Economic regulation of NATS (En Route) plc: consultation on approach to the next price controls review (CAP1994)

Heathrow's response

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Executive Summary

1. Covid-19 has had and continues to have an unprecedented impact on the aviation industry as a whole, including Heathrow. In 2020, Heathrow's passenger numbers dropped by 72.7% compared with 2019 figures to a total of 22.1 million passengers. This represents a drop of 58.8 million passengers compared to 2019. This drop in passenger numbers has led to a drop in revenues which has had a substantial impact on Heathrow's finances.

2. There is a large amount of read across from the CAA's consultation on NERL's next price control to the ongoing consultations regarding Heathrow's H7 price control. Both must be in place in 2022 and both are being set against the continuing backdrop of uncertainty.

3. The CAA's consultation addresses two key sets of challenges, both of which are pertinent when considering Heathrow's H7 price control and could have large impacts on the wider UK economic regulatory space:

    a. Adapting the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021. This is currently a key factor for Heathrow in discussions with the CAA. In July 2020, Heathrow submitted an application for a Covid-related RAB adjustment to reflect the unprecedented impact of Covid-19 on Heathrow's operations and revenues. This application set out the short and long-term consequences of a lack of regulatory intervention on Heathrow's ability to deliver for airport users in line with consumer expectations and the requirements of our Licence. How the CAA choses to implement both NERL's traffic risk sharing (TRS) mechanism and Heathrow's adjustment application will have long lasting consequences for both consumers and for investor confidence in UK aviation regulation.

    b. Developing a future regulatory framework for 2022. Discussions regarding Heathrow's H7 price control are ongoing. As is the case for NERL, dealing with future uncertainty will be key to ensure that the price control set is fit for purpose and allows long-term delivery for consumers. The environment has changed dramatically, meaning that the regulatory frameworks need to be thoroughly reviewed to ensure they provide the right balance of risk and reward. Additionally, the impact of Covid-19 has brought to the fore the demand risks inherent in aviation, increasing investors' perception of risk for both NERL and Heathrow.

4. The CAA's approach to the arrangements for 2020 and 2021 is deeply concerning. NERL has a defined TRS mechanism as part of its regulatory framework, a mechanism which along with other issues referenced in the CAA's 2003 regulatory policy statement was key to ensuring future investor confidence in the regulatory regime after NERL's refinancing.[1] However, in its consultation, the CAA does not appear to even be considering the option of applying the TRS mechanism as drafted and as accepted by NERL's investors. More worryingly, the CAA is consulting on the prospect of not implementing the mechanism at all.

5. We agree with the CAA that affordability and ensuring that charges are set at a level that supports re-establishing traffic volumes will be important following the impact of Covid-19. Accordingly, in order to balance affordability and financeability, it may be appropriate for the

[1] https://www.nao.org.uk/wp-content/uploads/2004/01/0304157.pdf, 1.12

CAA to consider the time horizon over which any recovery due through the TRS mechanism is recovered. However, retrospectively changing the conditions around the risk and reward balance of NERL's price control is not appropriate. The CAA's approach shows a clear lack of regulatory consistency, one of the key principles of Better Regulation, and threatens to further increase investors' perception of risk in the aviation sector.

6. Investors will regard the TRS as clear ex-ante promise by Regulators about the consequences of certain events. If the CAA do not allow full recovery of the value due to be recovered by the TRS mechanism then this would be inconsistent with that ex-ante promise. Such inconsistency could severely undermine international regulators confidence in the UK regulatory regime and impact more widely than aviation alone. The CAA have not considered this issue in the consultation, nor the potential long-term detrimental impact of such a consequence.

7. We agree with the CAA's assessment that it is important for the regulatory framework to support NERL's financeability and capacity to invest in the longer-term. While short term affordability cannot be dismissed, the CAA should not prioritise this above the long-term needs of future users. The actions taken by the CAA in either its implementation of NERL's TRS mechanism or Heathrow's RAB adjustment could have long-term impacts on the ability to sustain service quality, invest in projects which benefit users in the long term and keep charges as low as possible at a time when encouraging demand is more important than ever.

8. Our response addresses the key points and policy issues raised by the CAA's consultation for the periods of 2020-2021 and 2022 onwards.

Adapting the current regulatory framework to take account of the impact of Covid-19 on the sector in 2020-2021

9. The impact of Covid-19 on the aviation sector was unforeseen and has been on a scale unlike any shock we have previously experienced. It has had a profound impact on the finances of companies across the sector. For regulated companies, this impact has not and could not have been reflected in the price controls set. This has had implications for financeability under these current price control arrangements.

Traffic risk sharing and reconciliation

10. NERL's TRS mechanism is clearly set out in the price control to form the basis of the risk to which NERL is exposed. Ensuring that this risk reward balance is not changed retrospectively will be key for ensuring future investor confidence.

11. As set out by the Competition Commission (CC) in its decision on Sutton and East Surrey's Substantial Effects Determination application, forcing a regulated company to take on more risk associated with external events than reflected in its price settlement could increase the forward looking cost of capital.[2] In its decision, while the CC ultimately decided not to implement an adjustment to SES' prices, it was clear that it could be in the interests of users

[2] Competition Commission, Sutton And East Surrey Water plc Interim Price Determination: Final determination, August 2009, paragraph 4.98

for prices to be increased in the short term if it avoided higher prices in the medium to long-term caused by a higher cost of capital.

12. In the case of NERL, its price control was calibrated taking into account the risk to which NERL is exposed. This was made clear by the CAA in both its RP2 and RP3 decisions, where it set out that the TRS mechanism led to NERL being exposed to less systematic risk leading to the need for a lower cost of capital:

RP2: "*PwC estimated NERL's beta by considering traffic risk for the UK (based on airport betas), the way in which this is dampened by the traffic risk sharing mechanism in the charging regulations"*[3]

RP3: "*The traffic risk sharing mechanism limits NERL's exposure to this systematic risk. This in turn reduces its required cost of capital, which is beneficial to users as the lower cost of capital flows through to lower charges"*[4]

13. By looking to retrospectively change its approach to implementing the TRS and potentially not allowing NERL to recover the full amount of revenue lost due to the impact of Covid-19, the CAA is retrospectively altering the amount of risk NERL's investors are expected to bear. Following the conclusion of the CC's determination on SES, this would logically lead to a higher forward-looking cost of capital.

14. In addition, the creation of a precedent where a UK regulator did not implement a clear ex-ante mechanism as promised to the detriment of the regulated company could undermine investor confidence in UK regulation more widely. The CAA should consider this issue carefully.

15. The CAA sets out that its considerations are based on the precedent set by Member States and the Commission regarding the implementation of TRS in Europe. However, unlike the case in Europe where the considerations revolve around cost baselines and recovery period, the CAA's consultation goes further, suggesting that full recovery of the shortfall as specified by the mechanism may not be possible.

16. This approach would have an impact not just on NERL's future financeability and cost of capital, but on investor perceptions of regulatory risk across the UK aviation sector as a whole. This will lead to lower investment and higher costs for passengers in the long term and would be incompatible with the CAA's duties and Better Regulation principles. The CAA's tunnel-vision on short-term affordability risks jeopardising the long-term interests of consumers.

17. We agree with the CAA that there is a real need to ensure that charges are affordable. This tension between affordability and financeability could be effectively balanced by implementing a longer recovery period for the lost revenues associated with TRS in 2020 and 2021. This can be achieved simply, as suggested by the CAA, by using NERL's RAB. This mirrors the approach suggested by Heathrow in our application for a Covid-related RAB adjustment.

[3] CAA, Draft UK Ireland RP2 Performance Plan – Consultation Document, paragraph E16
[4] CAA, CAP1830, paragraph 9.9

18. A longer-term recovery horizon would ensure that users are not forced to cover the full revenue requirement over the next few years, a period where ensuring that demand is encouraged through keeping charges as low as possible will be key. Instead the revenue requirement will be split more equally among future consumers.

19. Additionally, using the RAB, which is a stable regulatory construct, to make the adjustment will ensure that investors can have confidence that their investment will be remunerated in the future. This will help ensure that NERL's future cost of capital remains efficient.

Financeability

20. The CAA notes that *"if any acute financeability issues were to arise, we will consider appropriate regulatory actions in line with our duties"*[5]. However, it also notes that there are *"limits to these regulatory levers where passing additional costs and increases in charges to users would not be affordable".*[6] This statement, coupled with the CAA's proposals regarding the implementation of TRS and potential changes to the recovery of NERL's pension costs seems incompatible with ensuring financeability and tackling acute financeability issues as they arise.

Developing a future regulatory framework for 2022 and beyond

Policy considerations

21. The impact of Covid-19 on traffic volumes over the coming years remains unpredictable. We have set this out clearly in our December 2020 Revised Business Plan. However, as the CAA notes, there are a number of regulatory solutions which can help to manage this uncertainty going forward.

22. We agree that a clear risk sharing mechanism will be a key tool in ensuring that uncertainty can be managed and that the price control continues to remain fit for purpose. However, confidence in such a mechanism for the next price control is likely to be limited if the CAA fails to implement the previously defined ex-ante mechanism for 2020 and 2021.

23. We agree that forward looking changes such as the use of the RAB to smooth recovery in the case of large shocks could allow any forward looking TRS mechanism to work more effectively. However, there must be confidence that it will be applied as defined.

24. The CAA also discusses the difficulties in setting allowances for operating and capital costs due to this uncertainty. Heathrow's Development and Core capital governance structure, reflected in the more flexible capital arrangements adopted by the CAA for NERL in its RP3 proposals, will allow the price control and charges through the period to reflect only the capital invested and ensure that the capital allowance and plan can respond to uncertainty.

25. When considering efficiency incentives, it should be noted that NERL's TRS mechanism means that it does not recover 100% of the revenues lost versus forecast given the structure

[5] CAA, CAP1994, Page 16, Paragraph 1.11
[6] CAA, CAP1994, Paragraph 1.11

of the risk sharing bands in its framework. This creates an incentive for NERL to operate as efficiently as possible in the new demand environment.

26. Additionally, as set out in our RBP, there are a number of tools which can be used to manage opex forecasting in this uncertain environment while ensuring efficiency. These include:

    a. Using a driver-based forecasting methodology to ensure than on overall efficient cost base is maintained when demand and other drivers change; and

    b. Introducing pass through for key areas of unforeseeable cost, to ensure that users only pay for the costs incurred in these areas.

27. The CAA also sets out its ambition to maintain an efficient cost of capital for the next price control period. In its document the CAA acknowledges that Covid-19 is likely to have shifted both the perceived and actual risks in the sector. We agree with this assessment.

28. Market data clearly shows that investor perception of risk in the aviation sector has increased post-Covid. This will necessarily lead to an increase in the cost of capital for the next price control period.

29. In its assessment of NERL's cost of capital the CMA focused on data from AENA, AdP and Fraport. The impact of Covid-19 has led to a step change in the asset betas of these comparator airports. Since this time, asset betas have been relatively stable at this higher level. This represents a fundamental reassessment of the systematic risks of airports by investors, with airports now being viewed riskier than the market average. Given the CMA's view that the asset betas for airports were an appropriate estimate for the asset beta of NERL[7], this can also be seen as representing a changing view of investor perceptions of NERL's riskiness post Covid-19.

30. Additionally, the CAA's approach to regulation and its lack of consistency risks further increasing this perception of risk and driving up the cost of capital further. Regulatory consistency and stability are key inputs into assessment of risk by investors, as has been previously acknowledged by the CAA.[8] Should the CAA continue to damage investor confidence with its actions, this will necessarily have an impact on the cost of capital going forward.

Timing and duration

31. We agree with the CAA's assessment that a longer price control duration would have strong benefits in terms of regulatory stability and incentives. In our RBP, we identified the key benefits of a longer price control duration to be:

    a. Allowing for better smoothing of user charges across the regulatory period;

[7] CMA, NATS (En Route) Plc / CAA Regulatory Appeal, Provisional findings report, March 2020, Para 12.76
[8] CAA, CAP1510, paragraph 5.20: *"However, good regulatory practice does depend on regulatory stability and price controls not being subject to unanticipated change once set for a specified period."*

b. Ensures efficiency incentives function as planned within the price control to promote long-term change and investment;

c. Creates a longer-term planning horizon for investors to deliver recovery; and

d. Provides greater certainty and stability for investors with a long-term view of the framework for recovery.

32. We agree with the CAA’s more flexible approach to setting price control arrangements. Given the uncertainty the sector faces and that current price control arrangements are no longer fit for purpose, focus should be on establishing a new price control as quickly as possible which better reflects the current realities of the sector. However, this should not come at the expense of establishing a robust process.