Economic regulation of Heathrow: policy update and consultation (CAP1940)

Heathrow’s response

Date: 18 August 2020

Prepared by: Heathrow Airport Limited

Status: Final

Making every journey better

Executive Summary

1. We welcome the CAA's document. It addresses a number of policy areas about which we expressed concern in response to the CAA's CAP1914 document. We welcome the movement towards a pragmatic resolution of a number of policy issues and particularly the increased visibility of the CAA's thoughts on the guidance for Heathrow's Revised Business Plan (RBP). However, as is clear to all stakeholders, there is a lot more to do. There are a number of key decisions to make ahead of the start of H7 in 2022 and the CAA needs to set out a clear path for how these decisions will be made.

2. The H7 price control will be set against the backdrop of the biggest crisis that aviation has faced. More than ever before, this will require the CAA to take a pragmatic and evidence-based approach to setting the price control, ensuring that it does not put unreasonable burdens on the industry and that it sets a financial framework that allows Heathrow to meet consumers' requirements for the H7 period. The key issues for this price control will be:

    a. **Implementing the right risk sharing and adjustment mechanisms:** Covid-19 has impacted passenger demand and the impact on future demand continues to be uncertain. The H7 framework will need to work in this uncertain environment. This will require a clear mechanism for appropriately sharing this risk and futureproofing the settlement.

    b. **Setting an efficient envelope for operating costs and commercial revenues, independent of passenger numbers:** With uncertainty in passenger numbers and the future context of aviation, the CAA cannot look to analysis of detailed scenarios to set the H7 price control. Instead, the CAA should focus on identifying an efficient level of costs and revenues for Heathrow based on robust and transparent benchmarking that can adapt to changing passenger volumes, such as through our driver-based methodology.

    c. **Ensuring that the interests of consumers are central to service quality incentives:** We know that Covid-19 has changed consumers' expectations and priorities. It is clear that the current SQRB scheme has outlived its usefulness. We need to ensure that our service quality regime reflects this by focusing on the delivery of the outcomes that are important to consumers, not detailed input metrics.

    d. **Ensuring that the cost of capital reflects market data and changes in investor perceptions:** Covid-19 has had a huge impact on passenger demand in aviation and has shown just how risky the aviation sector can be. This has necessarily changed investor perceptions of Heathrow's risk. The H7 settlement will need to reflect this and the CAA will need to ensure that the cost of capital set for Heathrow reflects these new market realities to ensure that the right decisions can be made over the period.

    e. **Implementing the right framework to allow capital to be delivered flexibly and efficiently:** The Q6 capital efficiency framework was designed to provide flexibility and facilitate collaboration between Heathrow and the airline community by learning the lessons of Q5. For H7, flexibility and collaboration will remain key requirements to ensure that Heathrow can invest in developments that meet changing passenger requirements. Any new framework should build on the successes of the Q6 framework and change only what is needed to rectify any specific issues that have been identified.

    f. **The proposed timetable for the CAA's 2021 process:** While CAP1940 provides further proposals on a number of policy points, the CAA makes no decisions and gives no indication of when decisions will be made. We need this clarity to inform our

Constructive Engagement discussions and understand how we can best work together to make the most of any updates that can be provided in 2021.

3. Covid-19 continues to have an unprecedented impact on the aviation industry globally. Passenger numbers at Heathrow continue to be substantially lower than 2019 levels, around 85-90% lower than June and July 2019. We continue to operate out of just two of the terminals at the airport with operations on a single runway.

4. Heathrow has taken swift action to address the financial impacts. We will cut costs by at least £300m in the remainder of 2020. In addition to cutting operational expenditure we have cut our capital investment and are now forecasting this to reduce to around £445 million in 2020 and £357 million in 2021. This is a significant drop compared to the previous forecast for the iH7 period, which forecasted £1,128 million of capital spend in 2020 and £1,837 million in 2021. Our actions will reduce average monthly cash burn from £240m to £159m per month.

5. Despite the swift action we have taken this crisis has put significant pressure on Heathrow's finances. In June we published our Investor Report highlighting the impact on our financial position. This update confirmed that the rapid deterioration in traffic and revenues has already led to Trigger events being forecast, which lead to a cash lock-up preventing dividends. In addition, Heathrow Finance is forecast to breach its RAR and ICR covenant thresholds for 2020, which has required Heathrow to obtain a waiver on financial covenants from Heathrow Finance creditors. Ratings agencies have begun to downgrade Heathrow's debt. Bond spreads have increased by 0.7% compared to other corporate debt, and listed airport asset beta's have increased by around 0.3 since the CMA analysis for NERL.[1]

6. If the demand situation does not rapidly improve and uncertainty regarding guidance and travel restrictions continues, we will likely be forced to cut costs and investment even further. This type of action is likely to be asymmetric, i.e. difficult to reverse, and could severely impact service levels and our ability to invest over the longer term in what passengers want and need as demand for air travel returns.

7. This brings into stark focus the risk Heathrow is exposed to and the real-world consequences of impacts to Heathrow's financial position. Put simply, Covid-19 has shown that Heathrow is not immune to the risks facing the aviation sector, even though our regulatory framework has consistently assumed we face lower risks akin to a utility firm. As a result of exposure to these risks, Heathrow's ability to finance its operations is not guaranteed. Pressures on financeability will inevitably lead to a reduction in the amount that Heathrow can invest in its services. The CAA needs to recognise that financeability is not just an issue for investors, but also has a real impact on consumers.

8. To prevent Heathrow from having to make further short-term decisions, which may be expensive or even impossible to reverse, we have submitted an application to the CAA for a Covid-19 related adjustment to the Regulated Asset Base (RAB). This would allow Heathrow to recover an appropriate amount of the losses incurred due to Covid-19 over a longer-term time horizon. This would allow us to have the certainty to continue to make decisions which are in the long-term interests of consumers without having a large or immediate impact on charges.

9. Our Investor Report also sets out our current traffic forecasts for 2020 and 2021. This forecasts passenger volumes of 29.2 million in 2020 and 62.8 million in 2021, representing a drop of 64% and 22% against 2019 volumes respectively. This baseline shows that the impact of Covid-19 will continue well into H7. There is consensus among all stakeholders that there is very considerable uncertainty regarding future passenger volumes.

[1] https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-(SP)-Limited-H1-2020.pdf

10. Through Constructive Engagement, we will continue to work with the airline community to gain their insights into the potential impact of the current situation on passenger demand through the H7 period in order to help form our forecasts for the Revised Business Plan (RBP) later this year. However, all parties have to recognise that, even at the end of 2020, we are not likely to have all the answers for the H7 period. The H7 control will need flexible mechanisms to manage this fundamental uncertainty of how the period to 2026 will unfold.

11. The context of the H7 price control will be very different from that of other price controls. As the CAA rightly identifies in its document, the price control will need to strike the right balance between ensuring Heathrow can finance its operations in the longer-term while allowing for flexibility in the development and implementation of the H7 price control to meet market realities at each point in the five years. Without these two aspects, Heathrow will simply not be able to deliver what consumers and the UK economy want and need from their hub airport.

12. This is a key moment for the CAA's leadership in the industry. Implementing a price control that can effectively strike this balance will require clear and decisive action. It also needs ruthless, pragmatic focus on establishing a few simple things in the price control with maximum flexibility for airport and airlines to adjust as it develops. Although the CAA's words in CAP1940 indicate a focus on delivering this balance, we would welcome more detail on the CAA's approach to ensuring the balance between financeability and market conditions. The CAA's response to our application for a Covid-related RAB adjustment will also set a clear precedent regarding the CAA's intentions in this regard. If the CAA does not prioritise setting a price control that reflects the current market context and the reality of Heathrow's place within it, investors will not have the confidence to invest and consumers will not get the outcomes they want, need and expect.

13. We continue to find the CAA's approach to setting policy for H7 concerning. In addition to being unsighted on timelines so close to the H7 settlement, there appears to be no concern for due process in forming its policy proposals. Through our IBP and responses to previous consultations we have provided the CAA with a large evidence base on policy issues such as capital incentives, cost of capital and financeability. However, the CAA's CAP1940 consultation does not acknowledge or appropriately address much of the information we have provided. We are in particular concerned about the Flint Global work on Heathrow's cost of capital which neither fully takes into account nor fully responds to the large evidence base submitted by Heathrow as part of the IBP. This points to a lack of transparency and a failure to implement an evidence-based approach to policy making. It is not acceptable for the regulator to act simply by declaring an opinion on a point where specific evidence has been provided.

14. The CAA's approach to the RBP and its requests for more and more detail are also concerning for two reasons:

    a. First, the CAA should not be seeking to make detailed decisions about how Heathrow should run its business for the next five years at the start of the regulatory period. These are decisions for Heathrow, as the operator of the airport to make. Such an approach would not be proportionate or targeted and so would not be in line with Section 1(4) of the Civil Aviation Act 2012 (CAA12);[2] and

    b. Second, continuously requesting more detail will not reduce the uncertainty we are facing, it will only serve to provide a false sense of accuracy and lead to unsatisfactory outcomes for all parties. Instead of chasing levels of detail which are unattainable, the CAA should focus on establishing a framework which can manage the current levels of uncertainty. In this regard, we welcome the CAA's further consideration of risk-sharing mechanisms.

[2] https://www.legislation.gov.uk/ukpga/2012/19/section/1/enacted

15. Throughout the document the CAA reiterates its commitment to furthering the interests of consumers as set out in its statutory duties. In the absence of the CCB, we welcome this renewed focus from the CAA. However, the CAA seems to focus narrowly on implementing outcome-based regulation for service quality only. Although mentioned briefly, there appears, for example, to be no real consideration of how consumer priorities should inform the CAA's revised capital governance proposals. The CAA also fails to link its policy approaches on WACC and financeability to the interests of consumers, when, clearly, ensuring appropriate investment in Heathrow's provision of airport services is paramount to protecting the interests of consumers. A general bias in CAA thinking toward focusing on the outcome and impact of decisions and mechanisms rather than trying to micro-control inputs would be particularly useful in the current context. If the CAA took this more holistic approach to the application of outcomes, this would lead to a better, more rounded H7 settlement.

16. We provide detailed responses to the policy points raised by the CAA in the main body of our response. The sections of our response mimic the structure of the CAA's document.

Developing the H7 Programme and responses to the April 2020 Update

17. As set out above, the key aims of the H7 price control should be to ensure the framework strikes the right balance of:

    a. Delivering on the key outcomes that are important for consumers;

    b. Ensuring that Heathrow can finance its activities;

    c. Responding to the realities of the aviation market; and

    d. Providing the flexibility to respond to changing circumstances through the period and beyond.

18. In its response to the Reforming Regulation Initiative, the CMA highlights the importance of ensuring that regulation is proportionate, future-proof and not unduly restrictive to minimise distortion to competition.[3] This will be particularly important in H7 where the aviation market will likely be subject to large amounts of rapid change through the period.

19. As identified by the CAA, due to this rapidly changing environment, financeability will be a key issue for the H7 price control. If the CAA does not prioritise a framework focused on securing Heathrow's ability to access efficient financing, the impact on the H7 charge will be unpalatable for all stakeholders and will impact Heathrow's competitive position as a hub.

20. The current market realities are that Heathrow's debt has been downgraded by rating agencies and that investors perceive Heathrow, and aviation overall, as a riskier investment. This has led to Heathrow's cost of debt increasing significantly compared to other businesses. In addition to the impact on Heathrow's cost of debt, the Covid-19 pandemic has also had a significant impact on equity investors' perception of the risk of airports leading to a rise in beta at AdP and Frankfurt airports.[4]

21. Unless the CAA takes clear action to reduce investors' perception of risk, this upward movement on WACC will have a significant impact on the airport charge (We estimate this as c. £7 per

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/904990/RRI_CMA_Response_.pdf, page 6, paragraph 8 b

[4] Comparison against the iBoxx index shows that Heathrow debt yields have remained high and its spread against the iBoxx has increased from around 15bps before the crisis to 85bps currently.

passenger based on 80 million passengers per annum through H7 or £8.80 per passenger based on 60 million passengers per annum). Overall, the 0.7% increase in bond spreads and the 0.3 increase in asset betas at listed airports results in an upward impact on Heathrow's WACC of around 3%.

22. There are a number of actions the CAA can take to reduce investors' perception of risk and help to mitigate this increase. These include:

    a. Making the proposed adjustment to Heathrow's regulated asset base;

    b. Ensuring that the regulatory framework allocates risk in a balanced way to the party best placed to manage it; and

    c. Building in specific protection against these impacts going forward through either a risk sharing and/or a price control reopener framework with either in-period price changes or using Heathrow's RAB to spread the impact on prices over a longer time period.

23. However, it should be clearly noted that while these actions may mitigate the increase in Heathrow's WACC, they will not change the reality that Heathrow is fundamentally viewed as riskier. In setting a framework that will support financeability and incentivise future investment at Heathrow, it will therefore be important not just to mitigate risk but also to ensure that Heathrow is remunerated for the risk it faces, as a riskier investment, under the reality of the price control as implemented.

24. It is clear from the evidence set out above and the further evidence provided in our submission on the RAB adjustment that Heathrow faces a level of sectoral risk not faced by other regulated companies in the UK. If the CAA does not ensure that the WACC set for the H7 period reflects the risks facing Heathrow, investment will not be financeable. We provide further detail on our views on WACC and financeability later in our response.

Traffic risk sharing

25. In CAP1940 the CAA furthers its discussion on the use of traffic risk sharing mechanisms to mitigate uncertainty in the period. We agree that it will be important that the H7 framework can deal with uncertainty and ensure that this risk is fairly and appropriately allocated. Traffic risk sharing and mechanisms to reopen or readjust the price control will form an important part of this.

26. The form and level of traffic risk sharing needed for the H7 period will be a key topic through the Constructive Engagement process. Ahead of the RBP we want to engage with the airline community on how these mechanisms can be implemented to both mitigate the forecasting uncertainty which will be inherent in the H7 process and incentivise traffic growth through the period. We believe such mechanisms could work both in airline interests and help to manage some of the uncertainties in setting the airport price control.

27. We agree with the airline community responses to CAP1914 which state that risk sharing should not insulate Heathrow from all risk. It is right that the airport continues to be incentivised to serve more passengers. Volume risk sharing mechanisms should only be implemented either where they are required to properly calibrate the regulatory framework to ensure the appropriate balance of risk, or where they are needed to manage uncertainty and ensure that the price control can adapt through the period without the need for any reassessment.

28. Through the H7 process it will be important that we do not lock ourselves into a risk sharing mechanism that becomes inappropriate for the H7 situation that actually occurs. Levels of certainty in the forecast may change between RBP and the CAA's final determination and we should ensure that the risk sharing mechanism can adapt to this changing context. We propose

that the level of risk sharing for the period be linked closely to the levels of uncertainty around the passenger forecast.

29. We see that shock protection will always be needed to adjust the framework for large variations against forecast. Examples of this in other sectors include the 10% threshold used in the NERL price control framework after which 100% of the revenue impact is shared with users. The mechanism set out in our Covid related RAB adjustment application could form the basis for this mechanism. However more careful consideration will be needed for any additional risk sharing at different bands up to this ceiling.

30. If through 2021 we are in a position of having more certainty about the external conditions of the H7 framework, it may be that risk sharing below a ceiling of 8%, in line with the proposed RAB-adjustment mechanism, is unnecessary and only serves to provide an extra layer of complexity. However, if external conditions such as Covid related lockdowns or changing guidance on social distancing continue to be in place forecasting passenger volumes will continue to be inherently uncertain and increased volume risk sharing may be needed to manage variations to forecast – be they sudden surges or drops in volumes - as they arise. We should therefore ensure that the H7 framework and process for establishing it allow us to respond flexibly to the changes in the external environment to ensure the price control is fit for purpose.

31. Another important consideration will be the correction mechanism used for any traffic risk sharing. As described in the Executive Summary, it will be important that the H7 control properly reflects the market context. In times of low demand, traffic risk sharing mechanisms could lead to airport charges which are higher than the market can bear.

32. As outlined by the CAA in its document, mechanisms which use the RAB to rebalance for volume impacts could help to smooth this impact over a longer time horizon. This would be consistent with the approach proposed in our RAB adjustment submission and could help to ensure that Heathrow’s charges remain competitive. Equally, mechanisms which adjust prices in-period could help to incentivise traffic growth if airport charges reduce as volumes grow, which would have benefits for consumers. We therefore need to ensure that the most appropriate correction mechanism is used in each case.

33. We consider that it should be a key aim of Constructive Engagement to come to a clear view of the appropriate volume risk sharing mechanism. We expect the CAA to be proactive in its approach to engaging on this topic to facilitate this engagement and ensure that the proposals put forward in the RBP are in line with CAA expectations.

Price control reopeners

34. We also consider that clear triggers for adjusting or reopening the price control are needed to provide clarity on the process and conditions for reviewing the price control conditions. Although provisioned for in the CAA’s Q6 decision, there is currently no clear and objective process for when and how the CAA would seek to review the conditions of Heathrow’s price control in extreme circumstances. This has led to confusion and a lack of clear advice from the CAA on when the price control could be reopened or reviewed. As Heathrow argued in the Q6 process, we continue to believe that the CAA should follow the practice in other settlements of pre-establishing the criteria and process for review and readjustment.

35. While an appropriately calibrated risk sharing mechanism may help to ensure that the regulatory framework can cope with some changes in outturn performance versus forecast, there may be a number of reasons in addition to passenger forecast variances that may require a review of the price control. There should be a clear process for this too.

36. As the CAA notes, there are many regulatory precedents for these reopeners, both in other regulated sectors in the UK and in other airports across Europe. Aena for example has an automatic review mechanism if annual passenger volume fall by 10% against forecasted volumes[5] and AdP has a review provision that can be triggered by either a variance in passenger volumes or in the case of exceptional and unforeseeable circumstances that lead to a disruption of the economics of the agreement.[6]

37. In many of these frameworks, these reopener provisions sit alongside traffic risk sharing mechanisms. Therefore, while we agree with the CAA that there would need to be careful consideration of how traffic risk sharing and a reopener provision would work together, there is clear precedent that they can be used in tandem to create a fair and balanced framework.

38. While traffic risk sharing and reopener provisions will help mitigate some of the uncertainty, they will not be a silver bullet. Alongside these mechanisms the CAA needs to ensure that the regulatory framework as a whole can cope with uncertainty and changes through the period. This includes ensuring it can deal with any additional costs brought about by Covid-19. We propose that these could be managed through mechanisms such as an expanded S-factor type mechanism, and allowing for the restart of the expansion programme through appropriate triggers to establish a framework for the delivery of expansion.

39. As we set out in our response to CAP1914, ensuring there is a specific plan in place to both define the regulatory framework for the delivery of expansion and reset the price control to implement this framework will be key to ensuring that expansion can delivered without delay for the benefit of consumers. We proposed that, on reinstatement of the Airports National Policy Statement, Heathrow, airlines and the CAA should recommence previous discussions to establish the framework required to enable the delivery of an affordable and financeable expanded Heathrow. This trigger, combined with a clear CAA policy on the recovery of expansion costs, will provide all stakeholders with clarity on how expansion will be delivered.

Scenario analysis

40. We disagree with the CAA's assessment that agreeing passenger volume scenarios should be a focus of Constructive Engagement. We do agree that the assessment of the impact of different passenger volume scenarios will be important for the development of the RBP, as set out in our response to CAP1914. But we do not consider that agreement on the scenarios themselves should be a main focus of our engagement. This is for three reasons. Firstly, any scenarios will be inherently inaccurate. Secondly, such a focus sets constructive engagement on an unproductive basis. Thirdly, in the face of current market uncertainty the focus has to be on models, assumptions and the way to prioritise choices as the market changes rather than defining one or two specific future plans.

41. Forecasting demand over a 5-7 year period, even in a capacity constrained airport such as Heathrow has been since c.2000, is inherently uncertain. This does not make it meaningless or unnecessary, but it does caution against excessive reliance on one set of numbers produced at one point in time. Perhaps historically, a single forecast done before the start of a Q has been more manageable given the progression of Heathrow volumes – although the challenges with the Q5 forecast for example further reinforce caution. Under the current circumstances of extreme uncertainty, trying to definitively lock-in one or two scenarios is particularly fraught. Almost the only guarantee is that they are likely to prove more inaccurate than in Q6.

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[5] https://www.boe.es/boe/dias/2014/10/17/pdfs/BOE-A-2014-10517.pdf
[6] https://www.parisaeroport.fr/docs/default-source/groupe-fichiers/finance/relations-investisseurs/r%C3%A9gulation/2016-2020/2016-2020-economic-regulation-agreement.pdf?sfvrsn=242508bd_8

42. We will continue to engage with the airline community and seek their input into our passenger forecasting methodology and assumptions through the Constructive Engagement process. It is very worthwhile us having a transparent, and as far as possible mutually agreed, method to make volume projections. We see this as a key pillar of our engagement for RBP. However, through early conversations, it has been made clear to us by the airline community that it will be difficult, if not impossible, to agree passenger scenarios for RBP.

43. The RBP will be Heathrow's plan constructed in consultation with the airline community and consumers and will be driven by the outcomes that are important to our stakeholders. In line with the Q6 process, it should not be the case that all inputs need to be agreed with stakeholders.

44. We remain convinced that the value of engagement on passenger scenarios is using them to understand how capital or other choices would be prioritised in different scenarios or how the regulatory framework should flex to meet the CAA's twin aims of financeability and affordability in an uncertain world. Requiring agreement on the scenarios themselves is unnecessarily setting Constructive Engagement to be conflictual and the RBP up to fail.

45. The CAA's document also seems to imply that it sees these scenarios as being not just potential passenger volume levels, but as being separate plans in their own right which should be informed by our consumer engagement. While we agree that different passenger volumes will impact forecasts for operating costs, commercial revenues and the level of capital Heathrow can finance, it is not necessarily the case that Heathrow's plan would be fundamentally different in each scenario. Rather there is a spectrum of choices based on volumes and the regulatory framework and incentives for the airport.

46. As we set out below in response to the CAA's revised business plan guidance, we see that our forecasting methodology for operating costs and commercial revenues will allow us to properly reflect the impact of passenger volumes. Equally our work through Constructive Engagement and our engagement with consumers will allow us to understand the aspects of our capital portfolio which should always be delivered and inform how to prioritise more discretionary spend, allowing us to flex our capital portfolio to changing passenger volumes.

47. As set out above and in our response to CAP1914, using Constructive Engagement and the outputs of our consumer research to prioritise capital expenditure for the H7 period should be the main aim for Heathrow and the airline community. This prioritisation will allow us to take forward the most beneficial investments through the H7 period that fit the financeability constraints we are working to.

Developing Heathrow's revised business plan

48. Uncertainty and managing uncertainty will be the key themes of the H7 Price Control. No previous regulatory period has had to consider the range of outcomes on each building block we now face for H7:

    a. Passenger volumes are inherently uncertain, potentially volatile and will likely be composed of a different mix of passengers and airlines;

    b. Consumer needs post-Covid are evolving, as are airline needs and business models, and so too must our capital plan and operating model and cost base; and

    c. There is no certainty that passengers will re-engage in any or all elements of our commercial offer, and the risk that new health regulations will limit the amount of space or dwell time available for passengers to engage in any offer.

49. In principle, we agree with the CAA's expectations for the development of the RBP. In line with the CAA's guidance, we will aim to produce an integrated, efficient and well evidenced plan which is financeable and deliverable over the H7 period. We will also endeavour to make as much information as possible publicly available subject to confidentiality constraints.

50. We also support the CAA's ambition to facilitate the development of the RBP by taking a more proactive approach to the Constructive Engagement process. Through the first phase of Constructive Engagement early this year, it was evident that clearer directional statements and policy clarifications from the CAA would have helped in many workstreams. This was most notable in relation to workstreams on outcomes-based regulation, regulatory framework and capital efficiency.

51. However, there are some concerning developments in the CAA's proposed guidance, in particular its guidance on 'scenarios', our response to which is set out above, and on forecasting for operating costs, commercial revenues and passenger volumes. The CAA's increasingly detailed requests on operating costs and commercial revenues do not reflect its stated intent to avoid unreasonable burdens and minimise the requirements of the collection of new data or development of new planning approaches. More fundamentally, it does not appropriately reflect the uncertainty that we face going into H7. Detail does not automatically lead to accuracy, nor does it lead to the airport being more closely held to account – yet these two assumptions appear implicit in some of the CAA's statements.

52. As we set out in our response to CAP1914, Heathrow's driver based methodology is the best tool for forecasting our operating costs and commercial revenues for the H7 period. Taking a driver based approach to forecasting is a well established methodology used frequently by regulators to set efficient cost and revenue baselines for regulated companies. In line with the CAA's guidance, this methodology integrates our forecasts for costs and revenues with our passenger forecasts and forecasts of terminal space in use through the period.

53. The CAA itself notes that the provision of a detailed bottom up forecast is unlikely to be useful for consumers and stakeholders in the short term and that the use of different passenger volume scenarios is likely to be the most useful approach for our RBP given the uncertainty we are facing. However, on the other hand the CAA is asking us for more and more disaggregated detail for our forecasts and assumptions, such as detail on the staff mix assumed across the period.[7] This is inconsistent and the two do not work together.

54. A good example of this is the CAA's comment regarding commercial revenues and assessing the impact of passenger mix on our revenue forecasts. While we agree and have demonstrated through our IBP that passenger mix is an important factor for our retail revenues, relying on an estimate of passenger mix to forecast our retail revenues is unlikely to improve their accuracy for the H7 period when passenger volumes as a whole are so uncertain.

55. As has been mentioned many times by the CAA in its documents and by us in our response, the passenger volume forecast for H7 is highly uncertain and based on a large number of assumptions. This in turn means that the passenger mix within the forecast will be even more uncertain. Using this to then forecast our commercial revenues, while it may provide a feeling of certainty through adding an extra level of detail, is likely to provide only a false sense of accuracy.

56. The CAA is confusing a perceived need for detail with the ability to effectively regulate Heathrow. The purpose of the price control is not to make all of Heathrow's business decisions at a micro level of detail for the next regulatory period but to set an efficient level of costs and revenues for the period which allows Heathrow to deliver the right level of service for consumers. Our driver based methodology provides clear and transparent forecasting which can easily be scrutinised by

[7] Page 99, Criterion 16

stakeholders. Heathrow has clearly demonstrated the effectiveness of this forecasting and we consider that the CAA's failure to engage with this alternative, more accurate, approach will result in less robust regulation and risks undermining consumer outcomes.

57. In an environment where resources for both airlines and Heathrow are limited, it is not proportionate or targeted to focus on trying to predict inherently very uncertain detail. Instead, a robust conversation about Heathrow's efficiency assumptions would help us to get to a better outcome for all stakeholders.

58. We welcome the CAA's action to update its business plan guidance to reflect the change in circumstances since our IBP. Our initial views on these detailed requirements are set out below:

   a. **Scenarios:**

      - As set out above, we do not agree that there should be a requirement to agree passenger volume scenarios for the RBP. This will take focus away from meaningful discussions on the inputs to the forecast and the methodology, and from gaining valuable insight from the airline community into their views on likely trends for H7.

   b. **OBR:**

      - We welcome the CAA's confirmation that we should continue to move towards an outcomes-based regulatory framework for the H7 period and develop the current SQRB accordingly. While we agree that this will require both a short and longer-term approach, it will be important that SQRB and the reinstatement or development of measures does not become a blocker to providing safe service in the short term. The safety of colleagues and passengers is our priority.

      - It will also be important to ensure that any short-term development or continuous improvement of the scheme through H7 does not leave Heathrow exposed to more risk than was assumed when the regulatory framework and associated incentives were established.

   c. **Capex:**

      - We respond in more detail with our views on the CAA's proposals for ex-ante incentives in the relevant section of our response.

      - We agree with the CAA that sufficient detail on our capital programme is required to allow stakeholders to understand and assess our proposals. However it is unlikely that the level of detail requested by the CAA will be available for every project at RBP submission. Trying to create a one-time list and assessment of all projects to fix at the start of a regulatory period was a mutually identified weakness in Q5. The benefit of the Development and Core approach to capex introduced to Q6 is that Heathrow and the airlines can be flexible in the delivery of projects through the regulatory period to meet consumer and operational needs as they arise. This flexibility will be particularly important for the H7 period given the inherent uncertainty that all parties face. The CAA should therefore not seek to assess and set the entire capex portfolio at RBP as it would fundamentally undermine this flexibility.

   d. **Cost of capital and financeability:**

- The CAA once again characterises the WACC as needing to be “no more than the efficient level necessary to compensate HAL for the business and regulatory risks it faces.” We have responded to this point previously, highlighting that this is misguided. In fact, the CAA in its own document gives a contradictory purpose for the WACC in its section on financeability and cost of capital, stating that it represents “the return that investors require in order to persuade them to commit capital to a business given its perceived risk exposure”. We welcome the CAA’s acknowledgement that the WACC should provide an appropriate return to shareholders to incentivise them to invest in Heathrow and would urge the CAA to reflect this in its business planning guidance.

e. ORCs:

- Our IBP proposals were focused on starting engagement with airlines about the future of ORCs and understanding from them how our structure of ORCs could best help airlines to make decisions that encourage sustainable behaviours and incentivise efficient operations.

- The current issues surrounding the under recovery of ORCs in 2020 has led us to reconsider our approach. Through Constructive Engagement we will engage with airlines to find the best way forward to avoid these issues in the future. Our revised approach includes:

    - Retaining the ORC mechanism for H7 to ensure appropriate application of the user pays principle;
    - Continuing to review which costs should be recovered through the ORC mechanism to ensure the services charged for through ORCs reflect the criteria set out in the ORC decision tree;
    - Reviewing the inclusion of fixed costs, such as allocated operating costs and annuities, in ORC prices to incentivise sustainable decision making and reduce the potential of large over and under recoveries; and
    - Looking at the possibility of setting longer-term pricing horizons for ORCs through our contracting approach to respond to airline requests for longer term price certainty.

f. Resilience:

- Resilience continues to be a key priority for us in the current environment and going forward into H7. We have been engaging with airlines regularly to ensure that our forward plans include clear triggers for reopening infrastructure to ensure a safe and resilient return to full operations as passenger volumes grow.

Efficiency incentives: capital expenditure

59. The CAA has still failed to evidence why a move to a full ex-ante framework is required, in particular in this changed environment. Stakeholder responses to the CAA’s CAP1876 consultation continue to be wary of an ex-ante framework, with Heathrow and the airline community in agreement that movement towards a stronger ex-ante framework may not be in the interests of consumers. However, the CAA appears to have pressed on with its approach.

60. In our response to CAP1876, we set out the key questions we think the CAA should be asking when reviewing whether changes to the current capital efficiency framework are required.[8] The CAA has not addressed or attempted to answer these questions in setting out its proposals.

61. We have requested on multiple occasions that the CAA provide a more detailed view on its proposals for ex-ante incentives and how they could be implemented in H7. While we welcome this update, which provides the most detail yet, we note that the CAA has only last week published its working paper on this topic and the proposals in both CAP1940 and its working paper are still silent on the details of how ex-ante incentives would actually be applied in H7.

62. We cannot yet take an informed view on whether the CAA's proposals would be acceptable from a financeability, deliverability or regulatory incentives perspective. We cannot do so without information on (i) the size of the incentive being proposed, (ii) on what proportion and nature of investment they would be applied and (iii) when and how the overall capital envelope will be baselined and how it can be amended through the period. Given this, our response deals with our view of the realities of implementing the processes described and is necessarily silent on whether the proposals would be deliverable and financeable in H7.

63. We have made multiple suggestions as to how we could adjust the capital incentives to improve on the current framework, setting out the implications of those changes in terms of incentives and governance. However, we are as yet unclear on the CAA's current views about these ideas. The report by Steer[9], provided alongside our IBP, built on CEPA's work for the CAA and proposed further dialogue on the application of a revised ex-ante framework to categories of works such as routine maintenance costs. The CAA's proposals do not consider this suggestion.

64. It should be noted that we continue to believe that the implementation of the fundamental changes set out by the CAA would not be appropriate nor beneficial. The CAA has not fully articulated why a move to a revised ex-ante regime would be beneficial for consumers. Nor do we consider that the CAA has satisfactorily addressed our previous concerns through its public consultation process.

65. The current framework was designed to address the issues we experienced through the Q5 period. Under the Q5 framework, capital projects were agreed at the start of the period. This limited flexibility across the period and led to large variances against forecast. The CAA acknowledged this issue in its Initial Proposals for the Q6 period:

   '*A key lesson from Q5 learned by HAL, the airlines and the CAA was that forcing all capital projects to be agreed at the time of the price review for the next five or six years did not reflect the dynamic nature of the industry and the need for flexibility in the capital investment plan'*[10]

66. In contrast, the Q6 framework and the introduction of Development and Core has proved a success in both allowing Heathrow and the airline community to adjust the portfolio during the regulatory period and ensuring that passengers only pay for the projects which have been carried out through airport charges. By the end of 2019 just under £2.9bn of capital has transitioned from Development to Core.

67. As we have highlighted throughout this response, flexibility will be key to a successful H7. It is essential that any future framework maintains the flexibility and cost reflectivity that the

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[8]https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/Heathrow%20Airport%20Limited%20(HAL)%20CAP1876(1).pdf, paragraph 24

[9] Steer, *Heathrow Airport – Assessment of CAA-consulted ex-ante capital allowance process,* December 2019, page 34, paragraph 7.13

[10]https://publicapps.caa.co.uk/docs/33/CAP%201027%20Economic%20regulation%20at%20Heathrow%20from%20April%202014%20initial%20proposals.pdf, page 209, paragraph 13.4

Development and Core framework delivers. We cannot return to a framework which requires upfront agreement to the projects or exact deliverables of the H7 capital plan and are concerned that the CAA's proposed approach could lead to this.

68. We evidenced our concerns as part of our IBP submission with supporting studies from Steer[11] and Frontier Economics.[12] Although the CAA's proposals in CAP1940 reference the views of stakeholders they do not publicly respond to the concerns and evidence we set out in the IBP. As set out in the Executive Summary, and at other points throughout the document, the CAA's failure to carry out transparent public consultation in this regard is concerning. We request that the CAA sets out clearly in its future consultation activity how it has considered and responded to the specific points and evidence raised by stakeholders when coming to its final decision.

69. Without prejudice to the concerns set out above, we would like to engage positively with the CAA on the development of capital efficiency policy for the H7 period. Our response below sets out our initial views on the CAA's proposals based on the information provided in CAP1940.

Criteria for developing new incentives

70. In principle, we agree with the CAA's criteria for developing new incentives. We agree that the aim should be to build on the current approach, which has been successful through Q6 in ensuring that we have a robust governance process which gives airlines a key role in the capital process and has helped to ensure efficiency through the period. There are clearly areas where improvements can and should be made, for example in the area of benefits tracking and realisation, and we are keen to work with the CAA on these.

71. We welcome the CAA's recognition of the merits of the Development and Core framework and its proposal to retain this as the basis of its H7 capital efficiency approach. The Development and Core mechanism is essential to ensure we retain the flexibility to amend the capital portfolio throughout the period. That is vital to ensure investment meets the needs of the consumer, airlines and the operation. It is also important to ensure that airlines retain their role in the capital governance process. The Steer report published alongside our IBP clearly sets out how an inappropriately applied ex-ante framework could effectively remove the integral role of airline stakeholders from the capital process.[13]

72. We agree that any incentives applied should be proportionate and symmetrical and that this should be reflected in the CAA's broader approach to establishing the H7 price control. The CAA's stated aim of not placing unreasonable risks on Heathrow to ensure efficiency and financeability will be key in establishing any future incentive framework. As set out above, the incentive rate applied will materially impact whether the CAA's proposals are financeable.

Broad Approach

73. We note the CAA's proposals that any ex-ante incentive would be applied at the Gateway 3 (G3) milestone in the project lifecycle. Applying an ex-ante incentive at this stage would mimic Heathrow's current capital efficiency framework. As acknowledged by the CAA, Heathrow already faces an ex-ante incentive at the G3 milestone under the current framework. Using G3 would therefore be consistent with the CAA's previous regulatory approach.

74. We cannot comment given the current level of detail provided on whether the CAA's current proposals would be consistent with an affordable and financeable price control. We do believe that in order to support affordability and financeability any ex-ante incentive should be set at a rate

[11] Steer, *Heathrow Airport – Assessment of CAA-consulted ex-ante capital allowance process,* December 2019
[12] Frontier Economics, *Ex ante incentives for investment at Heathrow*, April 2018
[13] Steer, *Heathrow Airport – Assessment of CAA-consulted ex-ante capital allowance process,* page ii

close to the 13% we are exposed to today at G3. A significant departure from incentives set at this level would necessarily impact Heathrow's appetite for taking risk. This in turn will require changes to the contracting approach and a likely extension to the time taken to reach G3. This would increase both the amount spent ahead of the G3 gateway, likely overall cost and the timescales for project delivery.

75. As a general principle in construction, increased certainty of final outturn cost leads to a higher overall cost. There are legitimate trade-offs to be made between flexibility in outcome, timeliness, control and cost – but it is unclear to us where the CAA wants to set the balance or what consumer rationale means it thinks that the current balance needs to change.

76. Among the potential consequences of increasing the ex-ante incentive at G3 are the following:

    a. In response to a stronger incentive at G3, more assessment and development work will be carried out before projects reach the G3 decision point. This will increase project timelines and delay the delivery benefits for consumers.

    b. Increased assessment and development work for the G3 decision will mean that more is spent upfront, ahead of G3, to assure both Heathrow and the airline community of the design, scope and costing of the project. This will likely lead to more nugatory project spend and, ultimately, to higher spend overall. This will in turn impact on the level of the airport charge.

    c. A stronger incentive at G3 will lead to a desire for greater cost certainty at this decision point. To deliver this certainty the supply chain will respond by increasing costs. This will lead to increases in overall project costs and, again, increases to the airport charge.

    d. Increased G3 incentives are likely to lead to more small decisions being taken at this Gateway to help manage the risk and provide more detail on the scope of projects for all stakeholders. This has already been evidenced through the Q6 framework and the current incentive at G3 which has caused the value of the G3 decision to be typically relatively small (i.e. an average value of ~£3m over Q6). A stronger incentive is likely to exacerbate this issue.

77. We welcome the proposal to implement a more targeted and symmetrical approach to timing incentives. Ensuring that these incentives are only applied where the timing of delivery is crucial to the delivery of benefits to consumers will ensure that they are applied in a targeted and proportionate manner, in line with Better Regulation Principles.

78. As the CAA rightly notes in its document, large ex-ante incentives will not be appropriate for all types of projects. The criteria for projects which should be covered by these new ex-ante incentives should be made clear. Again, this is a point that we have made repeatedly in response to CAA consultations and in our IBP supporting evidence base. In addition to reviewing the appropriateness of ex-ante incentives for projects which are substantially outside of Heathrow's control or which pose a greater risk to Heathrow, we consider that there should be more consideration of how ex-ante incentives could apply to lower value projects.

79. As is clear from the CAA's proposals, a move to the CAA's proposed ex-ante framework would mean more detailed monitoring of the scope and outputs of individual projects. While we see that this could provide benefits for some projects, in particular larger passenger experience focused projects, it does not seem proportionate to introduce this level of governance for low value or routine projects, for examples retail 'shell and core' fitouts or low value ongoing maintenance projects.

80. In these cases we consider that any new ex-ante framework should accommodate these projects by streamlining the governance around them, rather than increasing it. Our proposal is to set upfront ‘pots’ of spend for these types of project to which any proposed stronger ex-ante incentive would apply. Heathrow would then be free to meet the required outputs in these retail and routine maintenance pots how it best sees fit through the period. This would prevent clogging up airline governance forums with conversations on small scale and routine spend and allow more time for conversation on larger projects which require increased collaboration.

81. As noted above, we understand the need for increased identification and tracking of deliverables and benefits in an ex-ante framework. We are not against the development of proportionate and effective governance. However, we do not agree that the setting of Delivery Obligations (DOs) should be subject to agreement with the CAA. This is incompatible with the purpose of the Development and Core framework.

82. Development and Core is designed to facilitate collaboration between airlines and Heathrow to ensure that the right projects are delivered to meet the needs of users and can be flexed through the period. Adding CAA agreement to our capital portfolio and the scope it is intended to deliver introduces an extra layer of governance and complexity and will consequently only increase delivery timelines and costs.

83. It is also important that the change control process is proportionate and agile. There are many reasons why the timing, scope or cost of a project may change, including some outside Heathrow’s control. We need to avoid a requirement for numerous governance meetings or processes to approve all of these changes and update the capital baseline as this will create inefficiency. We propose, therefore, that the change control process should set out automatic approvals for a number of these changes upfront to avoid increased governance timelines and delays to delivery.

84. In line with the CAA’s expectations, we will engage with the airline community regarding improvements that need to be made to capital governance ahead of the H7 period, as we have during Q6 and iH7. As noted above we support better and more effective governance. However, in developing governance processes we should aim to ensure that they are proportionate, efficient and allow for maximum flexibility on project delivery through the period.

85. We agree with the CAA that we should consider how best to ensure consumer interests continue to be represented through the capital governance process. This was a key challenge raised by the CCB in their review of our IBP and should be progressed through the H7 review.

86. We also agree that better identification of project benefits and tracking of benefits realisation would be beneficial for H7. A key area of improvement here would be better sharing of the airline benefits that are delivered through Heathrow projects to allow for a complete picture of the benefits realised by our capital spend. We will look to set out or proposals for improving this process in our RBP.

Financeability and the cost of capital

87. Heathrow is not comparable to other regulated utilities. Unlike the utilities regulated by Ofgem and Ofwat, which provide essential services, consumers can choose not to fly. This means that, unlike other regulated utilities, Heathrow has and always will face significant demand risk. The impact of Covid-19 has shown how risky the aviation sector as a whole can be, and Heathrow’s business in particular. This has been reflected in investors’ perception of Heathrow’s risk compared to other companies and demonstrated by the spread of Heathrow’s debt increasing from 15bp to 85bp above the iBoxx index.

88. Ensuring financeability is maintained is a key benefit to consumers. If Heathrow cannot efficiently finance its investments, this will ultimately have impacts for consumers, either in the form of a significantly higher WACC and/or through a lack of investment. For the H7 period the CAA will

have to achieve the correct balance to ensure the outcomes which consumers require can be delivered.

89. Overall, we are disappointed in the CAA's approach to financeability and setting an appropriate cost of capital for Heathrow. We consider there are a number of significant shortcomings in the Flint Global report on Heathrow cost of capital. These shortcomings have led to underestimation of the cost of equity for Heathrow and a significant underestimation of the cost of debt.

90. We set out our concerns below in respect of:

    a. Underestimation of asset beta for airports;

    b. The use of different debt beta's for degearing and regearing estimates of the cost of equity;

    c. The approach to estimating the cost of embedded debt;

    d. The analysis of the cost of Heathrow debt relative to the iBoxx indices;

    e. Estimation of issuance and liquidity costs; and

    f. Changes in the level of notional gearing.

91. Each of these specific points is addressed in more detail below. However, we must express our disappointment that this report has not engaged with much of the data and evidence we presented in the IBP. We consider that the continued failure of the CAA to engage with the evidence we have provided on WACC issues over the last couple of years is a sign of a fundamental failure of process by the CAA. If the CAA do not engage with and respond to the evidence presented to them then they are failing in their duty to regulate in a proportionate, transparent and consistent manner.

Underestimation of asset beta's for airports

92. The CMA has recently robustly estimated the asset beta range for airports. While the CAA's document focuses on the output of Flint Global's work being '*broadly consistent'* with the CMA's provisional findings, there are a number of differences which produce a lower end result.

93. The approach taken by Flint Global is not as robust as that taken by the CMA. This reduces credibility in their overall approach and brings into question the lower number that it produces. In calculating the asset beta for H7 we would expect the CAA to use the most robust approach available, which would be that taken by the CMA.

94. Should the CAA choose to use the approach taken by Flint Global, this would clearly demonstrate that the aim of the exercise is to find ways to reduce the estimate of the WACC, not to come to a reasonable and robust answer.

The approach to debt beta

95. In the report, Flint Global use a different debt beta to estimate the asset beta of the comparator airports from that used to calculate the cost of equity for Heathrow. This approach is, again, not reflective of that taken by the CMA. In fact, it has no history of being used in other situations and is not supported by any theoretical or empirical evidence.

96. We have provided the CAA with a considerable body of evidence from NERA showing that empirical estimates of the debt beta of Heathrow do not support an estimate of debt beta greater than 0.05. The report from Flint Global takes no account of this evidence.

97. The failure of the report to address this evidence or produce empirical evidence of its own to support its position significantly undermines Flint Global's findings and points yet again to a failure of regulatory process on the part of the CAA and its consultants.

Estimation of the cost of embedded debt

98. The Flint Global report estimates the cost of embedded debt by using a 20-year trailing calculation of the iBoxx and rolling this forward for 2022 to 2026. This approach results in an estimated cost of embedded debt of 1.4%. This is significantly below the current embedded cost of debt of 2.1% and results in a material underestimate of Heathrow's cost of capital. This underestimate has arisen both as a result of failing to take account of the differential cost of Heathrow debt compared to the iBoxx index (see below) and as a result of the process of rolling forward 20-year trailing debt cost estimate in a way that does not reflect the reality of Heathrow's actual debt tenors and costs and thereby falsely assumes a reduction in cost that will not occur.

99. We are particularly disappointed with this second error. We have provided evidence to the CAA previously that such an approach is not valid and is not consistent with CMA good practice. This evidence has not been engaged with or responded to at all by Flint Global in their report. As such it demonstrates another significant failure in the CAA's approach to developing its views on WACC.

The relative cost of Heathrow Debt

100. The Flint Global report looks at 4 issuances of Heathrow debt compared to the index, and by inspection concludes that Heathrow can raise debt at the cost of the iBoxx index, despite two of the points showing that the cost of debt was considerably higher than the index. The Flint Global report provided no evidence or analysis to support this position.

101. We have provided significant quantities of evidence to the CAA in respect of the difference in the cost of Heathrow's debt to the index. This includes a detailed analysis by NERA, evidence on bond spreads in the IBP submission and evidence on the additional cost of index linked debt. None of this evidence is addressed or engaged with by Flint Global. As with the other areas of weakness in their report this demonstrates a major failure in the use of evidence by the CAA in respect of WACC.

Estimation of issuance and liquidity costs

102. The Flint Global report merely states that 10bp is a reasonable allowance for issuance and liquidity costs for Heathrow and provides no evidence to support this assertion. In contrast we have provided the CAA with a considerable level of evidence on this issue. In particular, the IBP provided detailed evidence on liquidity costs that showed that these alone were at least 10bp. As in the other areas of their report, the evidence we provided has not been addressed.

Changes in the level of notional gearing

103. Both the report from Flint Global and the CAA's document discuss the appropriate notional gearing assumption to be used for the H7 price control. The report from Flint Global suggests gearing between 52.5% and 60%.

104. We do not consider the de-gearing implicit in the 52.5% is credible, particularly in the current circumstances. It is clear that the impact of Covid will result in a higher gearing, making an assumption of a lower notional gearing nonsensical given the increase in gearing resulting from the pandemic.

105. Regulatory stability is a key tenant of economic regulation and ensuring that investors have confidence in the regulatory regime. The CAA also has a duty to ensure that its decisions are

consistent. As an important principle of regulatory stability and consistency, the notional gearing level should be left unadjusted.

Allowed tax costs

106. The CAA's document sets out, rather unexpectedly, that it is minded to move to a post-tax WACC calculation with an explicit allowance for tax. The CAA's document sets out very little evidence for this and why such a move would be in the interests of consumers.

107. As part of our IBP, and then reiterated in our response to CAP1876, we provided detailed evidence setting out why the current pre-tax approach to calculating Heathrow's WACC should be retained. For completeness, we have summarised this evidence base below:

a. A post-tax approach requires an accurate forecast of the likely level of tax. This is difficult where there are significant uncertainties in tax allowances and means that a number of assumptions have to be made;

b. It requires a forecast of the companies gearing to be implemented properly. This is straightforward where gearing is unlikely to change, however, as highlighted by the CAA itself, gearing will be a key issue over the H7 period;

c. It is difficult to validate as tax payments may not be fully settled until many years after the tax year, meaning that accurate details for historic tax may only be available several years in arrears.

108. Continuing with the current tax approach maintains regulatory stability and avoids the need to make a number of assumptions which may later turn out to be inaccurate. Both of these factors are particularly important for the H7 period where we will be facing significant uncertainty in a number of assumptions and where regulatory stability for investors will be critical.

109. In addition, this issue was reviewed by the CMA (as set out in our IBP submission). The CMA concluded clearly that it was in consumers interests for the current pre-tax approach to be retained. The CAA's duties require it to regulate in a consistent manner. To move away from a pre-tax approach without setting out in detail why the alternative approach is better and the factors that mean the previous regulatory judgement is no longer relevant is not regulating in a consistent manner and is therefore contrary to the CAA's duties.

Conclusion on financeability and the cost of capital

110. As with other areas in the CAA's discussion of WACC and financeability, we are disappointed that the CAA has chosen not to engage with this evidence as part of its process and continues to pursue a course of action for which the benefits have not been evidenced.

111. As we have set out in detail above we do not consider that the report provided by Flint Global is either robust or grounded in sound evidence. The report often diverges from the robust approach taken by the CMA and uses untested approaches without the backing of empirical evidence. These shortcomings should be rectified if the CAA is to rely on the report for its H7 price control.

112. We also continue to be disappointed by the failure of the CAA or its consultants to engage properly with the evidence we have provided through previous regulatory submissions. Alongside our IBP we provided a total of 11 appendices regarding the cost of capital for H7, including detailed evidence from NERA on cost of debt. The CAA has failed to engage with any of this evidence as part of its public consultation process showing a clear failure of transparent and evidence-based regulation.

113. As we have clearly set out in previous sections of our response, Covid-19 has had a significant impact on investor perceptions of risk and in particular on their perceptions of Heathrow's risk. This could have a material impact on Heathrow's cost of capital for the H7 period. The CAA will have to take into account this changed investor view when setting its cost of capital for the H7 period. We will provide an updated view of WACC for Heathrow in the RBP in November.

Regulatory treatment of Heathrow's early expansion costs

114. We have consistently made the case that clarity on the recovery of early expansion costs is required. Most recently, in response to the CAA's CAP1914 document we set out that the requirement for policy clarity still remains to provide certainty to investors on how this expenditure will be treated. We therefore welcome the CAA's proposals in its document.

115. The CAA's move to simplify its policy given the current circumstances is welcomed and should set a precedent for other policy decisions. The CAA's proposals for spend incurred up until the end of February 2020 are clear, easy to understand and implement and consistent with regulatory precedent, thus they have helped to provide some reassurance to investors at a time where Heathrow is perceived as being a riskier investment.

116. We note that CAP1940 sets out a proposed policy position from the CAA, however it does not provide a timetable for finalisation of this policy. Given the importance of clarifying the policy for the treatment of these costs for financeability, we request that the CAA provides a timeline for the resolution of this policy issue as soon as is practically possible.

117. We also note the CAA's proposals to apply the same treatment to winddown costs and costs incurred through the Supreme Court appeal process. Again, we welcome this move to keep policy for all capital expenditure aligned to regulatory precedent but request a more detailed plan for how this policy will be confirmed.

118. While we welcome the CAA's policy certainty on costs which have already been incurred, the CAA cannot forget about the need to establish a policy for the recovery of any future pre-DCO expansion expenditure. As we set out in our response to CAP1914, it is important that a policy is established for the recovery of early expansion costs to allow work on expansion to continue on reinstatement of the ANPS. A lack of policy clarity on early expansion expenditure caused delays and uncertainty, ultimately leading to the expansion programme being delayed.

119. To avoid this situation in future, the CAA needs to set out a clear policy for the recovery of early expansion costs before they need to be incurred in the future. Without this confirmation, the delivery of benefits to consumers brought by expansion could be delayed. We therefore also request that as part of this work the CAA sets out a process for the confirmation of policy on the recovery of any future planning and early constructions costs that need to be incurred. We consider that failure to have a clear position in place ahead any expansion work recommencing will lead to inefficient outcomes for Heathrow, airlines and consumers. In our response to CAP1871 we proposed drafting that would address this problem, we would welcome the CAA's detailed feedback on these proposals.

120. In line with our response to CAP1871, the CAA's proposals will allow Heathrow to begin recovery of early expansion costs from 2022 as long as they are determined to be efficiently incurred. As has been the case with previous reviews of our Category B expenditure, we will work with the CAA in good faith to ensure the efficiency of our expenditure can be reviewed transparently.

121. We agree with the CAA that it would be a pragmatic solution to conclude the reviews of costs from 2019 and the first quarter of 2020 in a single review. Given current resource constraints and

the reality that the expansion delivery team has been stood down following the decision of the Court of Appeal, it is important that this review is targeted and proportionate.

122. We set out our response to the CAA's proposal of applying a financing cost of 4.83% to costs in 2020 and 2021 in our response to CAP1871. Current market data for airport WACC is consistent with a WACC much higher than 4.83%. From a position of regulatory consistency, the CAA cannot apply a different WACC than the Q6 assumption for 2020 and 2021 that is substantially below the actual cost of capital for Heathrow.

123. Remunerating a portion of Heathrow's spend for 2020 and 2021 at a lower rate than other capital expenditure is inconsistent and the rationale for doing so continues to be unjustified. Again, the CAA has failed to respond to the concerns and evidence put forward by Heathrow in our previous responses on this issue as part of its public consultation process. We will not repeat this evidence here, but request that the CAA properly interacts with our response to CAP1871 ahead of publishing further policy proposals on this topic.

124. We also support the CAA's proposal that the costs incurred for 2018 on the planning application are efficient and to be treated in accordance with CAA policy on early costs when it is finalised. Heathrow has demonstrated that all these costs have been incurred for the planning application process and incurred efficiently.

Financial resilience and ring fencing

125. In line with our response on the CAA's proposals for the recovery of early expansion expenditure, we welcome the CAA's simplified approach in regard to financial resilience and ring fencing. The CAA's recognition that we are now in a very different position to when it previously consulted on these proposals and that a different approach is now required is encouraging.

126. In line with pervious responses on this topic, our view remains that any financial resilience licence conditions implemented by the CAA should:

a. Not cut across our existing financial arrangements;

b. Not create extra costs in excess of the benefits it will provide for consumers; and

c. Have regard to the CAA's duties and Better Regulation principles to ensure that any licence conditions are proportionate, targeted, consistent and transparent.

127. We continue to be of the view that the interests of consumers and bondholders are aligned and that our current financing arrangements and licence conditions provide sufficient protection. The CAA's proposals in CAP1940, although significantly slimmed down from previous consultation, do not address the comments we made in our response to CAP1832, many of which remain relevant to these proposals. We request that the CAA provides clear and express justifications as to why all of the proposals meet the relevant thresholds in the CAA12, and that the additional requirements address cases where action is definitely needed.

128. As with the CAA's proposals on capital efficiency incentives, in order to fully assess the proposals we would need more information from the CAA on how its proposals would be implemented, including further detail on the proposed drafting. Without this it is difficult to fully assess whether the CAA's proposals could cut across our financing arrangement and/or generate extra financing costs or administrative burden for Heathrow. The drafting of the CAA's proposals will be crucial in this regard.

Sufficiency of resources

129. In its August 2019 working paper, the CAA's proposal on changes to the sufficiency of resources obligation was significantly wider than the wording in CAP1940. The limited detail in the CAA's document makes it difficult to understand whether the CAA's full proposals are still under consideration or whether the only proposals remaining is the proposal to explicitly ensure that Heathrow has sufficient resources to operate in accordance with the Licence.

130. The CAA's proposals in CAP1832 proposed that the condition should clearly '*cover each of cash and liquidity facilities, as well as operational assets*'.[14] It proposed that the condition should require Heathrow to maintain these to provide airport operation services in accordance with the Licence.

131. If it remains the case that the CAA's focus continues to be on creating a condition that requires Heathrow to certify that it has sufficient cash and liquidity facilities for a 24-month period as well as sufficient operational assets, this proposal is unacceptable. As we set out in previous responses, such a condition would increase Heathrow's costs as we would need to raise more debt in order to hold the required cash. We request that the CAA' urgently confirms that this is not the intention of its condition. We expect the drafting of the condition will illuminate the depth of this proposal.

132. In line with our response to CAP1832, the CAA has not fully articulated why it thinks that the proposed changes to the sufficiency of resources at Condition E2.1 of the Licence are required. There is no further discussion of the benefits this change will bring.

133. The CAA sets out that its proposals will ensure that Heathrow has sufficient resources, not just to '*barely provide services at the airport*', but to provide services in accordance with the Licence. Heathrow's Licence already sets out the levels of service Heathrow should provide through the service quality regime. Therefore, Heathrow is already held to account for ensuring that these service levels are provided through the Licence and the proposed modification would be, at best, redundant.

Compliance certification

134. As set out above, the drafting and implementation of the CAA's proposals regarding additional compliance certification will be paramount to understanding the impact of the condition on Heathrow's financing requirements. If onerous certification is required, this will require Heathrow to increase its cash reserves in order to comply, and accordingly increase costs.

135. Heathrow provides abundant information to its investors as part of its financing arrangements and to comply with other regulations. All of this information is publicly available and easily accessible by the CAA on Heathrow's website. These primarily include:

   a. Publication on a semi-annual basis of an investor report providing more granular detail on Heathrow's performance and financial position; and

   b. Publication of any price sensitive information on a regulatory news service under the Market Abuse Regulation.

136. Additionally, at least every 12 months, Heathrow is subject to a going concern assessment which is verified by Auditors. This provides investors with comfort that Heathrow has sufficient resources for a 12-month period including under severe downside scenarios. Our 2020 H1 results for example provide confirmation that we have sufficient liquidity to meet out forecast needs for

[14] http://publicapps.caa.co.uk/docs/33/Financial%20resilience%20and%20ring%20fencing%20working%20paper%20completed%20.2.pdf, page 27, paragraph 2.26

the next 12 months, even under the extreme downside scenario of no revenue in the period.[15] This is, again, publicly available for the CAA to use.

137. Therefore, the CAA already has full access to the information Heathrow provides to its bondholders. Thus, it does not seem proportionate or in line with Better Regulation Principles and Section 1(4) of CAA12 for the CAA to add requirements to provide this information to Heathrow's Licence. If the CAA is of the view that it requires additional information to that Heathrow provides to its bondholders, to which the CAA already has access, it should set out the information it requires and why this is needed. We are happy to work with the CAA to provide any such information where it is available and reasonable to do so.

138. The CAA also notes that it will '*consider whether more onerous obligations should apply if HAL were to enter financial distress*'. As set out in our response to CAP1832, The CAA's previous assertions that the information that Heathrow has to provide to the CAA in the event of a change in circumstances or financial distress is limited[16] is not true. Such conditions include:

a. Condition E.1 regarding the provision of information in the regulatory accounts;

b. Condition E2.3 requiring Heathrow to inform the CAA in writing if the directors become aware of any circumstance which causes them to no longer have the reasonable expectation expressed in the most recent sufficiency of resources certificate;

c. Condition E2.5 requiring Heathrow to inform the CAA if Heathrow or a linked company seeks or is advised to seek advice regarding its financial position or ability to continue to trade; and

d. Condition E2.10 requiring Heathrow to inform the CAA should there be any change to any of the finance documents in respect of credit rating requirements.

139. Should any additional requirement from the CAA cause Heathrow to have to produce additional information to that already required in the event of financial distress by existing conditions or Heathrow's bondholders, this will cause an additional compliance cost and administrative burden for Heathrow at time when Heathrow's time and resources should be directed to ameliorating the distress.

Clarifying Heathrow's ultimate controller obligations

140. In line with previous responses, we agree with the CAA that a clarification of the ultimate controller condition to ensure that it does not apply to Heathrow's shareholders would be helpful and would provide increased certainty for stakeholders. We are happy to work with the CAA on the appropriate drafting of this condition.

141. However, we continue to find it difficult to see any benefit in the CAA's proposal for an annual confirmation that Heathrow has written to the ultimate controller to remind it of the undertaking. The CAA states that this is to '*raise the profile of compliance activities within the group*'. However, we fail to see how an annual reminder would achieve this and it may do the opposite in that it becomes an all too routine exercise.

142. We consider that, rather than introducing a requirement to repeat a task annually that would not serve any purpose and could instead serve to make people complacent about the condition,

[15] https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-(SP)-Limited-H1-2020-results-release.pdf, page 16
[16] http://publicapps.caa.co.uk/docs/33/Financial%20resilience%20and%20ring%20fencing%20working%20paper%20completed%20.2.pdf, page 39, paragraph 3.36

a requirement to obtain a new undertaking on change of ultimate controller would be more impactful and serve to remind the Covenantor of its commitments.

Alternative proposals for expansion by Heathrow West

143. We recognise that, given the decision of the Court of Appeal in February 2020 and the subsequent pausing of the development of schemes for the delivery of additional runway capacity at Heathrow, conversations regarding the CAA's treatment of Heathrow West's proposals are now largely hypothetical. However, we remain concerned about the CAA's comments in CAP1940 regarding the credibility of Heathrow West's proposals.

144. The CAA's document states that evidence from Heathrow West and Arcadis demonstrates that Heathrow West's proposals are '*reasonably mature and credible'.* We find it difficult to accept how this conclusion can be arrived at using the evidence base published in the Arcadis report. This report does not evidence any robust testing of Heathrow West's proposals and the CAA's short statement does not evidence the process it went through to establish this conclusion.

145. We request that the CAA clarifies how, on the basis of the information published, it considers the proposals to be '*reasonably mature and credible'.* Clarity is required to confirm our understanding that the CAA tests were focussed on ascertaining the CAA's future work prioritisation and not an assessment of the viability of the Heathrow West scheme itself.

146. Additionally, we have provided evidence to the CAA, most recently through our IBP, setting out why the operation of terminals by multiple operators would not be in the interests of consumers. As yet, the CAA has not fully engaged with this evidence. If further work were to be carried out on Heathrow West's proposals we would expect the CAA to properly address the evidence we have provided and set out why it considers that further work on the delivery of this scheme would be in the interests of consumers.

147. We acknowledge that the CAA will not undertake any further work at this time, and reiterate that we would continue to seek clarity and transparency on the scope of any further tests or assessments if the CAA were to re-engage with the Heathrow West scheme in the future.

148. Since the publication of CAP1940 the Planning Inspectorate have concluded that the Heathrow West scheme is not, or does not form part of, an NSIP.[17] This means that if Heathrow West were to bring forward a DCO application and the Planning Inspectorate maintains this view, the application would have to be reviewed. In light of this, we request that the CAA seriously considers whether any further work on Heathrow West's proposals would be in the interests of consumers.

[17] https://infrastructure.planninginspectorate.gov.uk/wp-content/ipc/uploads/projects/TR020004/TR020004-000201-s.53_Decision%20letter_Applicant_Refusal%20of%20Authorisation.pdf