Economic regulation of Heathrow Airport Limited: working paper on financial resilience & ring fencing

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's consultation of August 2019 on financial resilience and ring fencing for Heathrow Airport Limited (HAL) (CAP1832). It sets out the views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus and LEVEL.
2. It does not seek to comment on every point raised in CAP1832 - rather, it focuses on key issues; however, we may subsequently comment on others. For ease of reference, it broadly follows the structure of CAP1832. Emphasis is added, throughout.

Introduction & context

3. The CAA has omitted the term *'capacity expansion'*, something consistently included in the titles of its consultations on capacity expansion at Heathrow (LHR), from that of CAP1832. This isn't a frivolous observation; it goes directly to the CAA's statutory duties, one of which is the so-called *'financeability duty'*, which the CAA defines as having to *'… ensure that each licensee is able to finance its licenced activities'*.[1] This puts the most extreme interpretation on the scale of the CAA's financeability duty, which is in fact that it: '*… must have regard to the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted…*'[2] The CAA's undertaking to ensure that HAL can maintain licensed operations is highly questionable, whilst its artificial extension to the scope of the financeability duty to include capacity expansion is clearly wrong.
4. That it is seeking to artificially extend the scope of its financeability duty beyond HAL's licenced activities, to include capacity expansion, is a point that has been repeatedly put to the CAA by IAG, without any meaningful response. In particular, the issue was set out in detail in our submissions to the CAA's *'major consultation'* of March 2019 (CAP1782)[3] and its *'working paper'* of June 2019 (CAP1812).[4] Extracts of our responses are repeated at **Appendix 1** to this submission.

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[1] CAP1832, Appendix A, paragraph 5

[2] Civil Aviation Act 2012, section 1, paragraph (3) (a)

[3] Economic regulation of capacity expansion at Heathrow: policy update and consultation

[4] Heathrow expansion – affordability and financeability update

5. HAL's licenced activities are and will always be financeable, because the short run marginal cost (SRMC) is negative. The variable cost of facilitating every passenger is more than offset by revenue from airport charges and retail activities directly attributable to that passenger. So even if it found itself in financial distress, HAL (and any administrator) would always maintain the licenced activities.[5]

6. So, the hitherto unanswered question remains. With a financeability duty limited to HAL's licenced activities, having until now set no requirement for specific measures pertaining to financial resilience or ring fencing and with no financeability duty to capacity expansion, what has prompted the CAA to now seek such measures? In the absence of an alternative explanation, its overarching objective appears to be to protect HAL's shareholder returns from the negative effects of an inability to efficiently deliver capacity expansion. The cumulative effect of a lack of CAPEX scrutiny, a regulated rate of return far in excess of HAL's WACC and market confidence in the CAA's benevolent regulation, is that passengers' legitimate interests in cost-efficient capacity expansion are subverted, in order to guarantee that HAL can pay dividends.

7. The CAA has adopted an increasingly generous approach to HAL's expenditure on capacity expansion – something we described in detail in our response to the CAA's *'major consultation'* of July 2019 (CAP1819). An extract from our response is repeated at **Appendix 2** to this submission. Meanwhile, CAP1832 shies away from placing meaningful constraints on HAL's financing arrangements. HAL is effectively being invited to spend what it wants and to finance this how it likes.

8. What HAL wants is to inflate the RAB by spending as much as it can and what it likes is to be rewarded through the greatest differential between the regulated rate of return (set by the CAA) and its experienced WACC. One of the ways it does this is by leveraging capital structure. HAL is largely financed with debt, which is relatively cheap, because capital markets invest not in HAL's management, but in the regulatory certainty provided by a benevolent regulator. Debt markets are content with HAL's high gearing, because the CAA transfers such risks as exist onto consumers, meaning that a significant equity buffer (which would normally bear risk) is not required.

9. Much certainty stems from the CAA's continuing policy of setting a regulated rate of return based on a false gearing assumption of 60%, when it knows that HAL is far more leveraged and that its experienced WACC is much lower. The result is to provide far higher revenues to HAL than are required to service its debt and provide a fair

[5] It has been argued that SRMC is the wrong criterion, on the basis that infrastructure depreciates and must be continuously replaced. It is nothing to the point. First, any period of financial distress would be short-lived, because airports are strongly cash-generative; second, depreciation is not a *'cash flow'*, but an *'accounting construct'*, so SRMC is the right measure; and third, notwithstanding the above, the long run marginal cost (LRMC), which includes depreciation, is also negative.

shareholder return. The outcome is that bondholders are absolved of risk, shareholders are overcompensated and passengers pay the price.

10. With capital markets essentially investing in benevolent regulation, the CAA must ask itself whether one consequence, should it put meaningful constraints on HAL (for example, restricting its ability to pay dividends), would be that it faces a moral hazard.

11. The CAA understands capital markets' desire for certainty, but appears to seek to satisfy this by the latitude it gives HAL. It does not appear to have considered that whilst markets might react negatively to ex-post disallowance of CAPEX, no uncertainty arises from ex-ante CAPEX scrutiny. Indeed, we would argue that CAPEX having passed rigorous ex-ante scrutiny would provide markets with greater certainty than does the CAA's current *'laissez-faire'* approach. The correct approach, for which we have argued on various occasions, would be ex-ante scrutiny to bring discipline, rigour and certainty, followed by ex-post scrutiny to ensure these have been delivered.[6]

12. The proposals in CAP1832 make no mention whatsoever of keeping airport charges flat. We have repeatedly raised this point to the CAA, most recently in our submissions to CAP1782 and CAP1812. An extract from our latter submission is at **Appendix 3**. Meanwhile, the CAA continues to prioritise HAL's shareholders' returns over passengers' interests - and its current approach seems designed only to perpetuate this state of affairs.

Executive summary

13. CAP1832 fails to take into consideration a number of fundamental issues, including:
    - artificial extension to both scale and scope of the CAA's *'financeability duty'*;
    - an increasingly generous approach to HAL's expenditure;
    - the premeditated gap between HAL's regulated rate of return and its WACC;
    - a chronic lack of scrutiny/oversight of HAL's CAPEX programme; and
    - any ambition to keep airport charges flat.

[6] For example, see IAG submission to the CAA's Consultation on *'Core Elements of the Regulatory Framework to Support Capacity Expansion at Heathrow'* of June 2017 (CAP1541), paragraph 45. *"As the CAA points out, both ex-post and ex-ante scrutiny of CAPEX are required. In particular, rigorous ex-ante scrutiny (through an IFS) is absolutely crucial for investment of this scale – and will require much more detailed plans and costings than have so far been provided by HAL. That said; associated difficulties (not least in quantifying uncertain investment) will necessitate complimentary use of ex-post scrutiny, combined with some mechanism to return excess revenues from capital efficiency and/or over-forecast to customers."*

14. These matters have been repeatedly put to the CAA, without substantive response. It is unacceptable for a sectoral regulator to act as if these issues don't exist or to ignore the considered submissions of informed stakeholders. If the CAA disagrees with the points raised by IAG, it must say so – and it must say why. It does neither.

15. The remainder of this submission will address the CAA's more detailed and substantially less-significant proposals of CAP1832.

16. The CAA is vague about the problem it is seeking to solve by these proposals. It has neither stated clear objectives nor drawn independent conclusions on potential costs and benefits – and so has been unable to conduct any kind of impact assessment. Without taking proper account of the effects that its proposals may have on industry, it is hard to see how the CAA is balancing its duties.

17. The CAA does not say why it believes that any of its proposals would be effective in dealing with substantial financial distress – and it is far from clear that they would be. It does not suggest what mitigation measures might be available, should any of its proposals be triggered, while making no mention of alternative developers - and so the CAA appears to continue its support for *'HAL-only'* capacity expansion.

18. The CAA rejects the introduction of a **gearing cap**, on the basis that it would replicate existing conditions in HAL's bond documents. We agree – and note that capital market discipline has effectively optimised HAL's gearing, leading to a much more leveraged structure than assumed by the CAA in setting the regulated rate of return. By maintaining differential to experienced WACC, the CAA encourages HAL to spend as much as it can, as soon as it can – and puts the costs onto passengers.

19. The CAA also rejects a **prohibition on HAL disposing of its assets**, on the pragmatic basis that HAL has already mortgaged everything it has; however, what is unclear is why such a condition shouldn't be placed on new assets. There is no suggestion that the CAA has considered alternative mechanisms, such as special purpose investment vehicles, which have been used by other regulators. As it stands, the CAA's proposal would force passengers to fund capacity expansion, whilst allowing HAL to mortgage new assets to fund dividend payments. It is impossible to reconcile the CAA's policy in CAP1832 with its primary duty to protect the legitimate interests of passengers.

20. Recognising that strong and effective incentives already exist, the CAA is considering the introduction of an **obligation for HAL to maintain an investment grade credit rating**. The costs to HAL of losing its credit rating would outweigh any regulatory sanction that the CAA might conceivably impose - and so we see little benefit in this proposal, as it would not affect HAL's behaviour. The CAA suggests linking HAL's right to pay dividends to its maintenance of an investment grade credit rating. To an extent, this

would replicate market effects: when the cost of debt goes up, funds available to shareholders go down, but what the CAA doesn't say is what would happen to those funds. Presumably they would be paid as dividends, once an investment grade credit rating was reacquired. The CAA's proposal is simply to describe what HAL already has and may have in future, whilst presenting it as *'regulation'*.

21. The CAA proposes to extend HAL's existing **obligation for sufficiency of resources**, from existing operations to capacity expansion; however, there is no financeability duty to capacity expansion, while HAL's existing operations are and always will be financeable. The CAA does not suggest how it intends to determine and/or validate what resources would be required for capacity expansion. Its proposal would simply force passengers to fund whatever capacity expansion HAL decided to undertake, without specifying what such investment might be, or indeed requiring HAL to make any such investment.

22. Considering that a danger of financial distress might follow HAL disposing of assets and/or paying excessive dividends, the CAA proposes **compliance certification** requiring HAL to self-certify that its actions would not cause this, but doesn't suggest that it will restrict HAL's ability to do either or both. The CAA proposes to allow HAL to choose its own evidence base and how to test it, because it believes that HAL knows best and is anyway responsible for its own financial stability. This isn't regulation.

23. **Targeted curtailment of HAL's ability to make dividend & other payments** would be an effective tool, if the CAA did not resist linking it to efficiency and/or performance initiatives, suggesting that to do so would somehow interfere with HAL's debt financing arrangements. The initiative as currently described would simply preserve HAL's ability to continue paying dividends, so we cannot see a connection between its proposal and the outcome the CAA suggests it would achieve.

24. We agree with the CAA that it is appropriate to broaden the scope of a current requirement to not contribute to problems of financial distress, beyond HAL to be **ultimate controller undertakings**. The technical issue that CAA must resolve is transposition of the causal link between payment of dividends and financial distress. The philosophical question is why (and in what form) would it accept a *'good behaviour undertaking'* from a firm whose behaviour it has reason to doubt?

25. The CAA proposes improved **monitoring and information** requirements on HAL, equivalent those available to bondholders. We agree - and encourage the CAA to consider what actions it may take in the event of notification, but find it strange that it would consider regular meetings and access to HAL's senior management to be an *'enhanced information obligation'*.

Options for ensuring HAL has sufficient resources

Gearing cap

26. The CAA has concluded that the introduction of a gearing cap *'… would not be appropriate [because] similar tools are used in bond documents […] and are considered by credit rating agencies.'*[7] What the CAA seems to be saying is that there is no point in introducing a gearing cap, because for all intents and purposes, one is already in place.

27. We broadly agree; however, the bigger point is that WACC is a manifestation of the costs and risks facing a business – and in seeking to maximise shareholder value, HAL has adopted a capital structure intended to minimise its experienced WACC. An important aspect of HAL's capital structure are the assurances to which the CAA refers. So it is, in effect, capital markets that have decided the optimal gearing for HAL – and the CAA (rightly, in our view) appears to accept that this market discipline is more effective than would be a regulatory gearing cap.

28. It is somewhat incongruous therefore, whilst on one hand accepting that markets are the best discipline, that on the other the CAA indicates that it will continue to make a significantly more conservative gearing assumption: *'… a cap could […] be set at a comparatively high level (especially when compared to the* "nominal" *gearing level we propose to use in calculating the weighted average cost of capital)…'*[8]

29. In our submission to CAP1812, we pointed out that its modelling, the CAA had: *'… assumed a simple notional financial structure with gearing at no more than 60% [and had] not considered HAL's existing business securitisation…'*[9] We had previously raised a number of similar points in our submission to CAP1782, when we said: *'[i]t is all very well for the CAA to say that* '… it will remain the responsibility of HAL's management to decide on its actual financial structure and ensure that its business is financeable…'*; however, the CAA must set a notional WACC which it considers to be efficient. It must inform itself by, amongst other things, looking at HAL's actual capital structure and understanding what equity/debt ratios are achievable, as well as the true, post-tax cost of debt.'*

30. We do not endorse HAL's choice of gearing and note that it would be wrong for HAL to continue to enjoy the rewards of a manifestly conservative regulatory assumption, whilst the CAA seems bound to transfer overstretch risks onto passengers. As things stand, the CAA is allowing HAL a much greater return on equity than it is prepared to imply through the regulated rate of return, the outcome being that the existing gap

[7] CAP1832, paragraph 2.3

[8] Ibid, footnote 24

[9] CAP1812, paragraph 1.50

between this and HAL's experienced WACC is widened and so HAL is encouraged to spend as much as it can, as soon as it can, putting costs onto passengers.

31. The CAA lists a number of practical difficulties pertaining to the potential introduction of a gearing cap, including: *'… identifying an appropriate level…'*; *'... [removing] management and shareholder discretion…'*; *'… additional burdens and uncertainty…'*; and *'… the relationship with HAL's existing debt levels…'*[10] Whilst CAP1832 makes only passing reference, it concludes that *'… we do not propose to consider a gearing cap further*.'[11] Whilst not entirely agreeing that practical difficulties should preclude regulation where it is needed, because HAL's capital structure is subject to the influence of capital markets, the matter is academic.

Prohibition on asset disposal

32. The CAA concludes that the introduction of a prohibition on HAL disposing of its assets *'… would not be appropriate...'*[12], whilst making the point that such mechanisms are widely deployed in other regulated sectors, in order that: *'… the licensee's resources are also protected from falling into the hands of creditors.'*[13] It goes on to point out that: *'HAL's financing platform contains: fixed charges over all of HAL's significant assets, including shares held by HAL; and a floating charge over all of HAL's assets [which] severely limit the scope for an effective obligation [and that the CAA] would have to issue derogations for these arrangements or jeopardise HAL's existing and prospective financing….'*[14]

33. We are unclear what, if (as it says) HAL has already mortgaged everything it has to the debt markets, the CAA means by: *'… prospective financing…'*, unless it is to signal support for HAL's intention to similarly mortgage everything it is planning to build for capacity expansion. What the CAA does not explain is why, even if it would be impractical to put a prohibition on HAL disposing of existing assets, such a mechanism shouldn't be applied to new assets. The CAA simply says: *'[w]e do not consider this to be an appropriate or proportionate approach in the circumstances of capacity expansion.'*

34. In summary therefore, the CAA's policy is:

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[10] CAP1832, paragraph 2.5

[11] Ibid, paragraph 2.6

[12] Ibid, paragraph 2.8

[13] Ibid, paragraph 2.9

[14] Ibid, paragraph 2.10

- to force passengers to fund assets associated with capacity expansion, before they are able to derive any benefit;
- to give HAL absolute discretion over whether such assets are constructed;
- to allow HAL to allocate liens over those assets to debtholders; so that
- HAL's experienced WACC remains much lower than the regulated rate of return; and in this way
- continue facilitation of HAL's payment of excessive dividends.

35. It is impossible to reconcile the CAA's policy with its primary duty to protect the legitimate interests of passengers.

Obligation to hold an investment grade credit rating

36. The CAA says that: *'… an obligation in HAL's licence requiring it to (or a group company) to hold an investment grade credit rating could help bolster the credit rating obligations in HAL's financing platform and ensure that HAL has sufficient resources and manages its business in a financially robust way.'*[15] It concludes by saying: *'[w]e consider that there may be merit in the licence containing an obligation for an investment grade credit rating…'*[16] It is unclear why the CAA would think this is the case:
    - as the CAA recognises, strong incentives on HAL to maintain investment grade credit ratings already exist – and there is considerable evidence that they are effective, so there is no obvious reason to suppose that a regulatory requirement would provide a supplementary or greater (rather than a simultaneous, but slighter) inducement;
    - in circumstances in which HAL conceivably might fail to achieve investment grade credit ratings, the financial cost to its business would likely far exceed any regulatory sanction the CAA might impose – an eventuality which doesn't appear to have been considered by the CAA;[17] but in any case
    - credit ratings reflect the views of a small number of specialist firms, which take into account many factors outside the control of HAL.

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[15] Ibid, paragraph 2.12

[16] Ibid, paragraph 2.14

[17] The CAA does say that it may *'… need to address any increase in the risk of financial distress…'*; however, makes no allusion to its thoughts on how - in the absence of which our assumption is that its intention would be to increase HAL's revenues, rather than reduce its shareholders' returns.

37. Perhaps the most important benefit that might come from putting an obligation for an investment grade credit rating onto HAL, would be the suggested visibility it would provide to the CAA. There seems little requirement for such an obligation, because the CAA is perfectly entitled to require such visibility from HAL as and when it so chooses; indeed, for reasons that differ from those suggested in CAP1832, in our view the CAA would have been wise to pay more attention to HAL's finances than it has until now.

38. Credit ratings are issued by specialist agencies, which take into account many factors, so it is unclear how the CAA intends to operate a regulatory requirement: *'… focussed solely on the financial strength of HAL, without consideration of the complexities created by the financing platform…'*[18] The inescapable fact is that credit reference agencies do take account of all known complexities, so unless the CAA is anticipating somehow *'reversing out'* unwritten, nuanced, subjective and/or unquantified third party considerations, in order to arrive at its own *'vanilla'* credit rating, then its intention is unknown.

39. The CAA does not say how it would achieve it, but suggests that: *'… a credit rating obligation […] accompanied by a curtailment of HAL's right to pay dividends or make other restricted payments [would have] the potential to promote mitigating actions by management in the event that an investment grade credit rating were to become at risk.'*[19] Recognising that HAL's affinity to the payment of dividends is at the root of many problems, what the CAA is suggesting is to replicate effects that capital markets already deliver. In HAL's case, it is able to translate debt raised for expansion directly into dividends – and does so on the basis that the CAA will ensure that any shortfall in CAPEX will be covered by passengers.

40. It is straightforward mathematics that within any given revenue scenario, if the cost of debt increases then returns on equity will reciprocally fall. So, if HAL was to lose its investment grade credit rating, then its ability to pay dividends and/or make other restricted payments would be curtailed, because some of the money intended for that purpose would have to be redirected to increased obligations for servicing debt. What additional benefit might be brought by holding a *'regulatory mirror'* to this existing situation is unclear. The CAA does not elaborate on its plans for any residual free cash flow precluded from dividends, once increased costs of debt have been paid – and it would be little disincentive, if HAL were permitted to subsequently have unfettered access to these funds. In their absence, our expectation is that HAL would simply invest

[18] CAP1832, paragraph 2.15

[19] Ibid, paragraph 2.20

and/or reduce uptake of new debt, until such time as the required credit rating was reacquired, before reverting to pay (albeit, delayed) dividends.

41. There would be little benefit in requiring HAL to maintain an investment grade credit rating, while many of the associated problems dismissed by the CAA in this case are similar to those used to justify the rejection of other potential requirements.[20] We anticipate that of all the options for ensuring HAL has sufficient resources under consideration in CAP1832, a requirement to maintain an investment grade credit rating is the one that would have the least impact on HAL's *'business as usual'*. The point is underlined by the CAA when it says: *'… any such approach would need to consider how [to] take into account changes to the financing platform that HAL might negotiate with bondholders.'*[21] <u>The CAA's proposal is simply to describe what HAL already has and may have in future, whilst presenting it as *'regulation'*.</u>

Sufficiency of resources obligation

42. The CAA says that: *'… it is core to our aims of incentivising financial robustness […] that HAL has a robust obligation to have sufficient assets to operate the airport…'*[22] *It goes on to say that: '… we do not consider that the best way to achieve this is through either a minimum cash balance requirement or a restriction on asset disposals [but that] the sufficiency of resources obligation […] should clearly and transparently cover each of cash and liquidity facilities, as well as operational assets as well as all other assets.'*[23]

43. As the CAA points out: *'… HAL already has a licence obligation to maintain sufficient resources to operate its business [but that there is] a risk that it could be interpreted so as to mean a very low standard...'*[24] What the CAA does not make clear is why, in the absence of evidence that operating standards have been negatively influenced by HAL maintaining insufficient resources, it has changed its mind on the effectiveness of HAL's existing licence condition. Aside from this pre-existing regulatory obligation, in light of the strongly cash-generative nature of airports, there are compelling commercial

[20] For instance, both a **gearing cap** and **a restriction in the disposal of assets** are rejected for being respectively challenging in identifying an appropriate level and inappropriate and disproportionate, but the CAA dismisses problems of **an obligation for an investment grade credit rating** being expensive, unnecessary, confusing and inconsistent.

[21] Ibid, paragraph 2.22

[22] Ibid, paragraph 2.25

[23] Ibid, paragraph 2.26

[24] Ibid

imperatives on HAL to maintain sufficient resources to maintain operations to the required standards.[25]

44. It seems to us that the only plausible explanation for the CAA's proposal for a sufficiency of resources obligation is that HAL's concurrent investment in capacity expansion might lead to an insufficiency of resources. Whilst there may be foreseeable circumstances in which this might be the case, we would remind the CAA of two things:

    - the CAA's financeability duty does not extend to capacity expansion; and
    - HAL's licenced activities are and will always be financeable, because the short run marginal cost (SRMC) is negative.

45. The difficulty with the CAA's proposal for a sufficiency of resources obligation is that as long as HAL maintains an investment grade credit rating, its liberal dividend policy seems likely to endure and as long as the there is no gearing cap, it will continue to enjoy a rate of return well ahead of its experienced WACC - and so will continue to be incentivised to spend as much as it can, as soon as it can. It is in recognition of this reality that the existing licence condition, requiring HAL to *'… at all times act in a manner calculated to secure that it has available to it sufficient resources […] to enable it to provide airport operation services at the airport…'* is being extended to include capacity expansion – and in this way, ensuring it will be funded by passengers.[26]

46. The CAA specifically recognises that a sufficiency of resources obligation is intended for capacity expansion, when it says: *'… [it] might also require that any forecast projects or material capital expenditure projects […] should also be taken into account [but] it would not extend the obligation to requiring HAL to deliver substantial increases in capacity, such as the third runway and associated development…'*[27] It goes on to say that: *'… [w]e do not consider that this would add any substantial regulatory burden on HAL, given that [it] is implicit in its existing obligation.'* In reaching this conclusion, when it's proposals specifically increase the scope of a sufficiency of resources obligation to include capacity expansion, the CAA implicitly accepts that the additional burden will be borne by passengers. As it explains: *'… it would ensure that if HAL were to be delivering new capacity, it should have sufficient resources to do so.'*[28]

47. In summary, because the CAA protects HAL's dividends and rewards high levels of investment, a sufficiency of resources obligation would simply reinforce this state of

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[25] Not only to maintain passenger throughput, but also to achieve service quality standards, for which it is financially rewarded at levels above the costs of provision.

[26] Heathrow Airport Limited; Licence granted under the Civil Aviation Act 2012, paragraph E2.1

[27] CAP1832, paragraph 2.27

[28] Ibid, paragraph 2.29

affairs, whilst being funded by passengers. It would force passengers to fund whatever capacity expansion HAL indicates it will undertake, without specifying what such investment might be, or indeed requiring HAL to make any such investment.

Options for mitigating the impact of financial distress & providing information

Compliance certification

48. It is worth reproducing in full the CAA's rationale for considering this option, which is:
    - *'[a]nnual certification that the licensee has sufficient resources, together with the required supporting evidence, mitigates the likelihood and impact of financial distress by: providing assurance to the regulator that the management of the license is actively considering whether the business is financially robust; and requiring it to inform the CAA if this is not the case, better enabling it to develop and appropriate response if an issue arose.'*[29]

49. We would make the following points:
    - annual certification risks transforming what well-managed businesses ought to be doing on an ongoing basis into a *'standalone'* periodic task, which
        - might take place a considerable time after an issue became apparent to management - and so potentially be used to defend a lack of timely intervention/management inaction; and moreover
        - might unreasonably influence the timing of potential management action, if it was anticipated that it could affect the outcome of an annual review; however
    - implicitly the CAA doesn't trust HAL's management to consider its financial robustness in the absence of this obligation; which is
    - at odds with its apparent trust in HAL to report its own shortcomings, particularly with a threat of some form of sanction; but
    - the CAA doesn't indicate what form any sanction might take – and has seemingly not yet considered the question.[30]

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[29] Ibid, paragraph 3.4

[30] *"... better enabling it to develop an appropriate response..."*, ibid

50. The CAA again makes clear that it is considering this option solely on the basis of capacity expansion, for which it has no financeability duty.[31] It also reiterates its preparedness to force passengers to fund whatever capacity expansion HAL indicates it will undertake, without specifying what such investment might be, or indeed requiring HAL to make any such investment.[32]

51. The CAA explicitly recognises the timing problem set out above, when it says: *'… there may be some merit in requiring re-certification in the event of major disposals or prior material distributions to shareholders if those were to occur a significant time (such as six months) after the latest annual certificate.'*[33] In recognising the dangers of HAL disposing of assets and/or paying excessive dividends (both of which funded by passengers), the CAA's proposal is merely to require HAL to self-certify that its actions would not lead to financial distress, whilst making clear that it will not restrict HAL's ability to do either or both. This is not a robust approach to regulation.

52. It is interesting that in justification of its ongoing consideration of this approach, the CAA says that it: *'… would not, on its face, require significant additional compliance work from HAL.'*[34] In our view, there are bigger issues at play than HAL's convenience – or indeed, the CAA's. We do not agree that: *'… such certification has the potential both to promote mitigating actions by management and to stand in the place of investigatory and enforcement action by the CAA.'*[35]

53. If it was needed, further indication of the CAA's subcontracting of certification back to HAL is provided in a vague description of supporting evidence, including that:

   - *'[w]e consider that it is most likely to be appropriate for the board of HAL to determine what stress tests are appropriate for it to use in developing the evidence base to support its certification as it is best placed to assess this issue and has primary responsibility for the financial stability of HAL…'*; and
   - *'[w]e also think that the certification process can be used by HAL to provide a positive opportunity for it to conduct a formal forward looking annual* "health check" *on its own business.'*[36]

54. The CAA proposes to allow HAL to self-certify, choosing its own evidence base and how to test it, because it believes that HAL understands best what is required and is anyway

[31] Ibid, paragraph 3.5

[32] Ibid, paragraph 3.6

[33] Ibid, paragraph 3.9

[34] Ibid, paragraph 3.11

[35] Ibid, paragraph 3.12

[36] Ibid, paragraphs 3.14 & 3.15

responsible for its own financial stability. This has the obvious potential to provide false comfort to the CAA, further reducing its regulatory oversight.

Targeted curtailment of HAL's ability to make dividend & other payments

55. Curtailment of HAL's ability to make dividend payments would be an effective tool, if correctly targeted. It is unfortunate therefore, that the CAA resists linking this to efficiency and/or performance initiatives, while the only option for ensuring HAL has sufficient resources to which the CAA links this proposal is its maintenance of an investment grade credit rating, which (as described above):

    - would simply replicate effects that capital markets already deliver; and
    - does not elaborate on its plans for residual free cash flows, which would likely revert to delayed/index dividend payments.

56. It seeks to explain its position by saying: *'… the CAA's policy is not to develop policy options which would interfere with HAL's debt financing arrangements…'*[37] In the context of *'dividend and other payments'*, it isn't clear to us what this means, because debt is always serviced (pre-tax), while dividends are paid (post-tax), consequent on all other obligations having been satisfied. So unless it is thinking of default (which isn't suggested), the CAA does not explain why it considers that constraining HAL's ability to pay dividends could somehow impinge on its debt financing arrangements, but goes on to affirm that: *'… appropriate mitigation measures [must be] carefully designed not to interfere with HAL's financing arrangements.'*[38] In this single statement, the CAA acknowledges that it won't *'interfere with HAL's [existing] financing arrangements'* and it is consequently hard to understand what it is that it is planning to achieve.

57. The CAA continues to describe what it is unwilling and/or unable to do in relation to HAL's financing arrangements, for example that:

    - *'… the procedural safeguards of CAA12 mean that [investigation or policy development] may not be capable of being taken at a sufficient pace [while] HAL's board might come under pressure from shareholders, for example, to pay a dividend in circumstances where it was facing difficulties…';*[39] and

[37] Ibid, paragraph 3.16

[38] Ibid, paragraph 3.17

[39] Ibid, paragraph 3.18

- *'[a]ny step we take in this area should only lead to a limited and targeted curtailment of HAL's freedom of action…'*[40]

58. The CAA goes on to make the pertinent point that: *'… rules curtailing HAL's ability to make dividend and other payments could not be guaranteed to provide sufficient mitigation [but] would seek to preserve […] the financial position of the company, limiting the scope for shareholders to prioritise their interests over those of consumers…'*[41] This is the crux of the matter. Nothing in the CAA's proposal is likely to be effective, but would simply preserve HAL's *'financial position'* – and as it has repeatedly made clear, if HAL's financial position is unchanged, so will be its ability to pay dividends. So, whilst recognising its description of the problem, we cannot see a connection between the CAA's proposal and its suggested outcome, because *'preserving the financial position of HAL'* would not *'limit the scope for shareholders to prioritise their interests over those of consumers'*.

Ultimate controller undertakings

59. We agree with the CAA, when it says: *'[i]f HAL faces financial distress, it is appropriate to seek to ensure that other group companies do not contribute to the problems it faces.'*[42] We would go further and say that financial distress should not be initiated or perpetuated, in whole or part, directly or indirectly, by actions or omissions of other group companies. In our view, the onset of financial distress can (almost) always, ultimately, be traced to the payment of dividends, because if shareholders hadn't removed funds from an organisation, then it would still have them available. The issue which the CAA must resolve how to transpose the causal link between payment of dividends and financial distress into an *'ultimate controller undertaking'*.

60. The complexity of (and lack of transparency in) the structure of the group of companies of which HAL is part adds nothing to its function of running an airport. On the contrary, the objectives are purely concerned with capital – and this focus must add significant cost and/or deflect management attention from HAL's licensed activities. It is a subject on which we have previously commented – for example, in our submission to CAP1812, we said:

    - *'[t]he CAA raises an interesting question of* "… HAL's ability to service debt…". *As it will know, the vast majority of HAL's debt financing comes from Heathrow Funding Limited (HFL), while 100% of HAL's operating profits can*

[40] Ibid, paragraph 3.19

[41] Ibid, paragraph 3.22 – note: the CAA does not make clear what it means by *'financial position'*

[42] Ibid, paragraph 3.31

be written off against interest charged by HFL to HAL.[43] *It is therefore arguable that HAL has two functions - to inflate the RAB and to service debt interest; and also HFL - to issue debt & channel the proceeds to shareholders. The upshot is that between 2007 and 2019, HAL issued debt-financed dividends of £4.1bn; and*

- *'[c]ontinuing the theme, on 23rd July 2019 it was reported that HAL, Europe's busiest airport, posted a 4% rise in half-year revenue to £1.4bn and a pre-tax profit of just £7m (0.5%).*[44]

61. As the CAA points out, HAL is concerned that: *'… the CAA may be seeking to extend the scope of the definition of* "ultimate controller" *to its shareholders…'*[45] We are consequently unsurprised to learn that HAL has objected to the CAA's proposal: *'… to [define] the* "ultimate controller" *to make clear that it is the* "top" *holding company of HAL's group.'*[46] What is unclear from the CAA's description is:

    - how it will differentiate and/or define *'shareholders'* from holding companies, when the function of the latter is to act as the former; and
    - how its proposal will prevent payments of dividends to non-corporate shareholders of group companies which are not the *'ultimate controller'*.

62. <u>Technical issues aside, the fundamental question that the CAA must address in assessing the potential effectiveness of its proposals, is why it would accept a *'good behaviour undertaking'* from a firm whose behaviour it has reason to doubt – and how this could be given binding and/or legal effect.</u>

Monitoring & information

63. We note the requirement under which the CAA requires information from HAL is limited to the provision of regulatory accounts and sufficiency of resources certification, but that the CAA now wishes to: *'… facilitate [its] monitoring of HAL's financial health and develop a response to developing issues…'*[47] Whilst it indicates neither how it intends to measure *'HAL's financial health'* nor how it would approach *'developing a*

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[43] By means of a 'Public Infrastructure Exemption'(PIE)

[44] https://www.telegraph.co.uk/business/2019/07/23/heathrow-third-runway-done-deal-claims-airport-boss/

[45] CAP1832, paragraph 3.33

[46] Ibid, paragraph 3.34

[47] Ibid, paragraphs 3.36 & 3.37

response', we agree in principle that the CAA should have disclosure equivalent to that enjoyed by bondholders, specifically notification of:

- *'… trigger events or events of default occurring under the financing platform…'*;
- *'… any matter requiring creditor consent…'*; and
- *'… planned material changes to the financing platform…'*[48]

64. In supporting its proposal, we would encourage the CAA to take steps to ensure that it has the means at its disposal to take appropriate action, should any of the above be notified.

65. Finally, it appears strange that the CAA would say that: *'[e]nhanced information obligations could also require: regular meetings with the CAA; and access to HAL's senior management in circumstances of, and on matters relating to, the matter notified…'*[49] First, we consider it to be standard regulatory practice for the regulator to have regular meetings with a regulated firm; and second, a key characteristic of monitoring and information requirements is that they should extend beyond HAL to other group companies.

[48] Ibid, paragraph 3.37

[49] Ibid, paragraph 3.38

Appendix 1: the CAA’s financeability duty

IAG response to CAP 1782

Executive summary, paragraph 4

The CAA has taken on a role, over and above its statutory duty, to ensure the financeability of capacity expansion. It seeks to justify its position by simultaneously arguing that financing costs do and do not get passed through to passengers, and pays lip service to *‘affordability’*, focussing instead on ensuring that HAL’s shareholders are remunerated.

Approach to financeability, paragraphs 10 & 11

The CAA says that it will: *“… help ensure [HAL] can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed.”* This is not the duty imposed on the CAA, which is that it: *“… must have regard to the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted…”* So the CAA has no duty to help HAL raise large amounts of finance; it is an economic regulator, not a financial fixer. The CAA’s duties do not extend beyond being aware of (and by implication, sensitive to) HAL’s ability to finance current operations.

In reference to the Civil Aviation Act 2012, the CAA says: *“[t]his approach should also enable us to satisfy our duty under section 1(3)(a) CAA12 to have regard to the need to ensure that HAL is able to finance its provision of airport operation services at Heathrow (often referred to as the* ‘financeability duty’*)”*. In recognising that its chosen approach is incremental to its *‘financeability duty’*, the CAA explicitly recognises that it has assumed a role to ensure the financeability of capacity expansion at Heathrow, which goes beyond its *‘financeability duty’*.

Promoting economy & efficiency, paragraph 47

The CAA raises an interesting point, when it says *“… we propose to amend the draft efficiency condition to refer to the requirements of users (explicitly referring to both present and future users) and acknowledge the need for HAL to be able to finance its activities at Heathrow, in line with CAA12.”* As previously discussed, the CAA’s *‘financeability duty’* extends no further than HAL’s current activities and goes no deeper than *‘having regard to’* these. So, the CAA owes no financeability duty to future users, only a duty to further their interests once they become future users; however, not to ensure that they do. So, whilst we agree *that “… HAL’s approach should represent value for money for users in both the short and long term…”*, it is not the CAA’s responsibility to replace capital paid out in dividends, by

means of an artificially increased regulated rate of return. Specifically, the CAA must not muddle financeability of current activities with that of capacity expansion.

Alternative delivery arrangements, paragraph 49

It is interesting to contemplate the contrast between HAL's performance in terms of sharing information about its own plans and its view that the CAA has a duty to ensure financeability. It states that *"… third party providers should be required to demonstrate real prospects for viability, financing and rapid development of expansion proposals [and that] the CAA should set out a meaningful timeline for testing the credibility of Arora's proposals…"* HAL goes on to say that *"… innovations in the regulatory framework should only be introduced if they are in the interests of consumers."* This is an open-ended *'get out'* clause, in case Arora is able to prove that it has met whatever subjective and unequal targets HAL is able to persuade the CAA to set.

IAG response to CAP 1812

Introduction & context, paragraph 5

In our response to its recent consultation (CAP1782), we explained that the CAA has taken upon itself a non-statutory duty to ensure the financeability of capacity expansion. The focus appears to be on guaranteeing HAL's shareholders' remuneration, despite Government's recognition that affordability means holding airport charges flat.

Assessment of affordability & financeability, paragraph 34

We note that the CAA continues to rely on a primary duty to consumers as justification to: *"… demonstrate that the regulatory framework supports financeability so that HAL can continue to access cost effective investment grade finance."* We have addressed this point fully and on several occasions, including in our response to CAP1782. The CAA is yet to respond to the issues we raise, so they are repeated here:

- *"The CAA says that it will:* '… help ensure [HAL] can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed.' *This is not the duty imposed on the CAA, which is that it:* '… must have regard to the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted…' *So, the CAA has no duty to help HAL raise large amounts of finance; it is an economic regulator, not a financial fixer. The CAA's duties do not extend beyond being aware of (and by implication, sensitive to) HAL's ability to finance current operations.*

- *“In reference to the Civil Aviation Act 2012, the CAA says:* ‘[t]his approach should also enable us to satisfy our duty under section 1(3)(a) CAA12 to have regard to the need to ensure that HAL is able to finance its provision of airport operation services at Heathrow (often referred to as the ‘financeability duty’)’*. In recognising that its chosen approach is incremental to its* ‘financeability duty’*, the CAA explicitly recognises that it has assumed a role to ensure the financeability of capacity expansion at Heathrow, which goes beyond its* ‘financeability duty’*.*
- *“Notwithstanding the damaging consequences of how the CAA’s position affects HAL’s behaviour, the CAA segues towards a consumer benefits justification. On one hand, it takes a view that finance costs do not find their way to passengers:* ‘… [helping HAL] raise the relatively large amounts of capital necessary to allow capacity expansion to proceed […] should deliver benefits to consumers in terms of greater choice, less delay and lower fares…’*. In its very next breath, the CAA argues in the opposite direction:* ‘… [an incentive package would not] inappropriately raise [HAL’s] financing costs and, so, prices to consumers’*. The CAA cannot have it both ways: either financing costs are passed through to passengers, or they aren’t. They are.”*

Appendix 2: the CAA's approach to CAPEX

IAG response to CAP 1812

Introduction & context, paragraphs 8 & 9

HAL has failed to justify its proposed expansion costs. HAL's estimate of £265m for Category B costs (costs incurred specifically and directly in support of the DCO application) has doubled since February 2017, in response to which the CAA now proposes the introduction of a 'review point' at £500m+, above which HAL is invited to justify further expenditure.

A *'subset'* of *"early Category C costs"* (construction costs incurred before the granting of a DCO) has been added to Category C costs (construction costs typically incurred after the granting of a DCO). In April 2018 these were estimated by HAL to be £650m, by October this had risen to £1.6bn, while currently HAL puts these at £2.8bn. Furthermore, the CAA suggests that this figure may have to increase.

IAG response to CAP 1819

Introduction & context, paragraphs 2 to 5

HAL's confidence that it will be allowed to realise a generous return on whatever it spends is grounded in its belief in a benevolent regulator. HAL's spiralling estimates of early expenditure (now up to £3.3bn) are uncontrolled - and we have no confidence that its management can deliver the expansion on budget.

HAL's original £14bn forecast would deliver both the runway and new terminal capacity (T6A or T5XA) by 2026. HAL's new version of £14bn by 2026 only delivers the runway. This change in scope is significant as it reduces the available airport terminal capacity at runway opening, increases the total cost of the original scope by up to £3bn taking it above £17bn, and creates a greater affordability challenge as new passengers start using the runway much later.

HAL's confidence in future benign regulation is exemplified by public statements that it is beyond challenge: *"Heathrow expansion is* 'a fait accompli' *and will be a* 'critical part of any new prime minister's agenda'*, the airport's chief executive has said. John Holland-Kaye said plans to build a third runway were already underway as he warned off Tory leadership frontrunner Boris Johnson from interfering. He refused to reveal when he last discussed the plans with Mr Johnson but insisted the project* 'is now happening'*."*

The CAA appears to have adopted a lenient approach to HAL's escalating CAPEX, forgiving inefficiencies in Cat B spend, presiding over ever-increasing cost estimates and an unclear approach to risk, whilst putting both costs and risks onto consumers. This means that customer interests could be subsumed to HAL's shareholder interests.

Appendix 3: keeping airport charges flat

IAG response to CAP 1812

Executive summary, paragraph 9

The CAA continues to differentiate between financeability, affordability and holding charges flat; however, in our view, the three are effectively the same thing. Suppliers of unaffordable goods are unfinanceable, whilst Government has said that affordability means keeping charges flat. If the CAA has a different view, it should properly explain the basis on which is making such distinctions.

Updated assessment of affordability & financeability, paragraphs 16 to 18

In our response to the CAA's most recent consultation (CAP1782), we also explained that *'affordability'* and *'keeping charges flat'* are the same thing – not only in our view, but in that of the Secretary of State. On 24th May 2018 (the eve of a Parliamentary vote on Heathrow expansion), the Secretary of State for Transport, The Rt Hon Chris Grayling MP, gave a speech to industry, in which he said, *"[i]t remains one of my fundamental priorities to deliver the ambition I set in 2016 – to keep airport charges as close as possible to current levels – so price increases are not passed on to airlines, and ultimately consumers."*

This was followed by a Statement to the House of Commons on 5th June 2018, in which he said: *"[e]xpansion must also remain affordable to consumers. We took a bold step when I asked the industry regulator, the Civil Aviation Authority (CAA), to ensure the scheme remains affordable while meeting the needs of current and future passengers."*

Nothing changed in the period between the Secretary of State's speech to industry and his Statement to the House of Commons; on both occasions he was addressing the same issue and making the same points – so it is consequently clear that affordability requires that airport charges remain flat. The CAA should either accept or rebut the point, but ought not to ignore consultation responses from informed stakeholders.