

# **An updated estimate of Heathrow and Gatwick's WACC**

## **Note prepared for British Airways<sup>1</sup>**

**June 2013**

### **Introduction**

Following the publication of the CAA Initial Proposals and their supporting documentation, including the cost of capital papers by PwC, British Airways asked us to review our own estimates of the WACC for Heathrow and Gatwick. This was to take account of:

- the proposals included in the CAA and PwC papers; and
- recent relevant market evidence.

This note summarises our findings and is supported by four additional notes covering:

- Indexation and the cost of debt;
- Equity betas;
- The use of estimation points in the upper quartile of the WACC range; and
- Gatwick specific issues.

Each of these points is discussed briefly below and in detail in the corresponding note. We then draw together the implications of the notes for the estimate of the WACC and provide both ranges and point estimates for each of Heathrow and Gatwick.

### **Changes since the February Estimate**

As noted above, we have concentrated on four areas of the WACC estimate, although we have also taken on board issues raised by the CAA and PwC elsewhere in their approach. We briefly summarise our thoughts on the main areas where change has taken place before focusing on the implications this has for our WACC ranges in the following section.

#### **Indexation of the cost of debt**

While we believe that the estimate of the cost of debt proposed by PwC is appropriate for a traditional headroom-incorporating fixed rate for a price control period, we do believe that stakeholders would be better served by switching to an indexation approach.

Such an approach, referenced by the CAA in its initial proposals, would allow the all-in cost of debt to change as market conditions change. This removes the need to incorporate headroom into the estimated cost of debt since the uncertainty about future rates is addressed directly in the estimation approach.

Our separate note on indexation and the cost of debt provides a workable approach to indexation which, we believe, would be appropriate for airports. It draws on the approach developed by Ofgem under RIIO but addresses airport sector aspects relative to the energy sector ones considered by Ofgem.

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## **The equity beta and Gatwick specific issues**

While we agree with much of the data being used by PwC in its consideration of the riskiness of the airports and the appropriate equity return, as captured through the equity beta, we do not believe that the right interpretation of the data has been used.

A range of evidence points to equity beta values falling and consequently using the same ranges as were used for Q5 is not appropriate. The ranges need to be updated for the new evidence which shows that values in the lower part of the Q5 range would be appropriate. This is supported by a range of evidence presented in our Equity Beta note and BA's own submission.

There is a question as to the relativity between Heathrow and Gatwick. As our paper on Gatwick contends, we believe the CAA and PwC have over-compensated in their proposals for that airport for what is perceived by them as a small company with a higher volume risk situation. As explained in our note, we do not believe that they are a small company when it comes to raising funding and the level of volume risk is over-stated when the specific issues at Gatwick are considered. Consequently, while we believe that the relative position of the equity beta for Gatwick compared to Heathrow should be considered (with Gatwick having a slightly higher value), we do not believe the following adjustments should be made:

- a lower level of gearing; or
- a higher cost of debt allowance.

## **Chosen position in the WACC range**

The CAA proposes that once a WACC range has been established a relatively high percentile position should be adopted – above the 75<sup>th</sup> percentile in both cases. The justification for this is said to be based around investment incentives and social outcomes.

Having reviewed the arguments proposed by the CAA and how other regulators have addressed these issues – although often this is implicit rather than explicit – we cannot see a justification for moving away from the mid-point. The recent Ofgem RIIO precedent is instructive here, where the selected point estimate was driven by RAB growth, which is absent in this CAA price control. In fact, given the relative size of the airline asset base at the airports compared to the airport RAB, there could be an argument for a lower percentile value to be used to create incentives for airlines to invest and improve service quality and selection for consumers!

These arguments are detailed in our note on the use of the 80<sup>th</sup> percentile and are also subject to consideration in a separate independent report being prepared by Professor Sudi Sudarsanam, a former Competition Commission member.

## **New proposed WACC's and their implications**

Based on the changes noted above and some other minor adjustments, such as the use of the averaged tax rate across the period (20.2%), we are able to prepare new ranges for the pre-tax WACC for Heathrow and Gatwick. These are shown in the following tables.

With respect to the cost of debt we propose a value of 2.50% which would be:

- an opening value for an indexation approach; or
- a fixed cost of debt for Q6.

While the rates are the same at the moment, we believe that there is sufficient headroom in using a fixed 2.5% for Q6 (if not indexation is applied) since the current spot rate is well below 2% and a consideration of forward rates suggests that there is sufficient headroom in the 2.5% allowance.

Table 1: Range and point-estimate for Heathrow

Element	Low	High	Comment
Risk-free rate (%)	1.5	1.75	Unchanged
ERP (%)	5.0	5.0	Unchanged
Equity beta	0.95	0.95	Reduced given recent evidence
Post-tax Cost of Equity (%)	6.25	6.50	
Tax rate (%)	20.2	20.2	Calculation in line with CAA approach
Pre-tax cost of equity (%)	7.83	8.15	
Cost of debt (%)	2.5	2.5	Starting value for our indexation approach
Gearing (%)	60.0	60.0	
Pre-tax WACC (%)	4.63	4.76	
Mid-point (%)	4.7		The appropriate point trading off various stakeholder perspectives

Note: if the CEPA proposed approach to indexation were to follow the existing forward risk-free rate curve then the average over Q6 would be 1.9%, implying a reduction of 0.36 in the average WACC over this period (ie 4.35% rather than 4.7%).

Table 2: Range and point-estimate for Gatwick

Element	Low	High	Comment
Risk-free rate (%)	1.5	1.75	Unchanged
ERP (%)	5.0	5.0	Unchanged
Equity beta	1.0	1.0	Reduced given recent evidence
Post-tax Cost of Equity (%)	6.50	6.75	
Tax rate (%)	20.2	20.2	Calculation in line with CAA approach
Pre-tax cost of equity (%)	8.15	8.46	
Cost of debt (%)	2.5	2.5	Starting value for our indexation approach – no justification for Gatwick to have a higher value than Heathrow
Gearing (%)	60.0	60.0	No justification for reducing this value.
Pre-tax WACC (%)	4.76	4.88	
Mid-point (%)	4.8		The appropriate point trading off various stakeholder perspectives

Note: if the CEPA proposed approach to indexation were to follow the existing forward risk-free rate curve then the average over Q6 would be 1.9%, implying a reduction of 0.36 in the average WACC over this period (ie 4.45% rather than 4.8%).

## Conclusion

Following our review of the CAA's Initial Proposals and the arguments put forward, we believe that there are areas where further reduction in the proposals is necessary. These have been summarised in this

document and are set out in more detail in the supporting notes. In each case this leads to a point estimate of the WACC which is towards the lower end of the range that we proposed in February.

For Heathrow the real pre-tax WACC point estimate, based on using an indexed cost of debt which is subject to movements during Q6, is 4.7%.

For Gatwick the real pre-tax WACC point estimate, based on using an indexed cost of debt which is subject to movements during Q6, is 4.8%.

The following water-fall diagrams show the break-down of the adjustments to get from the CAA's Initial Proposals to our point estimate.

Figure 1: Heathrow water-fall diagram (using a 2.5% Cost of Debt)<sup>2</sup>

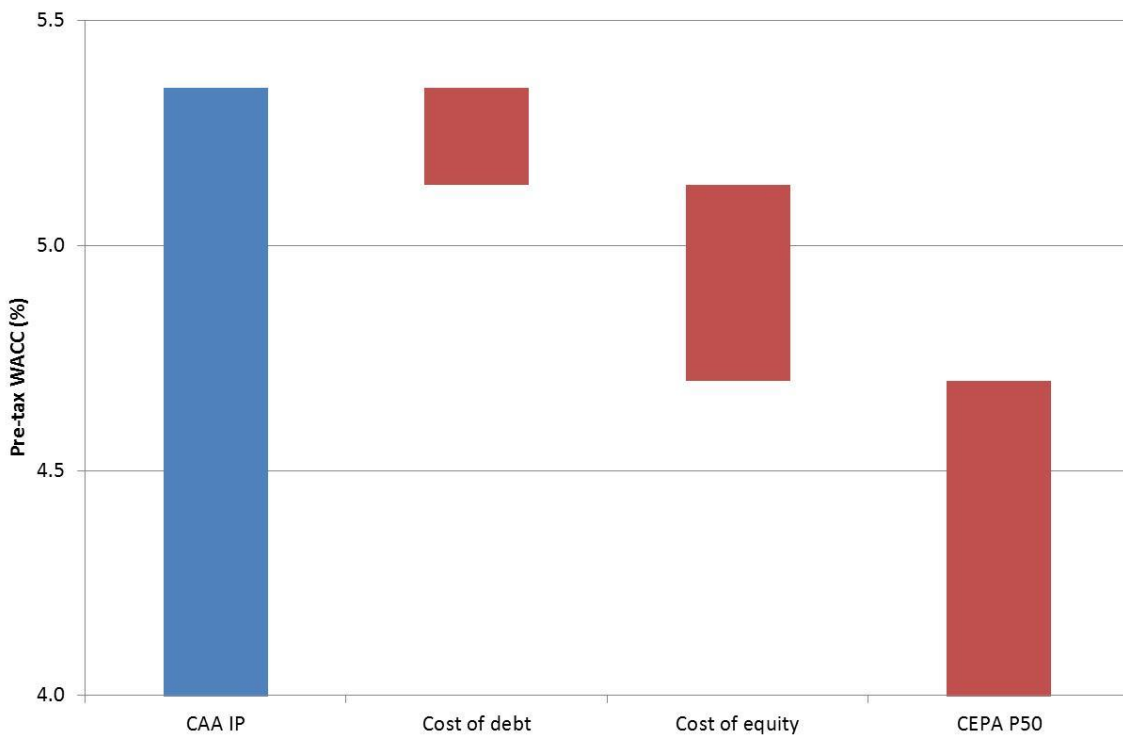
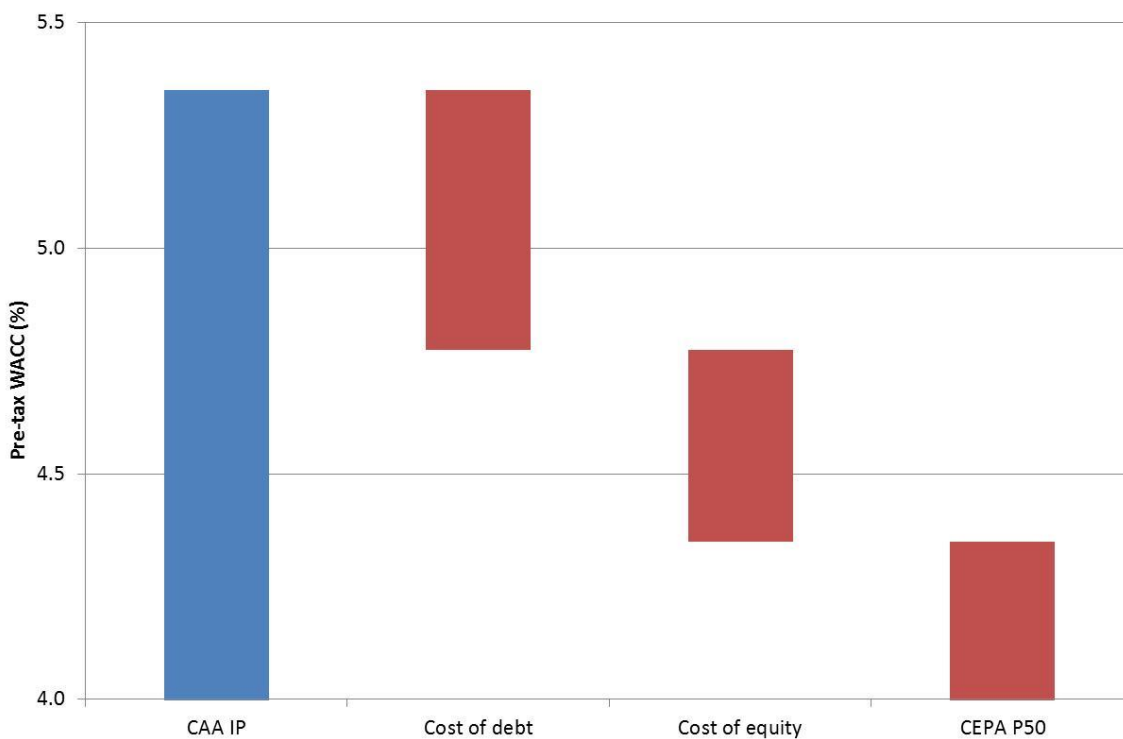


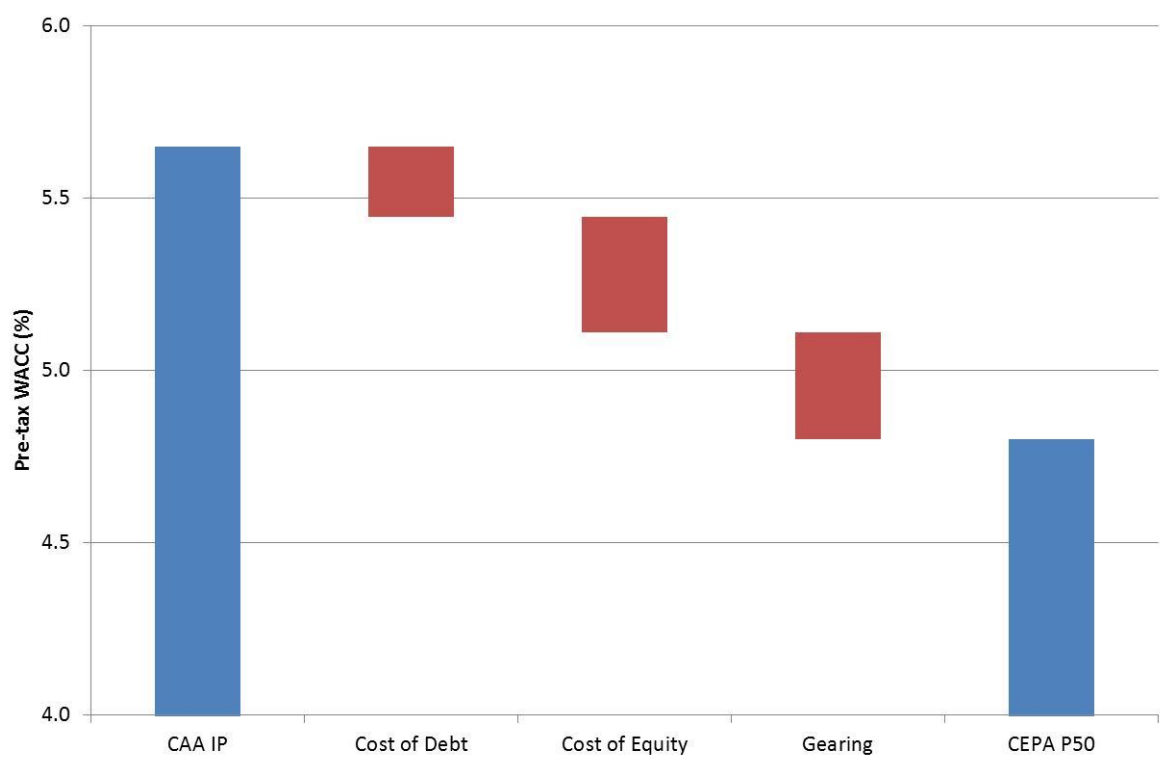
Figure 2: Heathrow water-fall diagram (using a 1.9% Cost of Debt)<sup>3</sup>



<sup>2</sup> CEPA P50 refers to the mid-point of the revised CEPA range.

<sup>3</sup> 1.9% for the cost of debt is derived from the current estimate for our cost of debt indexation approach.

**Figure 3: Gatwick water-fall diagram (using a 2.5% Cost of Debt)**



**Figure 4: Gatwick water-fall diagram (using a 1.9% Cost of Debt)**

