality of service;
- enabling essential investment to maintain ongoing and efficient operations. For both this and quality of service, we would need to consider whether there is evidence of short term issues in relation to the incentives provided by the existing regulatory framework in respect of quality of service and investment for 2020 and, particularly, 2021;
- mitigating financing issues that would lead to significant consumer detriment (higher prices or service disruption); and
- mitigating any undue upward pressure on the cost of capital in future, such as through reducing actual or perceived regulatory risk. We need to balance our duty to further the interests of consumers in terms of keeping charges lower in the short term and long term, such as through a lower cost of capital.

1.19 Matters relevant to consideration of options to resolve any issues include:

- whether these issues have been exacerbated by the decisions of shareholders to increase and maintain the level of gearing of HAL beyond that assumed in the regulatory settlement;
- the role of shareholders and whether they should take further steps to help HAL with the difficulties it faces and/or whether further regulatory intervention might be warranted;
- whether the likely impact of regulatory intervention on HAL's cost of capital should be dealt with now or at the H7 price control review; and

- other consumer costs/benefits and measures we should consider to better protect consumers.

Views invited

1.20 Views are invited on any aspect of the issues raised in this chapter and in particular the approach we have set out above to assessing HAL’s request.

Chapter 2

Our initial assessment of HAL's request

Introduction

2.1 In this chapter, we provide our initial assessment of HAL's request. We have considered the issues and evidence raised by HAL in the round through the lens of our statutory duties. We have examined whether HAL has demonstrated that its proposed RAB adjustment would further the interests of consumers relating to HAL's operations, investment, service levels, financeability, cost of capital and wider considerations (such as expansion of the airport and its hub status). We have also considered the initial responses and evidence provided by airlines.

2.2 Our assessment in this chapter first examines whether HAL has identified relevant issues that may need to be addressed to further the interests of consumers, including through avoiding consumer detriment. We then review the evidence provided by HAL in support of regulatory intervention and consider:

- whether HAL's proposals are appropriately targeted to address any such issues we have identified and whether its approach would be proportionate to the issue in question; and
- whether any action is needed either now, or whether these matters should be considered as part of the next price control review.

2.3 Further detail on our assessment on the issues raised by HAL is provided in Appendices C to F.

Potential issues to be addressed

2.4 We recognise that HAL has raised a number of important issues regarding the consistency between its regulatory arrangements and our statutory duties given the circumstances created by the covid-19 pandemic. In particular, HAL has raised the following issues:

- **the need for HAL to provide an appropriate quality of service:** HAL has raised the issue that, without the RAB adjustment, it may need to take actions in the short term that could reduce the quality of its services to consumers;
- **enabling essential investment to maintain ongoing and efficient operations:** HAL has raised the issue that it needs the RAB adjustment to support its planned investment;
- **mitigating financing issues that would lead to significant consumer detriment (higher prices or service disruption):** HAL has raised the issue that it needs the RAB adjustment to be financeable (including making its business attractive for future debt and equity finance);
- **mitigating any undue upward pressure on the cost of capital in future, such as through reducing actual or perceived regulatory risk:** HAL has raised the issue that the RAB adjustment could reduce the future required cost of capital and hence costs to consumers; and
- **other consumer costs/benefits, including the impact on charges of any adjustment mechanism:** HAL has raised other issues, including around needing the RAB adjustment to support expansion and its role as a hub airport.

Review of the evidence provided by HAL

2.5 We recognise that HAL has seen a very significant fall in its revenues as a result of the impact of the covid-19 pandemic and that there is uncertainty about the recovery. If the recovery in passenger traffic is relatively slow, this could put significant strain on HAL's financeability and its ability to invest. As part of our work on the H7 price control review, we will need to consider the latest information of the shape of the recovery and how regulatory framework should change to reflect these new circumstances.

2.6 Nonetheless, our initial assessment is that the evidence that HAL in support of immediate/urgent regulatory intervention appears to be uneven (in that it provides more detail on some issues than on others) and limited in a number of important respects, including:

- while HAL's request contains some illustrative examples of potential impacts on service levels and investment, it does not set out what the additional requirements and service level impacts are for 2020 and 2021 and why additional regulatory support is needed now. We would need robust justification that short term regulatory intervention is appropriate, as there are existing arrangements for incentivising HAL's service quality and that a significant short term reduction in investment may be an appropriate reaction to the present level of passenger traffic and uncertainty. We note that many companies across the aviation sector are reducing their investment and that HAL is starting from a base where it has provided high levels of investment and levels of service in recent years;
- we accept that there has been a significant impact on HAL's finances, but some of the issues it faces may be exacerbated by its high level of gearing, including the contribution to the overall level of gearing made by Heathrow Finance plc, which sits outside the financing ringfence created by its whole business securitisation. It is not clear from HAL's request what additional actions shareholders are taking to resolve these issues, particularly where they relate to management decisions to raise high levels of debt significantly above the notional level of gearing we have used to set HAL's price controls. Airlines have raised similar points in their responses. Nonetheless, we note that, if the impact of the covid-19 pandemic worsens, this may put further pressure on HAL's financeability and we will need to keep this under review; and
- HAL has provided little evidence to support issues it has raised around the RAB adjustment being appropriate to support plans for capacity expansion in the future, particularly as its appeal to the Supreme Court with respect to the Airports' National Policy Statement

has yet to be determined. Given this, and the longer term nature of capacity expansion (particularly in the context of the current crisis as a result of the impact of the covid-19 pandemic), there does not appear to be a strong case for addressing these issues now.

2.7 In relation to the work we will undertake as part of our next price control review, we will need to consider how to take account of the impact of the covid-19 pandemic in the regulatory framework to apply from January 2022. An issue that we consider warrants further investigation is the extent to which HAL’s revenue loss could raise issues for the RAB based economic regulation framework for HAL more generally. Inherently, a RAB based framework is intended to provide investors with a reasonable degree of certainty with respect to the remuneration of investment. This approach contributes to reducing the cost of capital required by investors to fund these investments, to the long term benefit of customers. At least in the current circumstances, HAL is not being remunerated for a significant proportion of the regulatory depreciation incurred for its past investments. Under the current approach taken to HAL’s regulatory depreciation, there would be no explicit opportunity for HAL to “catch up” the recovery of that depreciation in the future.

2.8 We will need to assess whether, if HAL were not to recover a significant proportion of the depreciation of past investments, this could lead to an increase in the cost of capital in the longer term, to the detriment of consumers. This consideration is separate from consideration of any direct impact of the covid-19 pandemic on the cost of capital. It would also be important to understand how previous and future opportunities to outperform price control settlements would affect these considerations. Appendix E summarises our current estimates of the outperformance that HAL has earned in the Q6 period.

Considering the appropriate approach to dealing with these issues

2.9 HAL's request focuses on a single option to resolve or mitigate the issues summarised above and proposes an adjustment to the approach to calculating its RAB.

2.10 Our initial overall assessment is that HAL's request falls short of robustly demonstrating that its proposed solution is appropriately proportionate and targeted to in terms of a short-term or immediate regulatory intervention. This is based on the following key findings:

- HAL's request focuses on a single remedy rather than a broader assessment of the issues it faces and consideration of how these might be addressed. The request does not include a detailed assessment of potential alternative options other than a brief discussion of the difficulties of securing further equity investment by shareholders;
- the proposed approach to RAB adjustments is not clearly focused on what is required to deliver appropriate levels of service quality and essential investment in 2021, so we cannot conclude what issues need to be resolved and what might be a proportionate and targeted option to address these issues in the particular circumstances faced by HAL. Instead, HAL's broad mechanism is calibrated against risk-sharing arrangements applied at other European airports and for NERL, which operate under their own regulatory frameworks and have responded to the covid-19 pandemic in different ways. Airlines have raised related issues which demonstrate that, in practice, European airports are responding to the crisis in different ways, but are not generally seeking changes to the price control that would increase prices to consumers;
- HAL has not provided evidence that it has fully accounted for both the cost savings it has made, and those it plans to make, in calibrating the proportionality of its proposed response. Similarly, we would expect

an "in the round" assessment of the relevant issues to consider the regulatory outperformance that HAL has achieved in the Q6 period and extension, from 2014 to 2019, to seek to show that the RAB adjustment is both proportionate and reasonable. While HAL has provided evidence showing that it has tended to underperform the assumptions made in setting its price controls over the last two decades, we do not see that this longer period is relevant as the regulatory framework does not seek to guarantee shareholder returns. As for its performance during the Q6 period, HAL appears to be suggesting it should both keep outperformance earned at the start of the period, and be compensated for the impact of the covid-19 pandemic at the end of period, which may not be a balanced or proportionate approach; and

- we have not seen evidence that HAL has fully considered and exhausted alternative options for funding, such as by raising a combination of new equity and debt. Nor has it addressed questions around its financial structure and the high level of leverage that it has decided to adopt. We note that a number of other airports, airlines and companies with significant exposure to the aviation sector have taken measures to raise new equity and debt finance in the last few weeks and months.[10] We, like other UK economic regulators, have generally taken the view that the financial structure, and financing arrangements, of HAL is a matter for the company, its management and shareholders to decide and manage within the price control settlement, and so have focused on a notional financial structure rather than replicating HAL's current or expected financial structure. If we were to conclude that HAL's chosen financial structure was exacerbating any financeability challenge it is currently facing, it would be important to consider whether any RAB adjustments would need to

[10] Including, for example, IAG, Virgin, Gatwick Airport, Sydney Airport and Rolls Royce. We provide further details in Appendix F.

be accompanied by additional regulatory interventions to ensure that its financial structure evolved in a way to improve its future resilience.

2.11 HAL's request is to adjust only one of the regulatory "building blocks" used to set charges for the H7 price control period (the RAB) in advance of other decisions on H7. We consider that there needs to be a very robust justification that consumer interests would be furthered by reaching early decisions on the price control before we carry out the wider review exercise and consideration in the round of whether the regulatory settlement functions in a way consistent with our statutory duties. This question is distinct from a decision as to whether HAL should in any way be remunerated for the impact of the covid-19 pandemic: rather it is about whether such a decision should be made ahead of, or as part of, the full H7 price control review.

2.12 Our initial assessment, based on the evidence provided by HAL so far and our analysis of it, is that HAL's request falls short of demonstrating that regulatory intervention of the form proposed is warranted at this stage. HAL has not demonstrated that its proposed solution is appropriately proportionate and targeted, we also note the following points in our assessment of the urgency of the request:

- we are clear that the covid-19 pandemic has created exceptional circumstances and we need to consider how the regulatory framework should be amended for H7. This work on the main H7 price review will start in earnest in a few months' time with the submission of HAL's business plan and will run through 2021;
- HAL's request does not propose any change to charges or make any other form of direct enhancement of cash inflows until 2022. We note that, while HAL's request seeks to provide additional headroom on gearing which could support it in raising additional debt to improve its liquidity position, the request does not provide a compelling case that this is an urgent requirement and should be resolved by consumers and not shareholders in circumstances where the issues caused by

the covid-19 pandemic are exacerbated by HAL's current high level of gearing; and

- there is a lack of clarity in the request around HAL's financial position and potential financeability issues it may face ahead of H7 if, for example, traffic recovery is much slower than expected. If HAL provides further robust evidence on these matters, we would consider how best to expedite our further work on financeability and the possible detriments to consumers associated with these matters.

2.13 We also note that HAL has not provided any information on its views of the impact of its proposals on competition in the provision of airport operation services. This is a matter that the CAA will need to consider in accordance with its duties in the event that our further consideration of the issues raised indicates that regulatory action may be, or may become, necessary.

2.14 If HAL has further evidence of potential difficulties in 2021 that should inform consideration of whether more urgent intervention is warranted, it has the opportunity to provide this information in response to this consultation.

2.15 Further, in reaching this initial view, we are mindful that evidence of the financial impact of the covid-19 pandemic on the aviation sector continues to emerge, and it is too early to understand the full impact, particularly for how long the current very low levels of flying will continue. Therefore, even though we are not proposing regulatory intervention now, and instead propose to consider issues as part of the full H7 review, we cannot rule out revisiting that position in the coming months depending on how the impact of the covid-19 pandemic on aviation, and HAL in particular, develops.

Summary of assessment

2.16 In this chapter, we have concluded that HAL has raised important issues regarding the consistency of the current regulatory arrangements for HAL with our statutory duties given the circumstances created by the covid-19 pandemic. These are important issues that we must consider thoroughly in line with our duty to further the interests of consumers under CAA12.

2.17 However, we have identified a number of difficulties with HAL's request for a RAB adjustment, including:

- a lack of assessment of different options;
- a failure to assess the proportionality of the proposed remedy; and
- an unevenness in the evidence that was provided, including in relation to evidence that would support urgent intervention by the CAA.

2.18 On this basis, our initial assessment, based on HAL's request and the evidence provided, is that HAL's submission falls significantly short of demonstrating that

- its proposed solution is appropriately proportionate and targeted to address key issues; and
- regulatory intervention is warranted at this stage.

2.19 While HAL has not made the case for immediate intervention, it has raised important issues that we should consider during the course of the H7 review, whether or not we conclude that earlier intervention is required. We provide further details on next steps in the following chapter.

2.20 In reaching these initial views, we are very mindful that evidence of the financial impact of the covid-19 pandemic on the aviation sector continues to emerge. Therefore, even if we decide not to make a regulatory intervention now, and instead consider the issue as part of the full H7 review, we cannot rule out revisiting that position in the coming months depending on both the responses to this consultation and how the impact of the covid-19 pandemic on aviation, and HAL in particular, develops.

Views invited

2.21 Views are invited on any aspect of our initial conclusions and in particular our findings that:

- HAL has identified a number of important issues in relation to the operation of the regulatory framework in the circumstances of covid-19; and
- it has not provided sufficient information to justify urgent regulatory intervention, nor has it provided evidence that demonstrates that its proposed remedy is proportionate or supported by an assessment of different options for dealing with the difficulties it has identified.

Chapter 3

Next steps and timetable

Introduction

3.1 This chapter:

- sets out the next steps for the H7 price control review and the analysis we plan to undertake;
- the next steps for the current price control period (which depend on whether further evidence is forthcoming that demonstrates an urgent need for regulatory action in consumers' interests); and
- provides our current view on the timetable for our decisions on these matters.

Next steps for the H7 price control review

3.2 We have explained in chapter 2 that HAL's request raises important issues regarding the consistency between its regulatory arrangements and our statutory duties given the circumstances created by the covid-19 pandemic. Nonetheless, HAL's submission has fallen short of demonstrating that its proposal for a RAB adjustment would be the most appropriate solution for consumers or that regulatory intervention is required at this stage. Whether or not, after this consultation, we decide more urgent intervention is required we will consider the issues raised by covid-19 during the course of the H7 review, when they can be assessed in the round alongside the other price control building blocks and the overall risk and reward package.

3.3 For the H7 price control review, we will need to develop an approach that is designed to respond to the challenges from the impact of the covid-19 pandemic in a manner that furthers the interests of consumers appropriately, including through ensuring that recovery in the level of traffic is appropriately supported. Taking this approach, we would consider whether an adjustment to HAL’s opening RAB for H7 is necessary and appropriately targeted to provide clear benefits to consumers and proportionate to the size of those benefits.

3.4 Other approaches that we might want to consider include:

- the profiling of regulatory depreciation and more closely linking depreciation to revenues;
- options for a more efficient allocation of traffic volume risks, particularly where this helps to reduce the required cost of capital; and
- actions to support greater flexibility and financial resilience.

3.5 We understand some of these areas, such as traffic risk sharing, are currently being considered as part of constructive engagement between HAL and airlines on HAL’s H7 business plan.

3.6 HAL has also recently provided a scenario for the H7 constructive engagement process that starts to explore the impact of not making the RAB adjustment on its activities and charges, and we will need to consider this further as part of this work and the H7 price control review.

3.7 In the development of any such changes to the framework for H7, it is important we continue to apply standard principles of good regulatory practice as an important aspect of promoting consumers’ interests over the long term. These approaches include taking account of the impact of our decisions on competition, maintaining the integrity of the RAB, setting out a regulatory framework with a balanced package of risk and reward, and both recognising and rewarding good past performance of businesses. This approach should prevent any undue upward pressure on the cost of capital and protect the interests of consumers.

Next steps during the current price control period

3.8 If further evidence is forthcoming that demonstrates an urgent need for regulatory action to further the interests of consumers, we would consider an appropriate targeted and proportionate response to address that need.

3.9 For example, if there were specific additional investments or operating costs that were needed to respond to the circumstances of the covid-19 pandemic and support the recovery of traffic in 2020 and 2021 by supporting consumers' confidence in the ability to fly safely, then we would consider how the regulatory framework could support those additional requirements.

3.10 Similarly, if HAL were to face urgent financing issues in 2020 or 2021, we could look at whether targeted regulatory action (and where appropriate support from shareholders and debtholders) would provide benefits to consumers. We will be doing further work to understand HAL's financial position (including using the CAA's price control model), the potential for consumer detriment and whether targeted regulatory intervention would be a proportionate and reasonable response to these issues.

3.11 However, we would need to work through the implications of placing any risks associated with HAL's actual financing structure on to consumers, including considering the impact on competition. As part of this, we consider that:

- there would need to be clear consumer benefits from bearing these risks;
- the costs to consumers of bearing those risks were proportionate to the benefits consumers would obtain in return; and
- all other reasonable options must have been exhausted so that regulatory action was necessary and appropriate.

Timetable

3.12 We are currently planning the following timetable for this consultation:

- stakeholders to provide responses to this consultation by 5th November 2020; and
- we will assess submissions provided by stakeholders and consider any further evidence provided with a view to publishing a decision

(and update on work we intend to take forward as part of the H7 price review) by the end of January 2021.

3.13 During this period, we expect HAL will continue with preparation of its business plan for H7 and will continue to act in a way consistent with the interests of consumers.

3.14 We note that both HAL and airlines will have the ability to appeal our decision on these matters to the CMA in due course, which could be through the licence modification that will be required to enable the H7 price control due at the end of 2021.

Views invited

3.15 Views are invited on any aspects of our plans for next steps, including the issues we intend to consider as part of the H7 price control review and/or whether there is further evidence that might support more immediate regulatory intervention.