

Virgin Atlantic Airways response to the CAA's consultation

Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues

Introduction

1. Virgin Atlantic Airways welcomes the opportunity to respond to the CAA's consultation, Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues (CAP1876).

In summary

1. In January 2020, the CAA published CAP1876. The purpose of this document is to consult further on some elements of the regulatory framework and on issues around assessing the financeability of Runway 3. The judgement by the Court of Appeal on 27th February means much of the content of CAP1876 has been superseded. However, we have provided a full response, ignoring the implications of the judgement, to offer the CAA useful, actionable feedback should they require it in the future.
2. The CAA sets out several fundamental aims for the regulatory framework:
 - Aim 1: create a framework that enables the efficient delivery of capacity expansion;
 - Aim 2: deliver affordable charges in the H7 price control period;
 - Aim 3: provide reasonable assurance about longer term affordability;
 - Aim 4: enable efficient equity financing, risk allocation and incentives;
 - Aim 5: expose debt finance to risks consistent with a low cost of debt.
3. Overall these aims are sensible and appropriate but, as with all things in this process, it is the detail that is important. CAP 1876 then moves on to consider three main topics:
 - incentives for capital efficiency;
 - allowed return (WACC);
 - the regulatory framework and financeability.
4. The remainder of this response addresses these chapters in turn.

Chapter 1 - Incentives for capital efficiency

5. The issue of ex-ante capital efficiency incentives was previously raised in CAP1782 (March 2019). The CAA suggested strengthening existing arrangements with new incentives under which HAL would bear a pre-determined share of any under/overspend against the capital expenditure baseline used to set the price control.
6. We noted in our response to CAP1782 that it should already be in HAL's best interests to manage a 'faster build and lower costs' scenario for R3, as the amount of debt needed would reduce and HAL would be provided with quicker financial returns from the capacity expansion. However, we also noted that if it can be clearly demonstrated that ex-ante incentives would be likely to protect consumers from the risks of capital cost escalation, we would be open to exploring the idea further. Although we were concerned about the risk of ex-ante incentives overcomplicating the regulatory process or leading to regulatory 'gaming' in the prior estimation of costs. We welcome the CAA's recognition of some of the practical challenges involved in developing new efficiency incentives and that further work would need to be undertaken as to how these would work in practice.
7. Although the CAA notes that a range of views were expressed by stakeholders in response to the previous consultation, most of these views appear to have been sceptical of how additional ex-ante incentives would work and clear that further analysis was needed. Indeed, in general stakeholders suggested that that, unless it is clear that tangible benefits would be likely to accrue to users, the CAA should focus on making existing processes work better and rigorously assess expenditure, only allowing efficient spending into HAL's RAB.
8. However, in CAP1876 the CAA clearly disagrees with much of the consultee responses. It acknowledges the desirability of more effective retrospective reviews of capital efficiency but is not persuaded that "sole reliance on such an approach represents a practicable or effective way forward"¹. The CAA notes the aspiration of airlines for it to rigorously scrutinise cost forecasts but believes that without a further commercial incentive on HAL not to understate its cost forecasts, it would be able to provide less assurance on affordability.
9. We are not opposed to the introduction of new capital efficiency incentives, but without further examination of specific proposals, and clear understanding of how they would work, we cannot commit to supporting the concept at this stage. We acknowledge that the CAA has set out a plan to consider issues such as the treatment of different cost categories, prioritising delivery obligations, how to establish the correct baseline, and how to accommodate any changes in design (scope or timing) and the process for assessing and adjusting for outperformance or underperformance.

¹ CAP1876, para. 1.10

10. We agree that these issues are extensive and complex and will be difficult to assess. We also believe that the CAA needs to be mindful of the risks of overcomplicating the regulatory process such that the burden of process outweighs the benefits it is intended to deliver. Furthermore, there is a risk of regulatory ‘gaming’, which we noted in response to CAP 1782 but which the CAA has not specifically acknowledged, in which the process could be open to manipulation by HAL.
11. We note that the CAA intends to publish further information on its approach to new capital efficiency incentives in the Spring of 2020 and we look forward to considering the CAA’s more detailed proposals.

Chapter 2 - Allowed return

12. We agree that the allowed return is a key component of any regulatory determination and even more significant in the context of capacity expansion. However, we are concerned that the reasons the CAA give for the importance of the cost of capital (WACC), as set out in paragraph 2.1 of the consultation, are entirely focussed on the returns to shareholders and investors and the risks they bear. The CAA state that:

“We are ultimately seeking to estimate a cost of capital sufficient to reward investors for an efficiently financed project, taking account of the risks that they will have to manage and incentive arrangements that will be part of our price control proposals.”²

13. The CAA’s statutory primary duty is to further the interests of users of air transport services. Of course, it is in the users’ interests to see an efficiently financed project that will deliver the third runway as quickly as possible promoting further competition and lower prices for consumers. However, there is no acknowledgement anywhere in chapter 2 of the impact that the cost of capital has on the price cap or the charges users will have to pay through airport charges. This is a key consideration in setting an appropriate WACC and an omission from the CAA’s thinking as presented in this consultation.

Determining the cost of equity finance

14. The CAA’s analysis around the cost of equity finance is focused on considering how expansion will impact on the required cost of equity. Several reasons are cited why expansion could potentially impact on cost of equity:
 - the asymmetric nature of construction risks and the consequent potential for sizable cost overruns;
 - potential increased variance in returns;
 - the potential for longer term risks, notably increased traffic risks in the future.

² CAP1876, para. 2.3

15. We agree that these are areas worthy of consideration. However, it is the extent and likelihood of these risks that are key and, based on the evidence so far presented, it is not possible to come to a view.

16. The CAA has set out two potential avenues for seeking to quantify this effect:

- scenario analysis;
- benchmarking of required returns

We consider these further below.

Scenario analysis

17. We are supportive of scenario analysis to understand how much risk HAL would face through capacity expansion. However, we would like to further understand the inputs, the scenarios and the sensitivities to these scenarios as these could strongly influence the perceived risk faced by HAL and therefore any cost of equity uplift.

Benchmarking of required returns

18. At present, we are agnostic as to PwC's estimate of an uplift between 0.25% and 1%. We would like to see the more detailed evidence. However, we do recommend that in considering the uplift in the cost of debt components (discussed further below), that the final required returns should also consider upward adjustments being made in other aspects of the cost of capital. We understand that financeability is key, but not over rewarding the shareholders must also be a central consideration.

Determining the cost of debt finance

19. The CAA has identified that around £16 billion of new debt will need to be raised by HAL. It goes on to note that there are limits to the liquidity of sterling debt markets and hence access to non-sterling markets is likely to be increasingly important. It notes HAL has previously cited this as a reason why it must retain an A- credit rating. We have not yet seen convincing evidence to support the need for retention of an A- rating.

20. The CAA considers a number of methods to ensure that the H7 price control's treatment of debt costs is more effective than that used in Q6. We welcome this approach particularly given the substantial windfalls achieved by HAL in Q6 through factors outside its control, we comment on a number of these issues below.

Debt indexation, limited pass through and tramlines

21. The CAA appears to prefer the tramlines approach in setting the cost of new debt finance, which involves setting a cost of debt annually based on an index and then defining an upper and lower band around the central cost. If that band is crossed (above or below), the

change in HAL's cost of debt would be added to the determined cost of new debt, so that the benefits and the higher cost of debt can be shared with the users in both directions. We understand this logic but have some concerns.

22. HAL has now raised so much debt that the CAA now appears concerned about the financeability of capacity expansion. We do not believe the upward risk caused as a result of HAL acquiring additional debt (such as the debt acquired as a result of leveraged buyout) should be paid for by the users. We need to understand the exact proportion of debt that supports the RAB and users should only pay for the risks related to this debt. If a tramlines approach were used, we suggest that a degree of asymmetry should be applied, with HAL bearing greater risks, reflecting the potential issues caused by its previous strategy.
23. With regard to debt indexation and limited pass through, we do not share the CAA's concerns. In the context of non-sterling debt, we understand this would be priced slightly lower to overseas investors as they do not take the additional risk of investing outside their domestic currency. The risk-based pricing system of sovereign risk, credit risk, liquidity risk, operational risk and financial risk would also apply here, but with an additional foreign exchange risk, which is now borne by HAL. Also, we do not see any perverse incentive for HAL at this stage to artificially raise the cost of debt in a limited pass through mechanism by borrowing longer term debt. It is in HAL's interest to secure very long-term debt to improve its short-term working capital management and display its financeability to lenders. Long term debt risk is usually dealt with via inflation linked bonds. HAL is best placed to decide on its financing strategy. We believe it is already in HAL's interest to achieve efficient debt financing.

Nominal debt costs

24. The CAA has suggested the use of nominal debt costs for part of the debt to replicate a smoother transition from RPI to CPI usage in H8. We agree with the use of this nominal debt if it only applies to part of the debt and not all. However, we do need a clearer understanding from the CAA regarding the range or roughly the proportion of new debt at a nominal rate. We agree this could potentially be another tool to improve HAL's financeability, especially during later stages of H7 where the issue of financeability is more likely to come up and is also closer to the transitioning period between RPI and CPI.

Liquidity costs

25. We understand the need for sufficient liquid funding for such a large-scale investment programme. However, we do not see the need to switch from a general transaction cost of debt approach, which includes liquidity costs, to a specific liquidity cost as a separate transaction cost for debt. We need more information on the proportion of liquidity facilities

that would be used over time and thus the cost of this funding, which we believe should only be measured as the proportion of the total debt to be raised.

Embedded debt costs

26. Considering the magnitude of the new debt that is to be raised, we believe both the weight and the cost of embedded debt should drop as new and refinanced debt gets added into the capital structure. We look forward to CAA's proposals on this matter.

Determining allowed tax costs

27. We are indifferent to the treatment of tax, whether it is embedded into the cost of capital components or treated separately. We do see the merit in using option 2, where there would be a separate tax allowance estimated and the WACC would be calculated on a vanilla basis. The vanilla WACC will allow all the stakeholders to focus purely on the risk and the returns without having to further adjust for tax.

Tax clawback mechanism design

28. We commend the CAA for recognising that HAL have been taking advantage of the tax-deductible benefits of gearing and we agree that this benefit should be shared with consumers in the form of reduced charges.
29. The creation of such a mechanism is, however, complicated, as it is a very subjective definition of the gearing over and above the set notional gearing. For this mechanism to be effective, we would need to understand what the modelled interest rate would be, for the CAA to compare against HAL's actual interest rates. The mechanism suggests that the tax benefits would only be computed if the actual interests are higher than the modelled interest rates.
30. The CAA has suggested the use of a "dead band" in the mechanism as there may be an over-reimbursement of tax benefits back to consumers in some circumstances, which may potentially raise the issue of financeability. This appears sensible but further detail on its operation is needed.
31. Our view on the adjustment method is that the clawback should be applied to HAL's revenue rather than the RAB, as this clawback would then be reflected on to passenger charges more directly. However, we understand that the alternative could be helpful in terms of financeability because the application of the tax clawback to the RAB would reduce the return of and on the RAB, ultimately reducing charges in smaller increments but over a longer period.
32. Overall, we would like to understand the entire clawback mechanism in more detail, including suggested quantitative examples. We are supportive of the general concept of clawing back the additional tax benefits to HAL as a result of its gearing. However, we are

also mindful that the mechanism should not disincentivise HAL from raising finance to support expansion.

Uncertainty mechanism for tax

33. Regarding the uncertainty mechanism for tax, we anticipate that the tax changes at an operational level would be more marginal as things stand now. Therefore, the windfalls or losses to HAL should also be marginal. However, if the regulatory framework does increase to beyond five years, there is likely to be more uncertainty over tax rates and tax laws and, therefore, an uncertainty mechanism would be appropriate.

Chapter 3 - The regulatory framework and financeability

Longer term regulatory certainty

34. Longer-term regulatory certainty is key to achieving affordability and financeability as businesses favour certainty. However, we need to be mindful of the inefficiency cushion a longer regulatory period could provide which would lead to unnecessarily high airport charges and windfalls to HAL. There is always a tension in defining the regulatory period between the flexibility and certainty offered by longer control periods and the inherent risk of windfall gains or losses associated with trying to forecast beyond a traditional five-year period.
35. We therefore note with interest CAA's proposals around providing greater long-term certainty in some areas, for instance the cost of equity, while retaining shorter term periods for other elements of the price control such as operating costs or traffic, where forecasting risks may be higher. This 'two-stream' approach to the control period has a degree of logic but would increase complexity and reduce transparency. That said, it should be explored further.
36. At present we remain open in relation to the length of the control period for expansion, pending further consideration as to whether a workable solution around the two-stream approach can be developed. However, a 15-year period would introduce significant forecasting risk. The extent of re-opening and review mechanisms that would be required in such a settlement is also likely to undermine the strength of incentives within the framework. These issues would need to be addressed for us to support such a lengthy control period.

Providing greater longer-term certainty on the cost of equity

37. We note the CAA's commentary around providing greater long-term certainty as regards the cost of equity.
38. The cost of equity is an integral part of the cost of capital. However, given the rise in alternative assets, we are not convinced that the returns observed in equity markets would

significantly change. PwC, in its initial workings, outlined various survey outcomes, academic literature and other key sources identifying that the long-term horizon of equity markets have changed and that the expected returns are significantly lower, reaching a new lower norm.

39. If there were to be a longer determination period then, assuming the CAA uses the appropriate inputs to the cost of equity (taking account of capex efficiency), we would be supportive of a longer-term business as usual cost of equity estimate. Our priority is a financeable and efficient HAL. We believe that if there is to be a construction risk premium then it should be proportionate to the amount of risk that HAL would incur in a given year.

Equity Commitment

40. We understand that the CAA is concerned about the seriousness of prospective equity investors and is considering whether HAL should provide commitment letters at various milestones prior to the final price proposals. We see merits to this approach, particularly given HAL's comments during Constructive Engagement that their investors may not proceed despite DCO approval if they do not support the CAA's final determination for H7.

Credit Ratings

41. We agree that HAL maintaining an A- rating is desirable, as maintaining a strong credit rating is desirable for any company. However, we do not believe that it is essential for overall financeability and that the position needs to be considered in the round. We set out several pieces of evidence that support this position below.

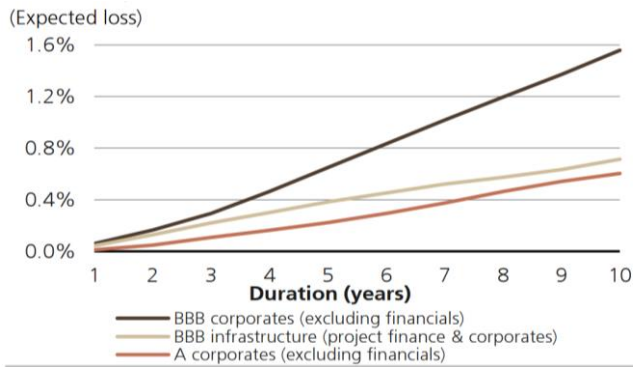
A BBB infrastructure debt is less risky than a "BBB" corporate debt

42. In its analysis of credit ratings in CAP1876, the CAA has used the cost of debt indices of A and BBB for non-financial corporates. It has also highlighted the difference in the volatilities between corporates in the two groups³. It is, however, worth considering how BBB infrastructure corporates perform compared to the broader BBB non-financial corporates. To do this, it is worth examining evidence from a UBS white paper on infrastructure debt⁴.
43. The UBS paper examines three key pieces of evidence, which are shown below in Figures 4.1 to 4.3. These charts suggest that BBB infrastructure debt on a longer-term basis, exhibits a lower expected loss than BBB non-financial corporates and is in fact similar to A corporates in terms of expected loss. BBB infrastructure corporates also have more robust EBITDA performance than BBB corporates and are subject to much lower ratings volatility.

³ CAP1876, pg.80, Figure C.9

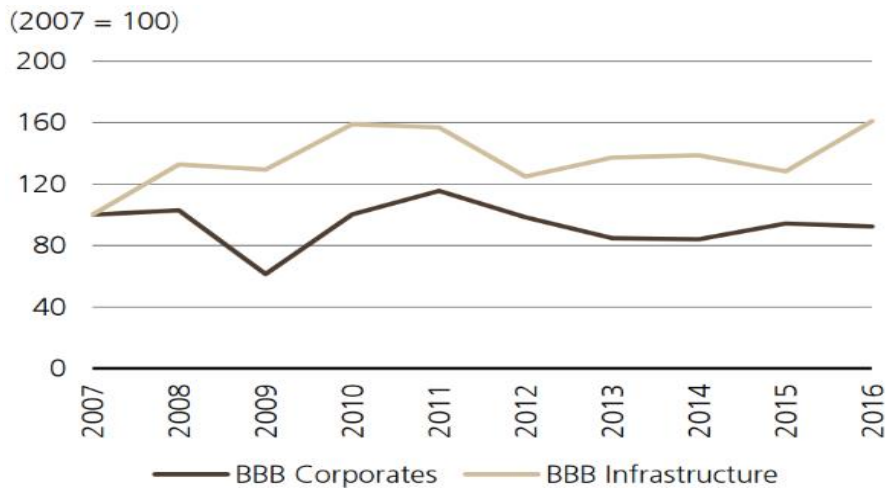
⁴ UBS, The case for infrastructure debt, Infrastructure white paper series: Part 1, December 2017

Figure 4.1: Expected loss of BBB infrastructure trending towards A-rated corporates



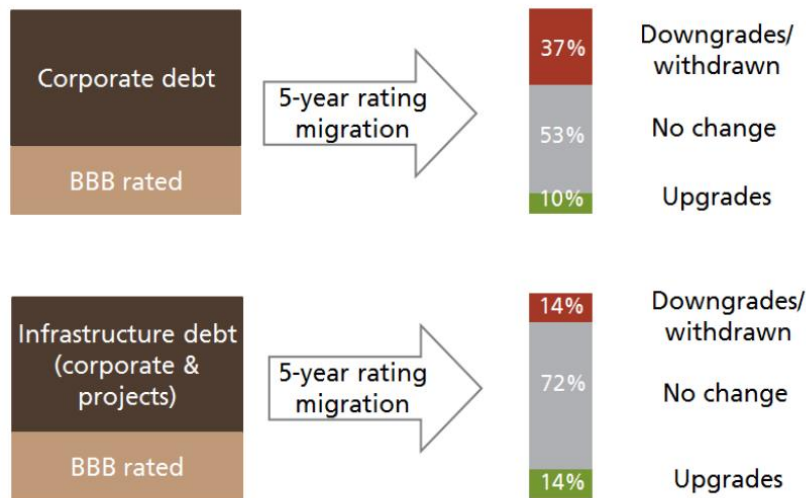
Source: UBS Asset Management, REPM; Moody's Infrastructure Default and Recovery Rates, 1983 – 2015

Figure 4.2: Infrastructure EBITDA has been more robust than corporates



Source: Bloomberg; note: all issuers rated BBB as at October 2017; infrastructure excludes telecommunications companies

Figure 4.3: Less downgrades from infrastructure over 5-year period



Source: Moody's Infrastructure Default and Recovery Rates, 1983 – 2016. Note: this refers to Issuer ratings for corporate and project finance infrastructure, and non-financial corporates.

44. This demonstrates that care needs to be taken when considering issues around credit ratings. The difference between an A- and a BBB infrastructure rating may not, in reality, be that large.

A BBB rating may potentially be more attractive to fixed income investors, due to the marginal uptick in yield.

45. The BBB rating group falls just below the A group. It is still an investment grade rating. We believe that this increase in margin in the cost of debt from A- could attract significant number of investors currently in search of yield and diversification of assets. This means that there may be more available debt with a BBB+ rating than with a A- rating, tackling the issue of financeability, with only a marginally higher cost of debt. In this context, it should be noted that this cost of debt may be higher, but it is not necessarily inefficient. It may simply be what an efficient financeable position looks like.

46. Figure 4.4 below is an excerpt from a Centrus report⁵ to the Commission for Aviation Regulation Ireland (CAR) on the financeability of Dublin Airport for its 2020 Determination. The chart suggests that BBB group has the highest distribution of corporate debt, showing that despite AAA, AA and A having a higher rating than BBB, there has been a greater

⁵ Centrus, Financeability Assessment of the Draft Price Determination in relation to Dublin Airport - The Commission for Aviation Regulation October 2019

demand for BBB debt (over \$7,000 billion) and perhaps reflecting the combination of the relatively higher risk of the rating group and the investment grade status of this group.

Figure 4.4: Global corporate debt by ratings category (Centrus)



Source: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro

47. Therefore, it is questionable whether there is a significant disadvantage in using BBB as a target metric group for financeability assessments, unless more evidence can be provided by HAL or the CAA's financial advisors regarding the added costs and complexity in raising debt as a BBB infrastructure corporate than an A- corporate.

Financial Structure and Gearing

48. The CAA has stated that it is considering the twin track approach to assessing financeability, assuming a notional company which has a whole business securitisation structure (WBS) but with a single rating on its senior class debt, rather than mimicking HAL's existing dual class debt.
49. Our response to this approach depends on the single class rating assumed by the CAA, as the metrics and targets would vary according to this single rating. Given that CAA is considering an A- rating (as an example) for the start of the period, we believe that there may be an inclination to continue with this rating for the rest of the period and therefore believe that a multi-class rating could be better. However, if a rating in the BBB group were to be assumed then this can cover the whole debt requirements. We do not believe that a BBB+ rating should be completely ruled out.

Assessing Financeability

50. The CAA have suggested using Return on Regulated Equity (RORE), Modified Internal Rate of Return (MIRR) and Running Yield as three metrics to be considered to analyse equity financeability. Our initial view is that the methodology is not incorrect but that

ultimately for these metrics to be useful they must be supported by appropriate, well specified and well evidenced inputs. The incorrect use of inputs would go against the CAA's broad aims and potentially reward investors more than is required. At this stage, we are unable to comment as to whether the CAA plans for inputs are appropriate, as there is not sufficient detail. We highlight this now as a potential risk.

51. Through its commentary, the CAA gives the impression that it is seeking to reward the investors for the risks in the H7 period itself, which suggests that the time frame for any assessment is very short. However, the real returns would only be realised beyond H7 and, therefore, the timespan for this analysis should be longer. The CAA correctly identifies in its commentary about MIRR that "we need to look at returns over a reasonably long period of time" and we believe this timeframe should apply to all three metrics.
52. With regard to running yield, the metric ignores any capital gains that the equity investors would make and focuses more on the post-tax cash to equity. Considering that the total value of HAL's business is likely to grow post R3 construction, we believe that the running yield may underestimate the true returns to equity investors.
53. We would ask the CAA to share its thinking on the assumptions and inputs to these metrics in detail as they can seriously influence the equity financeability in question. Variables such as market value of equity (running yield) and capital value of the business (MIRR) are estimated and would need to be discussed with stakeholders before undertaking the equity financeability assessment. We also ask the CAA to consider more fully post R3 returns and focus less on the returns during H7, as the true returns from R3 will not come until its construction is complete.
54. Overall, we believe that there is a significant amount of attention given to new equity finance, without enough consideration of potential equity injections from the existing owners that already understand HAL's business model better. This is especially true as any new equity investor would likely dilute the shares of the existing shareholders. There are, of course, examples of other airport transactions in the UK, some operating with EBITDA margins nearly half of HAL's current EBITDA margin that have still attracted equity finance from international institutional investors (see Table 1). This suggests HAL is in a strong position to attract equity investment.

Table 1. Recent airport transactions and EBITDA margins

Airport	Leeds Bradford	Liverpool	London Luton	London City	London Gatwick	vs. HAL
Transaction/ Reference Year	2018	2019	2018	2016	2019	2018
EBITDA Margin (Year minus 1)	31%	26%	31%	39%	54%	62%
Buyer	AMP Capital (Debt refinance & equity purchase by AMP)	Ancala Partners	AMP Capital	Ontario Teachers Pension Plan, Borealis, Aimco and Wren House	VINCI	

Source: York Aviation analysis of annual accounts data