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Paul Smith
Group Director of Consumers and Markets
Civil Aviation Authority

11th June 2021

Sent by email to: paul.smith@caa.co.uk

Dear Paul,

Re: CAA CAP2140: Heathrow's request for Covid-19 related RAB adjustment

Thank you for setting out your decision on HAL's request for a Covid-19 related RAB adjustment in your recent CAP2140; on behalf of all airlines operating at London Heathrow, we would like to set out our view on this decision, and our position in advance of initial proposals for the H7 price control.

Regulatory Intervention

Our understanding is that the CAA have decided to make a £300m intervention (in 2018 prices) to adjust Heathrow's Regulatory Asset Base ("RAB") on the basis that:

a) This will prevent a higher cost of debt finance arising in Heathrow's "notional" company, enabling the notional company to continue to access cost-effective investment grade debt finance;

b) It will incentivise additional investment by HAL during 2021, creating an expectation that HAL will be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity for a higher than expected increase in passenger traffic during the remainder of 2021; and

c) You will take further steps to protect consumers by conducting a review of these matters should HAL fail to deliver on quality of service

As will be clear from the positions that the LACC, AOC and numerous airlines operating at Heathrow have set out since HAL first requested a RAB adjustment in mid-2020, we have remained fundamentally opposed to any RAB adjustment that would compensate HAL for its losses as a result of Covid-19, not only as a result of the negative effect on economic incentives that would result, but also due to the precedent that would be created through the use of the RAB in such a manner.

Our opinion has remained that the RAB is used either as a mechanism for logging up of efficiently-incurred capital expenditure to form the basis of charges of future regulatory periods, or for smoothing Heathrow's revenue through NPV-neutral adjustments that might be made to the price path to ensure charges remain affordable.

We therefore welcome the CAA's consistent and now final rejection of HAL's arguments that it should be compensated for revenue losses[1] and applaud the statement that the CAA "disagree[s] with HAL that it is a fundamental principle of UK regulation that companies are guaranteed a recovery of regulatory depreciation"[2]; we agree that "no explicit protection for regulatory depreciation was built in to the regulatory regime for airports in the CAA12 (the Civil Aviation Act 2012) or Q6/iH7"[3]

Our view is that these matters can only be considered as part of the H7 periodic review, and recognise that the intent of this early intervention is intended to support the H7 package, acting to "reduce Heathrow's notional company gearing below an important threshold used to assess consistency with strong investment grade finance"[4], which serve to set a reasonable expectation that "the benefits to consumers from a lower cost of capital and greater service quality in H7…outweigh these cost from the RAB adjustment"[5]

We further note that regulatory depreciation is neither separable from the other building blocks of a price control ex-post once it has been set, nor is it not appropriate to later attempt to distinguish between them when HAL is remunerated through the WACC to hold volume risk on the revenue requirement in aggregate.

We therefore disagree that HAL has raised any valid question over future recovery of regulatory depreciation either in full or in part under a price cap regulatory regime with volume risk once it has been established as part of a price control.

H7 cost of capital

We agree with the CAA that issues raised by Covid-19 can only be considered within the context of the whole of H7, and any solutions – such as traffic risk sharing alongside this targeted RAB adjustment – that reduce the risk HAL faces, must manifest themselves in a way that allows "consumers to benefit from a lower cost of capital in H7"[6]

Given that the decision will be reflected in the modifications made to HAL's licence to implement the H7 price control, which we anticipate will come into effect in 2022, and that those other aspects of H7 will not be finalised until later this year or early 2022, we therefore cautiously reserve final judgement on the CAA's early intervention until we can assess the H7 price control as a package.

[1] Heathrow Airport Ltd, Application for Covid-related RAB adjustments, 21st July 2020
[2] Civil Aviation Authority, CAP2140 paragraph C39
[3] Civil Aviation Authority, CAP2140 paragraph 3.24
[4] Civil Aviation Authority, CAP2140 paragraph 26
[5] Civil Aviation Authority, CAP2140 paragraph 31
[6] Civil Aviation Authority, CAP2140 paragraph 5

It is clearly important to ensure that the notional company is able to efficiently finance its activities; we note the CAA estimate that gearing of the notional company would have increased to just over 70% in 2021 from 60% prior to Covid-19 as a result of the fall in demand[7]

Furthermore, we note that credit ratings agencies have signalled 70% as a threshold level beyond which credit ratings might be downgraded, and that the CAA aim to provide a strong signal to the market that the notionally-financed company should be regulated in a manner consistent with accessing cost-effective investment grade debt finance[8]

It therefore appears reasonable to expect that this intervention, which provides an estimated 2% headroom to this threshold level, would control any rise or even reduce the Weighted Average Cost of Capital ("WACC") to a level below what was expected for H7 before Covid-19 occurred, resulting in a net benefit to consumers from having made this adjustment through the H7 package.

Given the ongoing nature of the H7 periodic review, we appreciate that the CAA's decision on an early intervention involves an element of judgement at this stage prior to crystallising views on the remainder of the building blocks, incentives, and implementation of any risk sharing mechanisms; we welcome the comment that the CAA "may consider partially offsetting any adjustment in order to take account of HAL's outperformance against assumptions used for the Q6 price control"[9]

Nevertheless, it is reasonable for us to expect that the H7 package can demonstrate that both this RAB adjustment – along with any further adjustment and other measures introduced to control risk within the H7 package – should be clearly and transparently attributable to a WACC reduction and net reduction of consumer charges, an expectation clearly set out in the CAA's publication[10]

The relevant WACC in this case is that indicated early in H7 process by CAA, CMA and CEPA analysis, informed by the RP3 periodic review of NERL and settlements in other UK sectors, rather than the existing and outdated WACC underlying the Q6 settlement

Whilst we note the CAA view that it "would be undesirable for us to reverse interventions we make now during the H7 process"[11], we would like to understand what will happen to the adjustment in the H8 or H9 periodic review; once appropriate gearing is restored in the notional company, might it be reasonable to assume this and any other RAB adjustments are subsequently reversed once they have fulfilled their purpose?

We believe that this should be the case, since the consumer would otherwise be paying in H8 and beyond for support of the notional company that is no longer required; this will have spill-over to HAL's actual financing elevating the RAB for longer than is necessary.

Similarly, we would like to seek clarity over whether the additional investment of £230m – that HAL has persuaded the CAA will occur should any RAB adjustment take place – would be substituted for this RAB adjustment, such that consumers are not paying twice for the benefit of such investment.

[7] Civil Aviation Authority, CAP2140 paragraph 4.12
[8] Ibid.
[9] Civil Aviation Authority, CAP2140 paragraph 4.28
[10] Civil Aviation Authority, CAP2140 paragraph 3.62
[11] Civil Aviation Authority, CAP2140 paragraph C20

We agree with the CAA that the risk allocation for H7 is extremely important, determining allocation of risks between HAL and its customers, and setting a level of allowed return consistent with the risks that HAL has to manage but that is no higher than is necessary to fund an efficient level of investment.

Service quality & investment

In addition, the CAA state that the decision to adjust the RAB should signal "to HAL the importance of maintaining appropriate investment and service quality levels", alongside "providing strong incentives and financial capacity for HAL to be proactive in planning for potentially higher than expected traffic levels"[12]

We welcome the additional protections the CAA has introduced, which might result in the CAA "reducing the £300m RAB adjustment or making offsetting reductions to revenue"[13] should evidence emerge of HAL failing to deliver on an appropriate quality of service in 2021

In terms of capital expenditure, we note that HAL has persuaded the CAA that it intends to make additional investment of c.£230m (£218m in capex and £9m in opex)[14] should it have appropriate incentives; we agree with the CAA that its intervention should provide a strong and clear incentive to:

a) Undertake any necessary investment;
b) Maintain service quality; and
c) Provide necessary capex in 2021

Whilst we maintain the position that – as noted by the CAA – "HAL already faces incentives to undertake necessary investment through including efficient investment in the RAB and earning an allowed cost of capital"[15], we expect the contingent nature of the CAA's intervention applied alongside incentives from the SQRB regime to incentivise Heathrow to invest as indicated whilst accommodating:

a) Any "lumpy" recovery of Heathrow's passenger traffic
b) Delivery of service quality as traffic recovers
c) An uncertain pace of recovery for some time

It is our expectation that HAL delivers on these commitments, returning terminal capacity to active status at an appropriate time to ensure passenger service is not compromised in any aspect of its operation, and in the CAA's words "taking proactive steps to prepare for a higher than expected increase in passenger traffic"[16]; we will be collating evidence in this regard throughout 2021; in particular we expect to see HAL act to ensure:

a) Terminals 3 and 4 re-open in advance of rising passenger numbers;
b) Airlines are promptly returned to their home terminals, able to access their property and provide a full level of service to consumers;
c) Address bottlenecks that exist in the infrastructure;
d) Work with service providers and partners to alleviate emerging issues; and

[12] Civil Aviation Authority, CAP2140 paragraph 24
[13] Civil Aviation Authority, CAP2140 paragraph 32
[14] Civil Aviation Authority, CAP2140 paragraph 4.15
[15] Civil Aviation Authority, CAP2140 paragraph 3.39
[16] Civil Aviation Authority, CAP2140 paragraph 4.22

e) Work with the Department for Transport to ensure Border Force are fully resourced to meet expected demand

The existing Service Quality Rebates and Bonuses ("SQRB") scheme provides some protection from HAL excessively reducing operating expenditure, however it only covers limited aspects of HAL's infrastructure; we will be documenting and providing the CAA with evidence of any under-investment or lack of service quality to support its review, and look forward to any additional guidance provided as part of the H7 periodic review.

We remain available and welcome the opportunity to discuss further the points and questions raised within.

Yours sincerely,

Gavin Molloy
Chair – LACC
London (Heathrow) Airline Consultative Committee

Nigel Wicking
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