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British Airways Response to CAP2098
Heathrow's request for a Covid-19 related RAB adjustment

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

Executive Summary

We welcome the CAA's latest publication on Heathrow's proposal for a Covid-19 related RAB adjustment. Our previous analysis and conclusions on the topic were set out in our response to CAP1966¹; this set out our objection to Heathrow's request to insulate itself against traffic volume risk for which it has been fully remunerated:

- a) We remain **categorically opposed to Heathrow's proposed RAB adjustment**; it remains a proposal that is destructive to the regulatory economic principles that support UK economic regulation, and has furthermore been introduced by Heathrow in a manner designed to derail the H7 periodic review; it is at heart an attempt to bail out an over-indebted business whose investors have extracted all equity buffers to pay excessive investor returns
- b) Heathrow has portrayed their request as a necessary step to avoid breaches of debt covenants and a downgrade of credit ratings, yet in quarterly results, has **assured investors that there is no longer any risk of covenant breaches under extreme downside scenarios**, and that liquidity of £3.9bn is sufficient until at least 2023
- c) **Clear statutory duties** are laid out in the Civil Aviation Act 2012 ("CAA12"), primarily to **further the interests of consumers and to promote competition** in airport services; within this, it is specifically noted that the CAA is not required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements

¹ [British Airways response to CAP1966](#)



- d) The “ultimate aim of economic regulation”, as defined in CAA12, is to “replicate the outcomes of a competitive market”, a mission that has been developed to **protect consumers from monopoly power** as a result of over three decades of UK experience of incentive regulation, itself based upon a rich body of regulatory economics research
- e) Beginning with the privatisation of BT in 1984, the UK developed a price cap (or incentive) regulatory structure whose purpose was to expose the firm to an environment that **replicates the outcomes of a competitive market**
- f) In fixing a price cap ex-ante (i.e. in advance) as part of a multi-year settlement based upon **clear and fixed incentives** on cost and revenue performance, a regulated company can only beat the settlement by innovating to increase revenue, or increasing efficiency to reduce costs
- g) These incentives are then recalibrated only at the subsequent periodic review, building a “regulatory commitment” that independent regulators do not arbitrarily intervene in the settlement ex-post (i.e. after the fact); **Heathrow is asking the CAA to breach a key regulatory principle** that would not only undermine incentives, but also threaten the core tenets of the UK’s incentive-based economic regulation framework
- h) This design of incentive regulation applies both to the extremes of extraordinary profits and losses; any obligation to achieve an ex-post return on capital would **invite regulatory capture and seriously weaken consumer protection against monopoly**
- i) Any regulatory action in response to Covid-19 must therefore be considered within an **extremely robust framework so as not to undermine the regulatory commitment**, a situation that could arise should incentives be inconsistent over time
- j) We agree with the CAA that there was **no commitment to protect Heathrow from the impact of extreme traffic shocks** at the Q6 periodic review for the current price control, and Heathrow’s request can only be considered by reference to its statutory duties to the consumer and competition
- k) However, we support the CAA in assessing the impact of Covid-19 and potential options within a structured framework informed by statutory duties, though this **must be in keeping with the regulatory commitment to ensure incentives remain consistent**; within this context, assessing potential options to further consumer interests in line with the CAA’s statutory duties does not appear unreasonable
- l) In doing so, we **support the CAA’s rejection of directly compensating Heathrow, and instead taking an approach to develop a framework based upon statutory duties** to assess the broad range of issues, allowing multiple options to be considered, which in aggregate optimise consumer benefit within the H7 price control
- m) We caution against setting objectives for this framework that are either set to be too narrow, or that fail to account for the **duty to promote airport competition, which is ultimately the main economic mechanism that furthers consumer interest**

- n) In assessing potential packages of options, **furthering the interests of consumers** must be the main and over-riding objective, furthered by our proposed objectives to **promote competition, sustain regulatory commitment, incentivise firm efficiency, ensure efficient pricing and support service quality**
- o) We recognise there is the possibility that an additional, small intervention in Q6 under Package 2 might provide enhanced outcomes for H7, however we **can only consider this in the context of supporting regulatory commitment and efficiency** – for example – the creditworthiness of the **notional** company at the outset of H7
- p) A targeted RAB adjustment under Package 2 relating to Heathrow's RAR covenant would be an unacceptable outcome that would undermine regulatory commitment against the guidance of CAA12 by making an adjustment of a regulatory decision for Heathrow's particular financing arrangements
- q) **We therefore identify a preference for Package 1: considering issues only within the H7 periodic review**, this provides the only sound means of meeting all objectives, and fulfilling the statutory duties to the consumer and competition
- r) However, our preference remains **highly dependent upon the form that any intervention option might take at H7**, noting that whilst Option 1A appears to largely meet our core objectives, Option 1C appears to be a partial ex-post bail-out albeit offset by past outperformance: this could undermine key objectives that further the consumer interest

1. Heathrow's proposed RAB adjustment

- 1.1. To recap our position, we **remain fundamentally opposed to Heathrow's proposal**, which is fundamentally the wrong solution, both in terms of regulatory principle and fairness, to the issues raised by Covid-19, is ultimately harmful to the consumer, and **results in the double-charging of consumers for years to come**
- 1.2. We are disappointed that Heathrow continues to seek an adjustment to the Regulatory Asset Base ("RAB") – increasing its claim to an enormous £2.8bn – despite consistent feedback from airlines, and indeed the CAA, that it would **undermine the incentive regulatory structure**
- 1.3. Heathrow has presumptively assumed its proposal will be approved and as such included the proposal first in the Building Block Update ("BBU") of July 2020, and further in the Revised Business Plan ("RBP") of December 2020, resulting in a **deeply negative backdrop for discussions during Constructive Engagement ("CE")**; such discussions were largely unproductive as a result
- 1.4. As a direct result, it has been almost **impossible to assess a robust business plan for H7** that sets out priorities and plans during the next price control, with Heathrow portraying many components of the future price control as dependent upon a RAB adjustment that are in fact completely unrelated

- 1.5. The CAA's preliminary analysis² to assess the effect of the RAB adjustment on key metrics and covenants reveals the true nature of Heathrow's request – an attempt by Heathrow **to have consumers and airlines bail out the company and its shareholders**
- 1.6. To reiterate some of our key points in the previous consultation:
 - 1.6.1. Consumers have been compensating Heathrow for years within the current Q6 licence at an elevated Weighted Average Cost of Capital ("WACC") for assuming all passenger volume risk; **Heathrow cannot now argue that it should benefit from such risk and then also be protected from the same risk**
 - 1.6.2. Heathrow, through various management decisions, has elected to increase debt levels at its own risk beyond those of the "notional" company set at the Q6 regulatory settlement; again those **risks cannot be reassigned ex-post, especially having outperformed the settlement prior to the onset of Covid-19**
 - 1.6.3. The **proceeds of debt financing have been used to fund dividends exceeding £3.85bn**, far above the level warranted by any outperformance of the settlement, resulting in negative equity capital on the balance sheet to absorb risks when they materialise; these dividends include £100m only paid out to external investors after the onset of Covid-19
 - 1.6.4. We would strongly argue that **equity therefore needs to be put back into Heathrow's business by its shareholders - on a permanent basis** - to support the risk that Heathrow has been compensated by consumers to bear in the Q6 regulatory settlement; see section 8.3 for a summary of equity injections that have been undertaken by airlines in response to Covid-19
 - 1.6.5. Heathrow's **financing choices should have no bearing on any regulatory financeability assessment based upon a "notional" company**, otherwise principles of incentive regulation would be undermined
 - 1.6.6. Heathrow's proposal to inflate the RAB – the charging base that represents efficiently-incurred capital expenditure that benefits consumers – is the wrong mechanism to solve for the issues presented by the Covid-19 crisis; **inflating the RAB would result in consumers being charged a second time for Heathrow's assumption of the same risk**
 - 1.6.7. The **H7 periodic review is the only suitable forum to discuss future risk allocation or the regulatory framework**; this will ensure risks are calibrated to an appropriate WACC, and considered alongside all other building blocks

² [CAP2098A: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment - Appendices](#)

- 1.7. It is clear that **Covid-19 has raised issues over the allocation of future volume risk** and that the price control could benefit from a risk-sharing mechanism aligned to the ex-ante incentive structure; addressing such issues within the H7 periodic review is the appropriate place to consider any such package of measures
- 1.8. However, **considering the risk allocation at H7 confers no acceptance of, nor any willingness to consider, Heathrow's claim to £2.8bn of "lost" revenues**; any ex-post adjustment of the risks within the current Q6 price control period would be inappropriate and set a dangerous precedent for incentive regulation and regulatory commitment
- 1.9. Heathrow has also portrayed their request as a necessary step to avoid breaches of debt covenants and a downgrade of credit ratings; yet in quarterly results, has assured investors that **there is no longer any risk of covenant breaches under extreme downside scenarios**, and that liquidity of £3.9bn is sufficient until at least 2023³

2. Regulatory environment

- 2.1. **CAA12 sets out clear primary duties to further the consumer interest and promote competition** in airport service provision;⁴ alongside these are set out secondary matters to which the CAA must have regard when performing those primary duties
- 2.2. These primary duties are to further the interests of consumers of "air transport services regarding the range, availability, continuity, cost and quality of airport operation services", and also to carry out functions so as to "promote competition in the provision of airport operation services"⁵
- 2.3. In regards to secondary matters, it is noted that the **"CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements"** and further that **"ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market."**⁶
- 2.4. Whilst CAA12 forms the legal framework for the present regulatory licence model, it is itself **developed from over three decades of UK experience in regulatory economics**, practical implementation and other empirical matters
- 2.5. Further, this regulatory framework that informs the duties of CAA12 has evolved with a **central focus on the interests of consumers and their protection from monopoly power using instruments to promote or mimic competitive forces**; this should not be simply discarded in the interests of Heathrow's shareholders

³ [Heathrow \(SP\) Ltd, Results for the Year Ended 31st December 2020](#)

⁴ [Civil Aviation Act 2012, Chapter 1, General Duties, section 1](#)

⁵ Ibid.

⁶ Ibid.

2.6. It seems sensible therefore to consider how the UK regulatory framework came about, and to **consider the intent of incentive regulation under an RPI-X price cap**, as initially proposed by Stephen Littlechild for the privatisation of BT, and developed based upon the significant experience in implementation by a broad spectrum of UK regulators

2.7. The UK regulatory experience

2.7.1. As Littlechild sets out in his seminal paper on BT's privatisation options, "the **consumer's prime concern is with the range and quality** of the goods and services offered, **and the terms** on which these goods and services are offered, rather than the reasons lying behind it all"⁷

2.7.2. He continues, "**competition is indisputably the most effective means – perhaps ultimately the *only* effective means – of protecting consumers against monopoly power**. Regulation is essentially a means of preventing the worst excesses of monopoly"

2.7.3. This sowed the seeds of price cap, or incentive regulation, under which prices are not linked directly to underlying costs during the regulatory period, but detached for the duration of the price control to **create incentives that mimic a competitive environment for a time**

2.7.4. This price cap (incentive) approach, developed as RPI-X was deemed optimal by Littlechild due to **greater incentives for efficiency and innovation in contrast to rate of return (cost plus) regulation**, which has been extensively noted "can impose its social costs in the form of input inefficiency"⁸

2.7.5. As a result, price cap regulation is intended to expose the firm to an environment that **replicates the outcomes of a competitive market**⁹, where producers cannot influence the market price, and the only way to increase profits is to reduce costs¹⁰

2.7.6. This is particularly important where data suggest the amount to be gained by increasing X-efficiencies is significant¹¹, whose contribution towards output depends upon a degree of competitive pressure or other incentive factors

⁷ [Littlechild, S. "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983", Section 4.6](#)

⁸ [Baumol, W & Klevorick, A "Input Choices and Rate-of-Return Regulation: An Overview of the Discussion", The Bell Journal of Economics and Management Science, \(Autumn, 1970\), pp. 162-190](#)

⁹ [CAA12, Explanatory Notes 36\(b\): CAA's General Duty](#)

¹⁰ Newbery, D. M. "Privatization, Restructuring, and Regulation of Network Utilities", MIT. Press, Cambridge, Mass., 1999

¹¹ [Leibenstein, H. "Allocative Efficiency vs. 'X Efficiency,'" American Economic Review, Vol. 56 \(June 1966\), pp. 392-415](#)



2.8. The price control and incentive setting

- 2.8.1. It remains our clear position that any **ex-post reallocation of risk could have negative consequences for this UK regulatory framework**; re-opening of a settlement must be firmly grounded in consumer interest to prevent unintended effects in other sectors
- 2.8.2. An important principle of UK regulation is to **set incentives ex-ante at the start of the price control**, allowing regulated companies latitude to diverge from assumptions and beat incentives: this opportunity raises efficiency over the long run through a repeated game, with subsequent price controls resetting incentives
- 2.8.3. However, events that follow the setting of the price control, including management decisions taken by the regulated company, remain at the regulated company's own sole risk; were this not the case, and ex-post return on capital to become a target, this **would invite regulatory capture and seriously weaken consumer protection against monopoly**¹² with deep-reaching consequences for productivity and efficiency¹³
- 2.8.4. The building blocks of the price control are formed around a "notional" company against which financeability is assessed, with **debt deemed to form 60% of this notional company's capital structure** at the Q6 settlement
- 2.8.5. This concept of the "notional" company sits at the heart of regulatory setting of incentives, and the CAA's financing duty is focussed upon ensuring this notional company can remain properly capitalised based upon the parameters of the price control; this **remains only a secondary consideration to the primary duties to the consumer and competition**
- 2.8.6. This is **distinct from Heathrow's attempt to re-define financeability to cover all its own financing risks** created by diverging from the notional company; our clear position is that the **notional company should be the sole regulatory focus**
- 2.8.7. This position is supported by the Civil Aviation Act 2012 ("CAA12") stating that **"the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements** or put the interests of users at risk by making them pay for an inefficient operator's financing decisions"¹⁴
- 2.8.8. Furthermore, it is noted that – in relation to the secondary matters that include financeability – "The duty to have regard to these matters does not, individually

¹² [Littlechild, S, "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983", Section 14.7](#)

¹³ [The Economist: The Corporate Undead - what to do about zombie firms, 26th September 2020](#)

¹⁴ [Civil Aviation Act 2012, Explanatory notes 36\(a\) to Section 1, CAA's general duty](#)

or collectively, override the section 1(1) and (2) duty"¹⁵, those being the core duties to consumers and to promote competition

2.9. Regulatory commitment

2.9.1. A key part of UK regulatory frameworks is **maintaining incentives across price control periods, allowing incentives to drive gains in efficiency**, which are then recalibrated at the subsequent periodic review having taken advantage of the regulatory lag¹⁶

2.9.2. It is the existence of independent regulators – the CAA and others – that create a regulatory commitment to hold to those incentives, **restraining a government from arbitrary ex-post intervention in a price control once it has been set, the very thing Heathrow is asking the regulator to do**

2.9.3. This commitment not to intervene ex-post in pricing **applies to both the extremes of extraordinary profits and extraordinary losses**, since many of the arguments against maximum returns equally apply to minimum returns¹⁷

2.9.4. For example, in setting out arguments as to why it should be entitled to its returns ex-post, **Heathrow inadvertently opens the possibility of claims by the regulator to limit profits in years of plenty**, which by doing so would result in suboptimal incentives and economic outcomes in future periods

2.9.5. This is in **direct contravention of established UK precedent** for economic decision-making, where economic and – ultimately – public policy decisions, are, forward looking in nature, involving assessments of possible future implications of choices made today"¹⁸

2.9.6. An **ex-post intervention to secure a guaranteed return** on a sunk investment in a short-term context, therefore **has the perverse effect of undermining long-term regulatory commitment to long-term sunk investment costs**

2.9.7. As noted previously, any obligation to achieve an ex-post return on capital would also **invite regulatory capture and seriously weaken consumer protection against monopoly**¹⁹

¹⁵ [Civil Aviation Act 2012, Explanatory notes 36\(a\) to Section 1, CAA's general duty](#)

¹⁶ [Bailey, E. & Coleman, R. "The Effect of Lagged Regulation in an Averch-Johnson Model": The Bell Journal of Economics and Management Science Vol. 2, No. 1 \(Spring, 1971\), pp. 278-292](#)

¹⁷ [Littlechild, S, "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983", Section 14.7](#)

¹⁸ [Yarrow, G., Appleyard, T., Decker, C. & Keyworth, T. in a paper for the Regulatory Policy Institute entitled "Competition in the Provision of Water Services", April 2008](#)

¹⁹ [Littlechild, S, "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983", Section 14.7](#)

- 2.9.8. This is since **political pressure would develop to drive prices down to a level of marginal costs**, stemming from demands to reduce extraordinary profits, and preventing the firm from the ability to recoup any past investment costs
- 2.9.9. Instead, it is **stable, predictable policy, coherent and consistent across areas²⁰, that is able to allow a clear regulatory commitment to develop** across a multi-period set of price controls, and forms the foundational strength of UK price control regulation
- 2.9.10. This does not mean that there should be no regulatory discretion; **excess rigidity does not allow benefits of cooperation spanning multiple price control periods to develop**, which drive more efficient outcomes under game theory²¹
- 2.9.11. Any discretionary flexibility that is required within a regulatory framework, particularly in the context of new information or circumstances, must be handled carefully to ensure it is not used in an arbitrary manner, and instead **used within a framework that is accountable and transparent²²**
- 2.9.12. We therefore **support the CAA's development of a framework that assesses the issues raised by Covid-19 without undermining the regulatory commitment** developed by UK regulators since privatisation

3. CAA's assessment of case for intervention

- 3.1. We agree that CAP1138 sets out an ability for Heathrow to request re-opening of the price control, though note that **any such request must be considered in light of the CAA's statutory duties** at the time, and further that a request to re-open the price control does not in itself require CAA to take any action whatsoever²³
- 3.2. Furthermore, we agree with the CAA that there was neither "any clear expectation as part of the Q6 settlement as to what, if any, specific actions would be taken if the price control were re-opened, **nor any explicit commitment to protect Heathrow from the impact of extreme traffic shocks**"²⁴
- 3.3. It is therefore prudent and necessary to consider Heathrow's request, the impact of Covid-19, and potential options so long as they **further the interests of consumers and promote airport competition** in line with the duties of CAA12

²⁰ [Spiller, P. & Tommasi, M. "The Institutions of Regulation: An Application to Public Utilities", Handbook of New Institutional Economics \(pp. 515-543\)](#)

²¹ [Salent, D. & Woroch, G. "Trigger Price Regulation", The RAND Journal of Economics Vol. 23, No. 1 \(Spring, 1992\), pp. 29-51](#)

²² Ibid.

²³ [CAP1138, Notice of the Proposed Licence, Paragraph A12](#)

²⁴ [CAP2098: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment, Paragraph 1.8](#)

- 3.4. This assessment **must be grounded both in the duties set out in CAA12, and regulatory principles** set out above; Heathrow's proposals breach regulatory norms in a way that threaten the basis of regulation in other sectors across the UK: only clear consumer benefits or development of airport competition should result in radical regulatory innovation
- 3.5. This **supports the CAA's intent to assess options in a structured manner**, ensuring that consumer interests and competition are central to any proposed options for dealing with regulatory issues raised by the Covid-19 pandemic
- 3.6. As set out in our response to CAP1966, we support the **assessment of options as part of the H7 periodic review**; this is the most appropriate way to calibrate the price control as a package, achieving symmetry across building blocks, though addressing this within the H7 periodic review confers no acceptance of nor any willingness to consider Heathrow's claim to £2.8bn of "lost" revenues
- 3.7. Whilst we understand and respect the CAA's position to keep options open for early intervention – the short-term outlook has undeniably worsened as a result of a patchwork of government restrictions in response to the pandemic – **we believe early intervention neither to be necessary based on the evidence we see in Heathrow's financial disclosures, nor definitively required to support principles of regulatory economics**
- 3.8. Further, we are convinced that **potential unintended consequences could result from imbalanced, early intervention** stemming from incentives becoming imbalanced, which would lead to irreparable damage to the regulatory commitment
- 3.9. This is **especially so, considering the effect of the £750m capital injection** on the key RAR metric, though we note this has been misinterpreted by the CAA as an equity injection, when it is in fact a subordinated loan at ADI Finance 2 Ltd requiring repayment²⁵ that has been pushed down as equity to lower entities
- 3.10. Heathrow has presented evidence on the magnitude of Covid-19 on its business: we agree with Heathrow that Covid-19 has had a deep impact on aviation; however, as noted above, this is irrelevant; Heathrow has already been compensated for years within the current Q6 licence at an elevated WACC in order to hold all volume risk, in addition to which, a shock factor adjustment was applied to artificially further reduce passenger forecasts
- 3.11. **Heathrow cannot argue that it should both benefit from risk in years of outperformance and then be protected from it in leaner years**
- 3.12. Given Heathrow's request and their insinuation that they no longer wish to manage volume risks, it seems inappropriate for Heathrow to be paid through the WACC to bear volume risk in future, and it is **our expectation that the H7 WACC must fall**

²⁵ [Ferrovial S.A. January-September 2020 results, p9](#)

substantially from that of today to reflect Heathrow's reduced volume risk exposure

3.13. Whilst the airline community response to the Q6 price control consultation²⁶; stated that re-opening the price cap should only be in extreme circumstances, this is wholly **reliant on the licence modification process embedded in CAA12**

3.14. We recognise the CAA' holds broad powers to modify the licence in furtherance of the consumer interest under section 22 of CAA12²⁷, and the CAA have given us guidance that in considering all options, that this is defined as re-opening the Q6 price control²⁸; this is acceptable insofar as it relates to assessing potential options, and we remain **opposed to automatically intervening and modifying the Q6 licence** as a result of this re-opening

3.15. **We would challenge any suggestion that – given exceptional circumstances – a price control might be automatically re-opened and modified**, as this would ignore the net effect upon the whole of that quinquennium's price control package, and is unlikely to be in the consumer interest

3.16. **We can see no definition of exceptional circumstances in licence of law that would require a price control to be re-opened**; merely that Heathrow may make a request at any time, and that the CAA is only obliged to consider such a request in line with its statutory duties at the time.

3.17. In this respect, whilst we agree with the CAA that the effect of Covid-19 upon the industry has been large and that these events are pronounced, the **only reasonable basis upon which to assess this request can be based upon the CAA's primary duties to consumers and to promote competition**; only in this context can we assess impact upon any price control and potential options to mitigate its effect

3.18. However, we **reiterate that any intervention must be targeted, proportionate, and further the interests of consumers and development of competition**; consideration of an appropriate regulatory framework for H7 is more likely to achieve those goals than ex-post intervention within the present Q6 price control

3.19. Fundamentally, the effect on the incentives and the notional company are the key considerations, since the **incentives are best assessed as a package in the context of the whole price control**: interventions must be considered based upon their effect across all incentives, as would be required for the introduction of any traffic risk sharing mechanism

3.20. We therefore support the CAA in assessing the impact of Covid-19 and potential options within a structured framework informed by statutory duties, though this **must be in keeping with the regulatory commitment to ensure**

²⁶ [CAP1151, Notice Granting the Licence, Paragraph 2.167](#)

²⁷ [Civil Aviation Act 2012, Section 22: Modifying licence conditions and licence area](#)

²⁸ [CAP2098, Response to its request for a covid-19 related RAB adjustment, Paragraph 1.8](#)

incentives remain consistent; within this context, assessing potential options on a forward-looking basis to maximise consumer benefits in line with the CAA's statutory duties does not appear unreasonable

4. Approach to considering Heathrow's proposal

4.1. We note that the CAA has developed three broad approaches to guiding development of possible regulatory interventions:

- (a) Focussing on **compensating Heathrow** for the impact of "exceptional circumstances", and the reduction in passengers or revenue on its price control activities
- (b) Using a **framework based upon statutory duties to assess the broad range of issues** raised by the Covid-19 pandemic and considering the most appropriate package of options to address those issues
- (c) **Relying on Q6 allocation of risks**, noting Heathrow was paid a market Cost of Equity, along with an additional premium to manage risk

4.2. We note that the CAA suggests that options (a) or (c) might represent too narrow a focus, and do not properly reflect their statutory duties; in this regard, we agree, however our reasoning is not directly or solely based upon the nature of Covid-19, but upon principles set out above of how UK regulation was conceived has been implemented in law

4.3. Approach B: using statutory duties to consider broader issues

4.3.1. It is our understanding that this broader approach would allow the CAA both to assess issues resulting from Covid-19 within the H7 review, and also give flexibility within the Q6 price control to **design more optimal economic outcomes that might be beneficial to furthering consumer interests**

4.3.2. We agree with the CAA that using a framework to assess the broad range of issues to consider a balanced package of options is the most appropriate means of **balancing risk and reward within the context of the H7 price control**

4.3.3. However, we remain hesitant over any an approach that could introduce an option that permitted intervention within the current price control period, and we reiterate our main concern that **regulatory commitment must not be undermined**, creating poor precedent and diluting Q6 ex-ante incentives

4.3.4. Therefore, our support for this approach is conditional not only upon upholding the CAA's statutory duties, but also in **ensuring the principle of regulatory commitment remains intact** with consistent incentives

4.3.5. Assessing the issues in this manner confers no acceptance of nor any willingness to consider Heathrow's claim to £2.8bn of "lost" revenues, but reflects the reality that constructing **a balanced price control package for H7 with strong incentives may benefit from optionality** in this regard

4.3.6. This will at a minimum allow the CAA to consider a range of potential options within the context of its primary duties of furthering interests of consumers and promoting competition in airport services, with regard for **secondary matters that do not individually or collectively override those primary duties**²⁹

4.3.7. It is worth noting in relation to those secondary matters that:

4.3.7.1. "With regard to the need to secure that each licence holder is able to finance its provision of airport operation services (subsection (3)(a)). Whilst this should require the CAA to encourage efficient and economic investment by allowing a reasonable return over time, the financing duty does not require the CAA to ensure the financing of regulated airports in all circumstances, for example **the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions.**"³⁰

4.3.7.2. "The need to secure that reasonable demands for airport operation services are met and the need to promote economy and efficiency in the provision of such services (subsection (3)(b) and (c)). One would expect both of those needs to be met in a competitive airports market where airport operators provide the services demanded by passengers at minimum cost. The requirement to have regard to those needs reflects the fact that the **ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market.**"³¹

4.3.8. The primary duties in CAA12 must therefore inform the approach taken to assessing potential options, with **the regard for secondary matters appropriately subordinate**

4.3.9. Furthermore, **we support the application of the Better Regulation principles**³², which enshrine regulatory commitment within the body of CAA12

4.4. Approach C: relying upon Q6 risk allocation

²⁹ [Civil Aviation Act 2012, Explanatory Notes Chapter 1, General Duties, section 1](#)

³⁰ Ibid.

³¹ Ibid.

³² [CAA Better Regulation principles](#)

- 4.4.1. **At Q6, Heathrow was remunerated at a market-based cost of capital** that reflected volume risk inherent in the business: this is a natural product of deriving a maximum yield based upon a single passenger forecast
- 4.4.2. We note the CAA believe that an additional premium was paid to manage volume risk; this is not strictly accurate: instead, a downward adjustment was applied to passenger forecasts (the “shock factor”) based upon historic downward deviations against expected volumes
- 4.4.3. Nevertheless, **Heathrow went on to outperform those forecasts** from the inception of Q6 until the events of Covid-19 began to unfold in 2020, quantified by the CAA across all building blocks as £1.1bn from 2014 to 2019³³, then resulting in offsetting underperformance as passenger volumes fell
- 4.4.4. The **licence accepted by Heathrow contained ex-ante regulatory commitments that included all volume risk**; therefore, it would be reasonable to expect that the CAA’s duties would be fully discharged by relying upon the risk allocation of the Q6 price control in its entirety
- 4.4.5. Re-opening of risk Q6 could only be considered were risk to be rebalanced across all building blocks, and **prior out-performance against a reduced WACC offset against any underperformance in 2020 and 2021**, though we note how destructive this might be to regulatory commitment and incentive regulation
- 4.4.6. In order therefore to support the CAA’s assessment of this option as being too narrow, **we would need to be convinced that a broader approach (under approach (b)) has a demonstrable advantage to furthering consumer interests and development of competition**
- 4.4.7. It would suggest that the more efficient way to consider the issues resulting from Covid-19 may be to **link the assessment of risks within the H7 periodic review with the development of the balance sheet of the notional company**, which may require flexibility within the Q6 price control to result in more optimal economic outcomes for consumers
- 4.4.8. As a result, **using approach (c) might result in too narrow a focus and limit the ability of the CAA to consider the broader effects**, precluding packages of options to mitigate those effects, and ultimately be in conflict with statutory duties to the consumer
- 4.4.9. In conclusion, **we recognise that approach (c) could be too narrow, though this can only be in the context of balancing risk for the H7 periodic review**, and it is our main concern that regulatory commitment must not be undermined by creating poor precedent and diluting Q6 ex-ante incentives

³³ [CAP1966A: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment – Appendices](#)



4.5. Approach A: compensating Heathrow

- 4.5.1. Following from the above discussion, we agree with the CAA that **directly compensating Heathrow for any reduction in passenger volumes or revenues on its price control activities would be clearly inconsistent its duties** in CAA12
- 4.5.2. **Directly compensating Heathrow would not follow accepted principles** of fairness, nor and arguably most importantly, be in the interests of consumers or furthering competition
- 4.5.3. This stems both from consumer interests that are built upon an ex-ante framework of incentives that are designed to foster competition, and the regulatory commitment at the heart of UK regulation
- 4.5.4. **Heathrow would have CAA crudely reinvent the regulatory framework** to the benefit its shareholders with a total disregard to consumers, despite having benefitted from a £1.1bn outperformance from 2014 to 2019³⁴
- 4.5.5. Allowing **compensation on a unilateral basis would defeat the objective of licence modifications** to use such flexibility in a manner that supports ex-ante incentives that support efficiency, and ultimately benefits consumers
- 4.5.6. Without consideration of wider factors, such as previous outperformance in Q6, as previously argued in our response to CAP1966³⁵, **this approach would deliver little more than rate of return regulation**, along with its attendant faults

5. CAA assessment framework & key objectives

- 5.1. The **CAA then set out key objectives informed by primary duties and secondary matters**, and have used this framework to assess possible options for intervention in a way that is designed to further the interests of consumers
- 5.2. We **support the use of objective-based criteria** to assess options based their contribution to advancing interests of consumers and promote competition
- 5.3. We note that the **CAA have derived these objectives as a result of considering four main areas of consumer harm that could result** from the impact of Covid-19, and these are:
- (a) Protect consumers by avoiding undue increases in the cost of equity finance

³⁴ [CAP1966A: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment – Appendices](#)

³⁵ [British Airways response to CAP1966](#)

- (b) Protect consumers from difficulties raising debt
 - (c) Promote affordable charges in H7
 - (d) Protect efficient investment and service levels
- 5.4. Given that the ultimate aim of economic regulation as defined in legislation³⁶ is to – as far as possible – replicate the outcomes of a competitive market, since this is the most powerful mechanism in driving benefits for consumers, we **should be cautious of pursuing overly narrow objectives** that do not directly address some other key regulatory questions and principles
- 5.5. This is especially the case having established a need to consider the broader issues raised by Covid-19 under approach (b), to **ensure that linkages between issues are considered to develop an optimal option for intervention** that best meets the primary duty of furthering the interests of consumers
- 5.6. The objective framework set out by the CAA above appears focused upon **distinct problems perceived by Heathrow within the price cap model** that might arise from Covid-19 that have been used to justify their recovery of revenue through an adjustment to the RAB
- 5.7. Whilst these are valid might be considerations resulting from a particular intervention proposal, if we are to ensure that instead broader issues are considered, **we need to operate from objectives that directly support the existing incentive-based price cap model stemming from statutory duties**
- 5.8. This will **support the CAA and enable a robust, defensible and transparent process** when considering the broad issues resulting from Covid-19, particularly where consideration of issues takes place as part of the H7 periodic review
- 5.9. We therefore **suggest objectives that are slightly more focussed upon core economic and regulatory questions at the heart of regulation**, which directly tie into the CAA's statutory duties, and should as a result help the CAA to deliver a more robust assessment framework than is suggested at present
- 5.10. Effect on competition
- 5.10.1. We also note that the **CAA has made an initial assessment that intervention will not have a significant impact on competition**, though this assessment is also caveated when the CAA note some uncertainty remains, with further work set out by the CAA in Appendix J of CAP2098
- 5.10.2. Since promoting competition is a primary duty, it is **important to ensure that this assessment remains true under any proposed option**, especially since the

³⁶ [CAA12, Explanatory Notes Chapter 1, General Duties, section 1](#)

ultimate aim of economic regulation is to replicate the outcomes of a competitive market³⁷

- 5.10.3. For example, it was argued by Littlechild that **any obligation to achieve a sufficient return on capital would invite regulatory capture and seriously weaken the consumer's protection against monopoly³⁸**, largely by further raising barriers to entry for new competition
- 5.10.4. Given this **centrality of competition to furthering the consumer interest**, it is curious that a RAB adjustment is assessed in Appendix J5 as being not expected to have a material impact on competition: we would disagree
- 5.10.5. Consumers and the airlines that serve them have no choice of two-runway airport in the London area; for a network airline of our size, **we would be unable to directly transplant the same network and total connection possibilities to any other airport**
- 5.10.6. As a result of this monopoly power, the CAA has undertaken a Market Power Determination ("MPD") and **Heathrow has been deemed to hold Substantial Market Power ("SMP")**, resulting in the present licence-based price control
- 5.10.7. A **RAB adjustment would have the net effect of raising medium to long-term airport charges** by raising the potential charging base of Heathrow, allowing it to recover greater returns than otherwise would be possible both on the RAB through its cost of capital, and of the RAB through future depreciation
- 5.10.8. At a constant WACC, this **transfers consumer surplus directly to the producer** precisely because consumers and airlines do not have a choice of airports, and depending upon the elasticity of demand could result in a greater deadweight loss to society
- 5.10.9. Airlines operate in highly competitive markets against carriers operating their networks through other airports; competition operates between multiple permutations of city pairs, and as a result, **any increase in costs will lead to a rise in fares as a result of pricing at marginal cost in competitive markets**
- 5.10.10. The fact that passenger volumes are likely to build at Heathrow before those of other airports, and that Heathrow might not later be able to benefit due to capacity constraints **does not justify an argument that consumers could or should bear or absorb the cost of a RAB adjustment** set out in Appendix J8
- 5.10.11. In the absence of a competing airport able to accept a transfer of the whole of our business from Heathrow, **regulation is critical in creating incentives that promote or mimic competition** in provision of airport services; competitive

³⁷ [CAA12, Explanatory Notes Chapter 1, General Duties, section 1](#)

³⁸ [Littlechild, S, "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983", Section 14.7](#)

effects cannot be dismissed lightly when **competitive forces are ultimately the main economic mechanism that furthers consumer interest**

5.10.12. Finally, the fact that Heathrow is likely to see traffic volumes return before that of other airports reinforces the point that a RAB adjustment at Heathrow would have a **distorting effect on the little competition that does exist between Heathrow and other airports at which such an adjustment is unavailable**

6. Proposed assessment framework & key objectives

6.1. Considering the CAA's primary duties as a starting point, supported by key issues surrounding regulatory commitment, and finally the UK experience will allow us to design **robust objectives against which options can be assessed, and directly support an approach based up considering issues on a broad basis**

6.2. Overriding objective: furthering interests of consumers

6.2.1. **Furthering the interests of consumers must be the main and over-riding objective** of the assessment framework to ensure compliance with the CAA's primary duties

6.2.2. Ultimately, in the absence of a competitive market that can deliver this for consumers, **other mechanisms must deliver the benefits that competition would otherwise be able to bring**

6.2.3. We summarise our **proposed objectives for an assessment framework that meets the CAA's statutory duties** as follows:

- (a) Promote competition
- (b) Sustain regulatory commitment
- (c) Incentivise firm efficiency
- (d) Ensure efficient pricing
- (e) Support service quality

6.3. Objective 1 – Promote competition

6.3.1. Being the **most powerful mechanism available to deliver the consumer interest**, this should be a key objective at the heart of the assessment framework

- 6.3.2. Within the context of the Covid-19 pandemic, it is **at first hard to see what interventions would enable a direct development of competition** in airport services, however, it is **critical to ensure that any intervention made does not further reduce the development of competition**
- 6.3.3. This is a key point raised by Littlechild, where the **"ease with which regulation can be phased out (without disturbing competition)"** is a key consideration in the assessment framework for BT's privatisation³⁹
- 6.3.4. Furthermore, the **consequences of any option should not pre-suppose the way in which competition might emerge** – for example – by precluding terminal competition having embedded the present regulatory framework⁴⁰
- 6.3.5. Certain **interventions that could raise the cost of the system would preclude future access** to it under network liberalisation policies designed to introduce such competition; this would result in similar debates to those over the terms of access to British Gas pipeline infrastructure⁴¹
- 6.3.6. Therefore, we **must ensure that regulatory interventions neither act to shield the incumbent supplier from the effects of competition, nor prevent its future stimulation and development**

6.4. Objective 2 – Sustain regulatory commitment

- 6.4.1. As described above, regulatory commitment remains a vital part of the UK regulatory landscape, **ensuring that incentives remain consistent across multiple price control periods**, creating stability by ensuring intervention is not arbitrary and capricious
- 6.4.2. This speaks directly to the CAA's Better Regulation principles enshrined within CAA12⁴², such that **regulatory activities are carried out in a way that is transparent, accountable, proportionate and consistent**, and targeted only at cases in which action is needed
- 6.4.3. **Price cap incentive regulation and its variants have become the established precedent** in the UK following the privatisation of many previously state-owned monopoly utilities, delivering an incentive framework designed to mimic the effects of competition on the regulated firm

³⁹ [Littlechild, S, "Regulation of British Telecommunications' Profitability, Report to the Secretary of State, February 1983"](#)

⁴⁰ [Frontier Economics, "It should be terminal: an innovative approach to UK airport competition", March 2009](#)

⁴¹ [Armstrong, M. & Sappington, D., "Regulation, Competition & Liberalization", February 2006 Journal of Economic Literature 44\(2\): pp325-366](#)

⁴² [CAA12, CAA's General Duty](#)

- 6.4.4. The **regulatory lag**⁴³ in which costs become detached from underlying costs for the period of the price control, **allows incentives to drive gains in efficiency**, which are then reset at the subsequent periodic review
- 6.4.5. This restriction on the ability to reset prices for a fixed period **balances the need to share efficiency gains with consumers against the creation of consistent incentives** against which the firm seeks to outperform
- 6.4.6. As a result, the primary consumer interest duty is furthered through the **creation of a stable incentive to greater efficiency and innovation**, rather than by interfering between periodic reviews

6.5. Objective 3 – Incentivise firm efficiency

- 6.5.1. Supported by the regulatory commitment, promoting efficiency plays a key part under price control regulation by **mimicking the effects of competition, ultimately resulting in greater consumer benefits emerging** over multiple price controls
- 6.5.2. It is particularly important that this incentive is allowed to play out over time, since **competition is largely a process of discovery**⁴⁴ and ensures that firms are responsive to consumer needs
- 6.5.3. The firm becomes more productive over time as a result so long as the ratchet effect⁴⁵ of **regulatory opportunism is tempered by credible regulatory commitments**; this would dissuade short-term intervention between periodic reviews
- 6.5.4. It is also within the context of efficiency that generation of commercial revenues is incentivised, achieved by setting a baseline against which **innovation can lead to outperformance of the settlement**
- 6.5.5. Finally, **financing efficiency is promoted by the incentive nature** of price cap regulation; specifically, in Heathrow's case **by reference to a notional company** financed with 60% debt
- 6.5.6. The CAA's **secondary considerations to financing are fulfilled by considering the notional company at the periodic review**, not by a considering a subsequent failure by Heathrow to appropriately manage finances after that periodic review

⁴³ [Bailey, E. & Coleman, R. "The Effect of Lagged Regulation in an Averch-Johnson Model": The Bell Journal of Economics and Management Science](#) Vol. 2, No. 1 (Spring, 1971), pp. 278-292

⁴⁴ [Hayek, F. "Wettbewerb als Entdeckungsverfahren", Center for the Study of Law and Economics](#)

⁴⁵ Baron, D. "Design of regulatory mechanisms and institutions", Handbook of Industrial Organization Volume 2, 1989, Pages 1347-1447

- 6.5.7. The periodic review assesses the price control proposals **in the context of being financed by that notional company, resulting in consistent incentives over time:** it is this that **delivers an efficient cost of capital**
- 6.5.8. Were this not the case, the incentives based upon a notional company would be inconsistent over multiple periods of regulation, **leading to a breakdown of regulatory commitment, and a loss of efficiency incentives relating to financing**
- 6.5.9. This would be by creating a **perverse incentive to increase leverage to even more extreme levels**, safe in the knowledge that any future economic downturn that exposes the weaknesses of a financing strategy to take all value off the table through dividends will result in a bail out at the expense of consumers
- 6.5.10. It is **in this context that WACC considerations – cost of equity and ability to raise debt financing – can be considered**; if considered only as singular objectives outside the efficiency context, the CAA would be unable to consider a broader range of issues raised by Covid-19, and may otherwise pursue suboptimal options and interventions that conflict with its duties
- 6.5.11. The WACC and its component parts are reflective of the risk allocation within the price control – as set at the periodic review – **compensating the firm for exposure to risk that considers the entire package** within the context of the notional company
- 6.5.12. It is therefore **self-evident that modification of incentives within a price control period requires extremely careful consideration to ensure the balance of risk and incentives is not unduly affected**, and efficiency is not ultimately undermined
- 6.5.13. An incentive framework **promoting efficiency can therefore foster an environment that promotes discovery of greater economy and efficiency through innovation** – linking directly to the CAA's secondary consideration, which in turn supports the primary duty to the consumer based upon cost

6.6. Objective 4 – Ensure efficient pricing

- 6.6.1. The **"efficient price" for a service is one that maximises total economic surplus**, both that of the consumer and the regulated firm's profit
- 6.6.2. The single-till building block approach to determining the price control is based upon an efficient price; we arrive at this with a **starting point of marginal cost pricing**, described by Kahn as "the point at which the inquiry must begin"⁴⁶

⁴⁶ Kahn, A. "The Economics of Regulation: Principles & Institutions", 1971, Cambridge, MA: MIT Press

- 6.6.3. Improving for allocative efficiency develops the marginal cost pricing concept to that of **average cost pricing in order to cover the substantial costs of investment in network infrastructure**
- 6.6.4. It is upon this efficient pricing principle that the concept of the **Regulated Asset Base ("RAB") has been developed to capture the efficiently incurred sunk costs of previous investments**
- 6.6.5. **Without average cost pricing**, any ability to promote availability, range and continuity of service would not be appropriately incentivised, leading to **chronic underinvestment and deteriorating benefits to the consumer**
- 6.6.6. However, the converse **requires that costs introduced to the RAB represent efficient costs that improve the range, availability, continuity, cost or quality of airport services**, in order to meet the consumer duty
- 6.6.7. It is therefore a mechanism in which **efficient pricing that is informed by the RAB that delivers investment for the consumer**, ultimately delivers infrastructure required
- 6.6.8. Furthermore, this **ensures consumer protection against monopoly pricing**, and ultimately results in affordable charges that are informed by the economic principles that sit behind them
- 6.6.9. Within the context of a single till, **building blocks are considered to develop the ex-ante revenue requirement of the firm**, setting a price control that satisfies the forecast revenue requirement and sets incentives for outperformance of passenger volume and other forecast metrics
- 6.6.10. Additionally, the average revenue approach expressed by the maximum allowable yield per passenger allows pricing flexibility that approximates Ramsey–Boiteux pricing⁴⁷⁴⁸ and **offers a more efficiency pricing approach** that can minimise any distortion to consumer surplus
- 6.6.11. **Affordable charges are therefore the output of appropriate building blocks, incentives and risk allocation, resulting in efficient pricing**
- 6.6.12. As noted above in relation to other objectives, we would be **concerned by an objective that promotes "affordable" charges in isolation** without considering the broad range of incentives that comprise that charge, or indeed the impact upon future charges in H8 and beyond

⁴⁷ [Ramsey, Frank P. \(1927\). "A Contribution to the Theory of Taxation". The Economic Journal. 37 \(145\): 47–61](#)

⁴⁸ [Boiteux, M. "Sur La Gestion Des Monopoles Publics Astreints a L'equilibre Budgetaire." Econometrica, vol. 24, no. 1, 1956, pp. 22–40](#)

- 6.6.13. Were a significant discontinuity in the price path to result from the efficient building blocks that determine pricing, **we trust that the CAA will implement an appropriate PO adjustment** or similar mechanism
- 6.6.14. Given the primary duty to further the interests of consumers, this objective clearly allows for innovation of the price control model, appropriately **implementing new information that reinforces incentives in a manner that fosters regulatory commitment**
- 6.6.15. If charges appear unaffordable at the H7 periodic review, this suggests either that **input assumptions are inappropriate, or that risk allocation needs to be reconsidered**
- 6.6.16. As a result of this risk allocation, **Traffic Risk Sharing ("TRS") might be considered as an appropriate risk reduction mechanism**; this could allow balance to be restored, resulting in more affordable charges, rather than as an objective in its own right
- 6.6.17. In implementing any such scheme, the **incentives must be carefully considered to ensure an appropriate balance is achieved** between the fundamental economic trade-off of incentives and rent extraction
- 6.6.18. Additionally, **the recovery mechanics of any Traffic Risk Sharing mechanism should not unduly undermine the fundamentals of efficient pricing**
- 6.6.19. This is particularly the case where any such proposal begins to resemble rate of return regulation, providing **undesirable incentives in aspects of the firm's behaviour⁴⁹, especially near the floor of its band**
- 6.6.20. This demonstrates the **necessity of designing objectives with broad application due to the inherent interlinkages** between every factor comprising the framework of the price control

6.7. Objective 5 – Support service quality

- 6.7.1. Service is a core consideration of the CAA's primary duty, and delivery of service quality is **important not only to airlines delivering a synchronised service to consumers, but in meeting consumer expectations of service**
- 6.7.2. Consumers "**value high levels of service quality just as they value low prices**"⁵⁰, however if the firm is unable to capture the full economic surplus generated by increases in service quality, output quality may be set too low

⁴⁹ Sappington, D. "Price Regulation" in Cave, M. "Handbook of Telecommunications Economics", Vol1
⁵⁰ [Sappington, D. & Weisman, D. "Price cap regulation: what have we learned from 25 years of experience in the telecommunications Industry?" December 2010 Journal of Regulatory Economics 38\(3\): pp227-257](#)

- 6.7.3. However, the incentives are not quite so simple – for example, **revenue sharing can discourage the firm from investing in quality** because it requires the firm to bear the full costs of such investments, but allows the firm to retain only a fraction of the resulting revenues⁵¹
- 6.7.4. This **disincentive becomes more powerful as the price cap is more detached from underlying costs**, complicating potential interventions that might move prices away from the true underlying average costs
- 6.7.5. Heathrow is therefore regulated under a Service Quality Rebate and Bonuses (“SQRB”) scheme, **designed to address the specific shortcomings of price cap regulation on incentives to deliver service quality**
- 6.7.6. Designing an optimal and workable incentive regulatory mechanism that induces firms to deliver the welfare-maximising levels of service is a notoriously difficult task⁵², and any future **changes should consider the net incentive effect across the whole price control package**
- 6.7.7. This demonstrates the importance of considering **service quality as an objective in its own right** in support of the CAA’s primary duty to consumers, such that any proposed intervention within an option supports the other objectives in its delivery
- 6.7.8. The other aspect of service quality is **meeting capacity demands alongside supporting future investments that deliver consumer outcomes**; our view is that the average revenue approach to setting the price cap through a maximum per passenger yield already appropriately incentivises Heathrow to match terminal supply and demand
- 6.7.9. Nevertheless, we would view a **failure to meet capacity demands as a clear violation of Heathrow’s licence**, and regulatory intervention would at that stage be appropriate to compel terminal re-opening should Heathrow refuse despite clear demand requirements
- 6.7.10. This infrastructure has already been paid for within the existing RAB, and we **fail to see why consumers would be required to fund anything in addition to secure access to infrastructure for which they are already being charged**
- 6.7.11. A **price control package that comprises an efficient WACC with balanced incentives will ultimately deliver investment**; the firm will be compensated ex-

⁵¹ [Kridel, D., Sappington, D. & Weisman, D. “The Effects of Incentive Regulation in the Telecommunications Industry: A Survey” Journal of Regulatory Economics, 1996, vol. 9, issue 3, 269-306](#)

⁵² [Sappington, D. “Regulating Service Quality: A Survey” February 2005, Journal of Regulatory Economics 27\(2\) pp123-154](#)



ante at a rate appropriate to the risk, alongside return of its investment through depreciation over time

6.7.12. In addition, the primary duty to further consumers' interests by meeting capacity demands is **naturally delivered by means of setting the price cap based on a maximum average revenue per passenger**

6.7.13. This sets a **clear incentive to expand demand beyond that forecast** by the regulator at the time the price cap is set, since usage-based prices reduce the cost of covering the regulated firm's expenses⁵³

6.7.14. **Service quality incentives should therefore be a key objective of the assessment framework**, but only by working alongside other objectives can they achieve a balanced and desirable outcome

7. Options for regulatory intervention

7.1. Having considered an **appropriate assessment framework, from which we have developed core objectives**, it is appropriate to set out our ranking of the CAA's options alongside any others that might be identified

7.2. It is our view that – keeping objectives in mind based upon regulatory principles – the **consumer interest is best ultimately furthered by committing to assess appropriate intervention only as part of the H7 price review**

7.3. Any **action separate from the H7 periodic review risks causing an imbalance within the H7 price control package**, since any intervention might not then take consideration all the entire set of objectives and hence CAA duties, resulting in an intervention that is suboptimal for the consumer interest

7.4. We therefore **assess each option alongside our framework of objectives** set out above, which is a development of that considered by the CAA

⁵³ [Brennan, T. "Decoupling in electric utilities", August 2010 Journal of Regulatory Economics 38\(1\): pp49-69](#)

Assessment key

BA assessment vs objectives	Could meet objectives	May not fully meet objectives	Unlikely to fully meet objectives	Undermines objectives
		Optimal package identified		

BA assessment

	No intervention	Intervention			
	Commit to no Q6 + H7 intervention	<u>Package 1:</u> intervene at H7 review	<u>Package 2:</u> targeted intervention + H7 review	<u>Package 3:</u> apply TRS to 2020 & 2021	<u>Package 4:</u> apply Heathrow's proposal
Promote competition	Yellow	Green	Yellow	Red	Red
Sustain regulatory commitment	Yellow	Green	Yellow	Black	Black
Incentivise firm efficiency	Green	Yellow	Red	Black	Black
Ensure efficient pricing	Red	Green	Green	Black	Black
Support service quality	Green	Green	Yellow	Red	Red

7.5. As this summary sets out, amongst the options raised by the CAA, **Option 1 provides an optimal solution that can maximise objectives that are designed to advance the interests of consumers**, since this allows the greatest optionality as to the exact nature of its intervention

7.6. Our detailed analysis is considered below:

7.7. Option to commit now to not intervening

7.7.1. This option is considered and dismissed in the consultation document, and would have **committed the CAA to only consider forward-looking risks** as part of the H7 price review

- 7.7.2. Whilst appealing on the face of it both to airlines and consumers, in considering objectives that advance the consumer interest, this **could commit the CAA to a suboptimal H7 price control**, even if ultimately it turns out that there is no requirement for any intervention within the H7 periodic review
- 7.7.3. It may be – for example – that the impact of Covid-19 has a lasting **effect upon the financial metrics of the notional company** that spill over from the present price control, affecting the opening balance sheet for the H7 price control
- 7.7.4. Should this be the case, regardless of any risk-sharing mechanisms implemented for H7, the **opening balance sheet of the company may require adjustment** in such a way that **ensures the H7 price control package is sustainable**
- 7.7.5. This may therefore require an intervention – but only at H7 – that places the **notional company on an even financial footing before considering the risks within the H7 price control package**
- 7.7.6. Even if this type of intervention were not required, it might be suboptimal to commit to not intervening in this manner before the H7 price control package is known, though we discuss below how any such intervention **must be tightly circumscribed and ultimately reversed at the H8 periodic review**
- 7.7.7. We note that the CAA has assessed this option as being unviable due to the deterioration in the outlook for the sector since the previous consultation, with **uncertainty over the traffic recovery**
- 7.7.8. Any such uncertainty could lead to pricing inefficiency, therefore **under our objective 4**, this option could fall foul of advancing consumer interests by failing to take account of Covid-19 in a way that would ensure efficient pricing, and additionally lead to a more consistent regulatory commitment over time **under our objective 2**
- 7.7.9. However, the CAA comment that Heathrow has submitted a Revised Business Plan (“RBP”) **that assumes the CAA allow its proposed RAB adjustment; this does not appear a relevant consideration** at this stage, and we would urge the CAA to let Heathrow’s aspirations guide their regulatory response
- 7.7.10. Further considering this option, **under our objective 1**, a situation could result where there is both an **unworkable ex-ante price control, and simultaneously an absence of effective competition**, which is the defining feature that allows ex-post competition law to replace such regulation⁵⁴

⁵⁴ [A framework for such a transition is set out by Yarrow, G., Appleyard, T., Decker, C. & Keyworth, T. in a paper for the Regulatory Policy Institute entitled “Competition in the Provision of Water Services”, April 2008](#)

- 7.7.11. This situation cannot be allowed to develop, since it would be **prejudicial to the development of greater competition** and might not fully support a regulatory framework whose provisions are fully effective incentives
- 7.7.12. Considering this option **under objective 2** might result in a similar assessment, since situation could develop where an unworkable H7 price control would itself result in an **inconsistency of incentives over time between multiple price controls**
- 7.7.13. However, it should be equally borne in mind that under game theory, a repeated game played with **multiple periods requires consistency of incentives considered on a forward-looking basis**, an activity that is undertaken only at the periodic review
- 7.7.14. This is since **economic decisions, including public policy decisions, are forward looking in nature**, involving assessments of possible future implications of choices made today⁵⁵
- 7.7.15. For firm efficiency, suboptimal outcomes might result if changed and more demanding incentives are implemented, causing a “ratchet effect”⁵⁶; avoiding this would support **a non-intervention option that would fully meet objective 3 (and objective 5)**, though it must be considered that these objectives support an advancement of consumer interests when operated in conjunction with each other, and cannot be solely considered in isolation
- 7.7.16. Furthermore, whilst an **option to not intervene would categorically remove the potential for any ex-post opportunistic behaviour by the regulator**, this position that has been deemed by studies to be inefficient and reductive to welfare⁵⁷ when balanced against other objectives
- 7.7.17. Therefore, in support of objectives that advance the consumer interest, it would be **sensible to consider different intervention options to avoid a perverse outcome resulting in the notional company**, and a reduction in consumer benefit as a result
- 7.7.18. We therefore summarise our assessment against our key objectives below:

Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
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⁵⁵ Ibid.

⁵⁶ [Spiller, P. & Vogelsang, I. “Regulation, Institutions and Commitment in the British Telecommunications Sector”, World Bank Policy Research Working Paper 1241, January 1994](#)

⁵⁷ Baron, D. “Design of regulatory mechanisms and institutions”, Handbook of Industrial Organization Volume 2, 1989, Pages 1347-1447



7.8. Package 1: no intervention before H7, consider interventions at H7

- 7.8.1. It is noted that this option **would involve no immediate intervention, but a consideration as part of the H7 periodic review** of key issues surrounding Heathrow’s cost of capital, and the appropriate provide of charges and incentives for investment and service quality
- 7.8.2. We support this option, which is the **most appropriate means of advancing the interests of consumers** by meeting the key objectives identified above, though is not without some caution in implementation, particularly since our analysis suggests that little to no intervention is necessary, nor is for consumers to fund
- 7.8.3. We have made a separate, initial assessment of the CAA’s potential options set out in the appendix to CAP2098 further below; considered in the context of our objectives that further the consumer interest, **some of the options presented do not score highly due to ex-post effects on competition and commitment**
- 7.8.4. This remains the case even if those options are **calibrated by considering the effects of Heathrow’s Q6 outperformance: we agree with the CAA that this is highly relevant to determining the scale of any intervention**
- 7.8.5. It is, in our view, only reasonable to assume that investors based their expectations solely upon the **arrangements explicitly in place during Q6 and its extension periods, which imply no expectation of compensation for traffic-related losses**
- 7.8.6. If restoration of the notional level of gearing required any equity injection, it **may be appropriate to allow recovery of estimated efficient direct costs of doing so through some mechanism**; we set out below some caution on how to estimate those costs in the context of Heathrow’s business, and also express our further opposition to placing any such adjustment on the RAB
- 7.8.7. **The implementation of a fully developed Traffic Risk Sharing mechanism** in a manner that supports regulatory commitment could support H7 incentives, calibrating future risk alongside support of service quality standards, whilst also ensuring both firm and pricing efficiency
- 7.8.8. We support the CAA’s view that this does not require retrospective application to generate a credible commitment; in fact, the opposite is the case, that **applying any such mechanism retrospectively would severely undermine regulatory commitment**

7.8.9. Consistent incentives are those that are set ex-ante and priced as part of the package of risk incorporated within the price control; **consistency derives from making modifications in a transparent and forward-looking manner at the periodic review**, rather than the disincentives to efficiency that are created by ex-post intervention

7.8.10. A limited intervention at H7 therefore represents the greatest opportunity to promote competition through use of mechanisms that:

7.8.10.1. Enhance incentives and do not preclude future development of competitive forces

7.8.10.2. Sustain a regulatory commitment of consistent incentives by implementation at the periodic review on a forward-looking basis

7.8.10.3. Do not disincentivise the firm to act inefficiently, particularly in relation to its financing efficiency, but focussing on the notional company

7.8.10.4. Result in a price cap that represents efficient pricing, informed by ex-ante cost assessment and commercial revenue generation opportunity

7.8.10.5. Support service quality by acting against disincentives to reduce quality under the price cap regime

7.8.11. We therefore summarise our assessment against our key objectives below, though caveat that this is **highly dependent upon the form that any intervention might take at H7**

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Package 1: intervene at H7 review					

7.8.12. Following from above, we also note that **several preliminary options for intervention under package 1 are laid out in Appendix I of CAP2098**; once more developed, these options need both to be further assessed against objectives to ensure they remain appropriate interventions, and also to be quantitatively assessed as part of the H7 price control proposals

7.8.13. Our initial reaction to these three options is as follows:

7.8.14. **Option 1A**: to compensate investors for the costs of providing **new equity to restore HAL's notional financial position** to that in place before the Covid-19 pandemic

- 7.8.14.1. This would allow Heathrow to fund additional direct costs associated with issuing new equity, though **this can only ever be in the context of the notional company**, otherwise financing efficiency would be undermined under our objective 2
- 7.8.14.2. The CAA has noted that Heathrow has already raised £750m: specifically, this was **shareholder-funded subordinated debt injected into ADI Finance 2 Ltd, of which £600m was pushed down** to “regulated” entities, noting also that no specific regulatory ringfence exists around Heathrow’s specific legal entities
- 7.8.14.3. The CAA note that certain fixed costs might be reasonably funded by consumers in issuing equity; we **suggest this assumption is flawed under the present ownership structure**, and might lead to inconsistent incentives
- 7.8.14.4. The **present ownership structure has already successfully raised new funds from those same shareholders at relatively minimal cost**; such a fundraising requires no involvement from an investment bank and relatively low legal, tax and accounting advisory fees to achieve
- 7.8.14.5. However, these considerations relate to fundraising for the real company, not a notional company, therefore it **might not provide the appropriate information for the design on any economic incentive** in support of our objective 2 for equity fundraising under the notional company
- 7.8.14.6. We note further that the evidence cited from Ofgem⁵⁸ in support of a £40-65m allowance for equity fundraising **draws from examples that include publicly listed companies, and fund-raising in non-UK markets**
- 7.8.14.7. The CAA must be clear that Equity Capital Markets (“ECM”) activity for publicly listed companies incur relatively high fees due to the underwriting risk on banks, and fees are further **elevated in US markets compared to European markets, where a rate lower than 2% can be achieved** for large placements with multiple Global Co-ordinators and Bookrunners
- 7.8.14.8. In addition, a distinction should be drawn between the underwriting costs relating to public equity fundraising, and **the far lower costs of private fund-raising for unlisted companies, particularly if funds are raised from existing shareholders**, in which case costs are minimal; it is therefore critical that in setting any such allowance, the CAA is aware of appropriate comparisons for Heathrow’s company and capital ownership structure
- 7.8.14.9. This does lead to a question over whether a **change in control event might warrant any separate regulatory reassessment**, a logical

⁵⁸ [Ofgem, Cost of Raising Equity](#)

consequence if equity fundraising is not possible from the current owners, which might then be inserted into Heathrow’s H7 licence: this would need to be discussed further at the H7 periodic review

7.8.14.10. Considering the ease with which Heathrow has raised funds from shareholders, and the fact these funds represent the required equity buffer that was removed through excess dividends by those same shareholders, **it is unclear there should be any cost associated with restoring those funds to Heathrow’s balance sheet**

7.8.14.11. Nevertheless, **this requires analysis at the level of the notional company**, which can consider whether the balance sheet would have been compromised by the effect of Covid-19 regardless of the activity in Heathrow’s real balance sheet: **the CAA should be cautious of polluting the two separate issues on different balance sheets**

7.8.14.12. We comment further on equity injections in section 8.2

7.8.14.13. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Option 1A: new notional equity					

7.8.15. **Option 1B:** provides funding necessary to restore HAL’s notional gearing to 60% by the start of H7 without an equity injection

7.8.15.1. This approach, **solely focussed upon the notional company balance sheet**, focuses on keeping the notional company adequately funded; this is achieved by building up retained earnings (rather than paying them out as dividends), and topping up any difference through additional charges

7.8.15.2. An approach along these lines, focussed solely on the notional company and **ensuring that incentives for efficiency of financing remain sufficiently powerful**, and is a more proportionate approach that could maintain consistency of incentives over time

7.8.15.3. Whilst we agree with the CAA that this would require calibration – since the closing notional balance at the end of Q6 would inform the opening balance sheet at the start of H7 – **we disagree on the scale of the intervention suggested by Heathrow, since such an intervention can only focus on the notional company** rather than Heathrow’s actual financing activity that informs its indicative £1.4bn calculation

7.8.15.4. We therefore are reluctant to support this (or any other specific) option **until the entire risk package of H7 has been finalised and the effect of each potential option quantified**

7.8.15.5. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Option 1B: restore notional equity					

7.8.16. **Option 1C:** place a “floor” under the equity losses for the notional company

7.8.16.1. This approach – in the words of the CAA – **assumes that investors would expect the CAA to intervene to fund the under-recovery of specific price control revenue building blocks in 2020 and 2021**, so would create a floor or cap on the losses that equity investors would suffer – though the CAA appears to suggest this is ex-post

7.8.16.2. This option appears wholly inconsistent with the aims of package 1 to consider issues at the H7 periodic review, instead acting in a manner similar to packages 3 or 4; **the periodic review is primarily forward-looking in order to ensure regulatory commitment remains intact**, else key principles would be undermined

7.8.16.3. This approach to revenue recovery appears to undermine the purpose of price cap regulation, and instead introduces a form of rate of return regulation by alternative means, and we reiterate that any obligation to achieve an ex-post return on capital would also **invite regulatory capture and seriously weaken consumer protection against monopoly**⁵⁹

7.8.16.4. It should be noted that **there are clear issues that need to be considered when operating revenue caps** that consider over- and under-recovery whilst operating under a price cap incentive regime⁶⁰, as opposed to the price cap in effect at present

⁵⁹ [Littlechild, S, “Regulation of British Telecommunications’ Profitability, Report to the Secretary of State, February 1983”](#), Section 14.7

⁶⁰ [Stoft, S. “Revenue Caps vs. Price Caps: Implications for DSM” 1995](#)

- 7.8.16.5. In particular, the price cap at present allows pricing flexibility that approximates Ramsey–Boiteux pricing⁶¹, whereas **revenue caps motivate relatively large price changes in the opposite direction to those of Ramsey pricing⁶³**, and might therefore lead to greater pricing inefficiencies than the Crew-Kleindorfer effect would suggest⁶⁴
- 7.8.16.6. This effect is itself particularly applicable at Heathrow, demonstrated by – as suggested by Heathrow in its RBP – an **incentive to lobby or even settle for a higher price with a corresponding lower volume**, especially where terminal infrastructure is assumed to remain closed due to the suggested marginal cost structure of the business
- 7.8.16.7. This would clearly **violate any objective for price efficiency**, and further would **result in Heathrow being incentivised to avoid meeting capacity and service quality standards**
- 7.8.16.8. We discuss these points further in our critique of Heathrow’s proposed RBP price adjustment mechanism, set out in our proposed **Traffic Risk Sharing mechanism that is designed to ensure these economic incentives remain appropriate**
- 7.8.16.9. We recognise that the **CAA then sets out a decomposition of losses that might have occurred during 2020 and 2021 based upon expected returns**, along with a discussion surrounding losses that might be expected to accrue to equity and debt
- 7.8.16.10. This **entire approach appears very focussed around an incompatible ex-post reconciliation of an ex-ante incentive-based price control**, undermining the key objective to ensuring an ongoing regulatory commitment to ex-ante incentive-setting
- 7.8.16.11. Whilst not agreeing to this entire approach, we agree that **equity capital is inherently capital that is at risk in any business**, further accentuated for Heathrow with a cost of equity (1.1) above unity
- 7.8.16.12. We further argue that this option provides significantly more extensive protection than is set out in any reasonable assessment of the Q6 price control, which we would argue was nil, due to the inflated WACC

⁶¹ [Ramsey, Frank P. \(1927\). "A Contribution to the Theory of Taxation". The Economic Journal. 37 \(145\): 47–61](#)

⁶² [Boiteux, M. "Sur La Gestion Des Monopoles Publics Astreints a L'equilibre Budgetaire." Econometrica, vol. 24, no. 1, 1956, pp. 22–40](#)

⁶³ [Vogelsang, I., & Finsinger, J. \(1979\). A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms. The Bell Journal of Economics, 10\(1\), 157-171](#)

⁶⁴ [Stoft, S. "Revenue Caps vs. Price Caps: Implications for DSM" 1995](#)

representing compensation for all volume risk, **acknowledged by Heathrow in multiple debt investor prospectuses**⁶⁵

7.8.16.13. As a result of recovering notional company debt costs, the CAA estimate a sum equal to the return on debt (£832m) and return of debt (£1,010m) less HAL’s realised EBITDA in 2020 and 2021 (£426m) equal to £1.4bn, which **we believe would be significantly lower or even reversed taking both a lower WACC to represent removal of volume risk into account alongside previous outperformance** from 2014-2019 in Q6

7.8.16.14. **Option 1C could therefore be detrimental to the consumer interest** given its negative effect in relation to many of the issues we set out in this paper, spanning all our proposed objectives to advance the consumer interest

7.8.16.15. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Option 1C: Floor on 2020 & 2021 losses					

7.9. Package 2: targeted intervention now, consider further intervention at H7

7.9.1. We note that the CAA state that this will allow for issues to be considered at the H7 periodic review – as under package 1 – with **the addition that more immediate regulatory intervention might be allowed ahead of the start of H7**

7.9.2. **Triggers for such intervention are suggested**, which include Heathrow’s financeability creating difficulties for consumers, the impact on the cost of capital if there are clear advantages to taking action ahead of H7 that could prevent higher prices in H7, or other short-term issues that assist in ensuring Heathrow maintains appropriate service and investment levels

7.9.3. A potential RAB adjustment is considered, which formulaically would not have any effect on charges until H7: this **RAB adjustment is framed in the context of assisting headroom to Heathrow’s RAR covenant of 1-3%, estimated at a £200m-600m** intervention, though with caveats over the calculation of any intervention

⁶⁵ [Heathrow Finance plc November 2019 prospectus](#)

- 7.9.4. Whilst we can see potential scenarios where a targeted intervention might assist – for example – the credit rating of the notional company, which would allow more efficient pricing to result in H7, this is in very limited circumstances
- 7.9.5. However, the triggers cited appear to suggest interventions based upon Heathrow's actual financial position rather than those of the notional company, therefore we see disincentives to Heathrow's financing efficiency as a result
- 7.9.6. The suggested intervention to support Heathrow RAR covenant is also inconsistent with multiple public statements made by Heathrow in relation to its finances and covenants, and we set out in section 8.1 below further information on this key ratio, in particular the additional financing headroom not apparent in the headline ratio that has allowed Heathrow to pre-pay suppliers £300m
- 7.9.7. Regulatory economics is clear that a price cap creates a general disincentive to service quality that is specifically corrected through the Service Quality Rebate and Bonuses ("SQRB") regime embedded in Heathrow's licence
- 7.9.8. Therefore, interventions to support service quality should neither be necessary, nor are supportive of the incentive created by the existing SQRB scheme, which would be partially undermined as a result
- 7.9.9. We also fail to see what additional specific investment is required in 2021 that might be supported by any such intervention, having not been exposed to formal governance through the established Gateway process, and especially considering the paucity of plans for H7 surrounding capex that have been presented to date in the RBP
- 7.9.10. We therefore see any such interventions outside of the H7 periodic review as being difficult to calibrate to further the interests of consumers, particularly given the reasons and justifications for any such adjustment by Heathrow are not borne of any regulatory principle, but derived from a fixation on a RAB adjustment
- 7.9.11. More fundamentally, an intervention to support the RAR covenant is neither necessary nor appropriate for reasons we set out in section 8.1 below; Heathrow has explicitly stated that it has sufficient liquidity to avoid any covenant breach, and can clearly afford to make optional prepayments that have elevated this ratio within covenants at the 31st December 2020 measurement
- 7.9.12. Any early adjustment can only therefore be in support of the notional company at the opening of H7, and the RAB is irrelevant to any approach that furthers the consumers interests
- 7.9.13. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Package 2: targeted intervention + H7 review	Yellow	Yellow	Red	Green	Yellow

7.10. Package 3: application of H7 traffic risk-sharing approach to 2020-2021

7.10.1. The CAA notes that this package would involve immediate interventions similar to package 2, whilst also **committing to a reconciliation for 2020 and 2021 on the same basis as any forward-looking risk-sharing mechanism for H7**

7.10.2. We welcome the CAA’s assessment that this package would not be a proportionate response to its duties to the consumer interest, and agree that it is in violation of a number of our objectives that would further those interests

7.10.3. We agree with the CAA that this formed the basis of investor expectation at Q6, simply as it did not exist; retrospective application **will neither support regulatory credibility of any such a mechanism if it is introduced in future, nor be consistent with the Q6 incentive package and WACC**

7.10.4. The application of TRS to 2020 and 2021 would neither be transparent nor in line with furthering the consumer, **violating all efficiency and pricing objectives that would support such consumer interest**

7.10.5. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Package 3: apply TRS to 2020 & 2021	Red	Black	Black	Black	Red

7.11. Package 4: Heathrow’s proposed risk-sharing arrangement for 2020-2021

7.11.1. The CAA notes that this package would involve a RAB adjustment as proposed by Heathrow, with a **commitment now to a substantial adjustment that compensates Heathrow for the regulatory depreciation** it has not recovered in 2020 and 2021, with an **additional adjustment to be made later based upon the shortfall in revenue** in 2020 and 2021

7.11.2. This mechanism would provide a broad adjustment to the RAB **estimated now at £2.8bn based upon the increased effect of Covid-19** since Heathrow's original request was made

7.11.3. We welcome the CAA's assessment that this package would not be a proportionate response to its duties to the consumer interest, and agree that it is in violation of a number of our objectives that would further those interests

7.11.4. Ex-post recovery or **reconciliation of regulatory depreciation significantly undermines regulatory commitment required of incentive regulation**, and we refer our earlier analysis set out in this paper alongside warnings from Stephen Littlechild as to the economic consequences of this approach

7.11.5. We therefore summarise our assessment against our key objectives below:

	Promote competition	Sustain regulatory commitment	Incentivise firm efficiency	Ensure efficient pricing	Support service quality
Package 4: apply Heathrow's proposal					

8. Other considerations

8.1. The Regulatory Asset Base and RAR Covenant

8.1.1. It is notable that Heathrow have stated in their full year 2020 investor update that "Under our current traffic scenario, we do not forecast any covenant breach in 2021. As part of our going concern assessment, we have also considered a severe but plausible downside scenario whereby traffic reduced to 27 million passengers. **In this downside scenario, we concluded that sufficient mitigations would be within management control to avoid any covenant breach**"⁶⁶

8.1.2. Any adjustment of the RAB designed to create a buffer to Heathrow's Regulatory Asset Ratio ("RAR") covenant – net debt to RAB – is **unlikely therefore to be in consumers' interest** for three key reasons:

8.1.3. Firstly, such an **alleviation would be based upon own Heathrow's financing needs far in excess of those in the notional company geared at 60%** that is a core part of the incentive structure that forms the basis of the licence⁶⁷

⁶⁶ [Ibid.](#)

⁶⁷ [CAP1151: Economic regulation at Heathrow from April 2014: Notice granting the licence](#)

- 8.1.4. Secondly, since the RAB is intended to inform airport charges by representing efficiently incurred capital expenditure not yet recovered, it is **unclear how this mechanism benefits consumers or promotes efficiency**: there is no consumer benefit derived from adjusting the RAB in isolation, other than allowing future charges to rise for as long as an increment sits on the RAB
- 8.1.5. Thirdly, Heathrow has **clearly stated in many recent investor presentations⁶⁸ that this covenant is no longer under threat** following the injection of £750m in subordinated debt to ADI Finance 2 Ltd: pro-forma analysis shows significant headroom, though this pro-forma analysis has been selectively omitted in other recent presentations where Heathrow still advocate for a RAB adjustment
- 8.1.6. It is **notable that Heathrow was able to pre-pay £247m of expenses** due in 2021 to targeted suppliers as a result of the capital injection at ADI Finance 2 Ltd: this would appear to reduce the cash element of the net debt calculation and inflate net debt at the 31st December 2020 measurement date⁶⁹
- 8.1.7. In relation to this, Heathrow state “within cash generated from operations, the increase in trade and other receivables includes £247 million relating to prepayments made to suppliers at 31 December 2020. The total includes a £60 million payment to HMRC in relation to Heathrow’s payroll taxes payable to HMRC during 2021. A further £11 million of prepayments in relation to IFRS 16 lease liabilities are included within cash flows from financing activities. These **prepayments were made in order to manage banking covenant ratios**”⁷⁰
- 8.1.8. It **should be noted that this does of course raise the RAR covenant by raising net debt as the cash component of that calculation falls**, since these prepayments are included instead within trade receivables – a current asset
- 8.1.9. Given both that Heathrow has **sufficient liquidity to avoid any covenant breach, and that it can afford to make optional prepayments**, this does not suggest the necessity of any intervention in advance of H7 whatsoever, even before considering that fact that economic decisions are forward-looking in nature and are deliberately not accounting concepts⁷¹
- 8.1.10. Any proposed regulatory intervention – either in H7 or in advance of H7 – **must support incentives within the price control**: for the same reasons, Traffic Risk Sharing (“TRS”) structures must meet the same standards and avoid inappropriate use of the RAB as a recovery mechanism within the H7 price control

⁶⁸ [Heathrow SP Ltd Q3 2020 Results presentation](#)

⁶⁹ [Heathrow Investors & Insurers Update, January 2021](#)

⁷⁰ [Heathrow \(SP\) Ltd, Results for the Year Ended 31st December 2020](#)

⁷¹ Yarrow, G., Appleyard, T., Decker, C. & Keyworth, T. in a paper for the Regulatory Policy Institute entitled “Competition in the Provision of Water Services”, April 2008



8.1.11. We **comment separately on TRS structures to progress discussions** in advance of the CAA's Way Forward and Initial Proposal consultations

8.2. Equity support for Heathrow

8.2.1. It remains the case that an **equity injection by shareholders is the only permanent solution to Heathrow's recurring debt issues**: this is best achieved by returning dividends to restore equity capital buffers within the Group

8.2.2. Heathrow's **financing structure is complex, and it is important to gain a complete understanding Heathrow's capital structure** to ensure proposed intervention operates as intended, and has not been masked by accounting treatment

8.2.3. The CAA has experience through regulation of NATS En-route Ltd ("NERL") of **operating licence conditions that place limitations on debt, aiming to prevent a repeat of issues encountered under the original PFI structure** in 2001

8.2.4. Looking further afield, the **Bank of England's Prudential Regulation Authority operates to ensure "firms are adequately capitalised and have sufficient liquidity for the risks they are running or planning to take"**⁷²

8.2.5. This involves **implementation of various capital requirements** on banks derived from the Basel Committee on Banking Supervision, stress testing sectors to ensure resilience, and ring-fencing UK retail banking deposits from 1st January 2019

8.2.6. Whilst we recognise that Heathrow does not present the same systemic risks to the wider economy as these other examples, as a result of Heathrow's Substantial Market Power ("SMP"), **consumers and airlines operating at Heathrow has no choice other than to rely upon the airport**

8.2.7. Some form of **regulation of Heathrow's balance sheet may therefore be in consumers' interest to prevent recurring financing issues and restore permanent equity to the business**, and we urge the CAA to consider how a structure might operate within an appropriate incentive framework at Heathrow

8.3. Airline equity fundraising

8.3.1. We include below a brief summary of European airline equity fundraising that has taken place to support businesses following the start of Covid-19 based upon available public information

⁷² [Bank of England: Prudential Regulation Authority Annual Report 2019-2020](#), Strategic Goals



Airline	Equity raised	Airline	Equity raised
IAG	€2.74bn	Lufthansa	€300m
easyJet	£419m	Norwegian	NOK 13.1bn
Finnair	€500m	Ryanair	€400m
Icelandair	US\$200m	SAS	SEK 14.3bn
Jet2	£692m	Tui	€500m

Yours sincerely,



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