

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

CAP1832



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Enquiries regarding the content of this publication should be addressed to: economicregulation@caa.co.uk

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About this document

Views invited

This working paper focusses on options the CAA is considering to provide further assurance that Heathrow Airport Limited (“HAL”) operates in a financially resilient manner and that risks to consumers arising from financial distress are appropriately mitigated while not cutting across the financing arrangements that HAL already has in place to support its regulated business. It considers options for possible changes to the financial resilience and ring fencing provisions in HAL’s licence that may be appropriate, in particular, given the scale and challenges of the development of new capacity at Heathrow airport. It develops further the thinking we set out in our consultations on the regulatory framework to support capacity expansion at Heathrow in June and December 2017.

We welcome views on all the issues raised in this working paper.

Please e-mail responses to economicregulation@caa.co.uk by no later than 11 October 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact James Wynn-Evans (economicregulation@caa.co.uk).

Executive summary

Introduction

1. In addition to our main consultation papers on developing the regulatory framework and price control arrangements for HAL, we are publishing working papers to address further issues and detailed aspects of the regulatory arrangements. The first such paper discussed the cost of capital and incentives.¹
2. Our consultations on the regulatory framework to support capacity expansion at Heathrow in June and December 2017 set out our initial thinking on financial resilience and ring fencing.² As indicated in the October 2018 Consultation, this working paper develops that thinking in the light of stakeholders' views and the further work we have undertaken.

Our approach to financial resilience

3. Consumers can suffer detriment when service providers experience financial difficulties, including because financial distress can cause disruption to services and investment. The importance of the services provided by HAL emphasises the significance of its financial health to consumers.
4. There are existing conditions in HAL's licence that relate to financial resilience. HAL has also successfully financed the redevelopment of Terminal 2 and created strong arrangements to facilitate its access to the UK and international debt markets to support the financing of its regulated business, which we refer to

¹ See CAP1674, Economic regulation of capacity expansion at Heathrow: working paper on the cost of capital and incentives www.caa.co.uk/CAP1674

² See:

- CAP 1541: Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow ("the June 2017 Consultation") www.caa.co.uk/CAP1541;
- CAP 1610: Economic regulation of capacity expansion at Heathrow: Policy update and consultation ("the December 2017 Consultation") www.caa.co.uk/CAP1610; and
- CAP 1722: Economic regulation of capacity expansion at Heathrow: policy update and consultation ("the October 2018 Consultation") www.caa.co.uk/CAP1722.

in this working paper as its “financing platform”.³ The size of the investment required to deliver capacity expansion (the development of a third runway and the associated infrastructure at Heathrow) will, however, bring new challenges for HAL to manage.⁴ Given this, and the impact of corporate financial distress on construction projects that we have seen elsewhere,⁵ we consider it is appropriate to consider whether we should seek to strengthen further the licence protections that relate to financial resilience, while taking full account of HAL’s circumstances and respecting its financing platform.

5. We consider that it is appropriate to progress our work on this issue at this stage of the development of the regulatory regime to support capacity expansion (and to do so transparently) through this working paper. While we have not reached a firm view as to whether (and if so what) changes to the regulatory regime are required to further the interests of consumers, it is important that investors and other stakeholders have early sight of the protections that we are considering. Addressing these issues at this stage will also allow any changes we propose to be taken account of appropriately in setting HAL’s cost of capital. Nonetheless, we have no evidence to suggest that the changes envisaged in this working paper will lead to an increase in HAL’s cost of capital.
6. Our approach seeks to recognise the continuing success of HAL in using its existing debt platform to raise new finance and that financial distress is a low probability but potentially high impact event. As we noted in the December 2017 Consultation, the financing arrangements used by HAL creates benefits for consumers in enabling it to raise large quantities of debt finance. We also note that bondholders and consumers have a common interest in HAL remaining financially robust.

³ Details of the arrangements comprising HAL’s financing platform can be found at: https://www.heathrow.com/company/investor-centre/offering_related-documents

⁴ While we observe that the conditions in HAL’s licence dealing with financial resilience and ring fencing do not necessarily reflect practice in other sectors, this is understandable given the different circumstances of each sector. We do not consider that these differences of themselves justify changes to HAL’s licence. Further detail on the CAA’s approach to comparisons with other sectors is set out in chapter 1 at footnote 16 to paragraph 1.25.

⁵ See, for example, the disruption to the construction of Midland Met Hospital after the collapse of Carillion.

7. To the extent that our proposals promote HAL's financial resilience and help it to avoid experiencing financial distress, they will be in the interests of both bondholders and consumers. At the same time, we need to recognise that, if HAL were to experience financial distress, the interests of bondholders (who are primarily interested in the repayment of their loans) and consumers (who will be interested, for example, in continuity of service and the longer term benefits of expansion) may diverge. Significant adverse impacts on consumers could arise from this. Bearing these factors in mind, we are considering appropriate, targeted and proportionate options that address this potential tension in the interests of consumers without cutting across HAL's financing platform.
8. Our aim is to protect consumers from the disruption that financial distress could cause by:
 - reducing the likelihood that HAL does not have sufficient resources to operate its business; and
 - mitigating the impact of financial distress should it occur, including through the provision of information to the CAA.
9. In this context, we must:
 - recognise the impact and importance of HAL's existing financing arrangements, while avoiding actions that would cut across those arrangements (such as restrictions on the ability of HAL to make payments to satisfy its obligations under the financing platform);
 - seek appropriate protection for consumers against the risks of financial distress; and
 - not undermine HAL's ability to deliver capacity expansion by making it difficult or more expensive for it to raise finance.
10. That said, and for the reasons outlined above, we do not consider that it would be appropriate for the CAA essentially to delegate the entirety of its financial resilience policy in relation to HAL to bondholders or other lenders to HAL's corporate group. This would be the case if we were to rely solely on the mechanisms set out in HAL's financing platform. Our view is, therefore, that we should continue to develop options for promoting HAL's financial resilience that

could work to enhance the protection given to consumers from the consequences of financial distress should it occur. These options will be designed to work in conjunction with, or alongside, rather than cutting across, the existing provisions of HAL's financing platform.⁶

11. The further analysis that we have conducted, together with our assessment of stakeholders' responses to the December 2017 Consultation, indicate that the additional steps summarised in Table 1 are worthy of further consideration.

Table 1: summary of key developments discussed in this working paper

Proposal	Description	New or existing condition?
Sufficiency of resources.	Enhance the existing sufficiency of resources obligation to (i) provide greater granularity over the nature of sufficient resources (including cash, liquidity and operational resources) and (ii) cover operation of the airport in accordance with the licence.	Builds on existing obligation and ensures consistency within the licence.
Obligation to maintain credit rating.	HAL to have and maintain an investment grade credit rating. Create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the investment grade credit rating is lost.	New provisions.
Sufficiency of resources certification.	Enhance the existing certification of sufficiency of resources, to clarify that HAL's board is expressly expected to consider each of: (i) operational; and (ii) financial resources robustly. Bolster supporting evidence required. Create a trigger for new rules creating a targeted curtailment of HAL's ability to make dividend and other payments if the certificate given is not "clean".	Builds on existing certificate and evidence requirements. New provision for trigger.

⁶We also note that some debt finance is issued further up HAL's corporate structure. The aim of our proposals is also to avoid adverse impacts on this financing, as discussed in chapter 3.

Targeted curtailment of HAL's ability to make dividend and other payments.	New rules creating a targeted restriction on HAL's ability to pass funds to its shareholders and make other payments in the event that the triggers apply (subject to carve outs to avoid undesirable consequences and any inappropriate negative impacts on bondholders).	New provision.
Ultimate controller obligation.	Clarify HAL's existing obligation to make clearer that: (i) the undertaking should be provided by the top holding company in HAL's corporate group, not its shareholders; and (ii) group companies are expected to provide information for CAA. Require HAL to remind ultimate controller of its obligations annually.	Refine and clarify drafting of existing obligation. New provision for annual reminder.
Information provision.	Require provision of information in line with information provided to bondholders under HAL's financing platform. More onerous obligations to apply in the event of financial distress.	New provision.

12. We do not consider that the options of placing a gearing cap on HAL or a restriction on HAL's ability to dispose of assets which were discussed in the December 2017 Consultation should be considered further as part of this review. We are not considering options other than those set out above.
13. The structure of this working paper is as follows:
- chapter 1 summarises the issues raised in the December 2017 Consultation, stakeholders' responses and our latest thinking on our approach to financial resilience; and
 - chapters 2 and 3 build on the analysis set out in the December 2017 Consultation and set out more detail on the options summarised in Table 1.

Next steps

14. We invite comments from stakeholders on the issues raised in this working paper by 11 October 2019. Having considered them, we intend to produce a further working paper on the issues covered here later this year.
15. Our work on financial resilience and ring fencing sits alongside the development of the price control arrangements to cover the expansion of Heathrow. As such, it complements the discussion of the use of credit ratings in the assessment of the financeability of capacity expansion at Heathrow set out in the March 2019 Consultation.⁷ In this context, we note that our approach to setting HAL's price control should itself support financial resilience by being balanced so that risks are identified and HAL is rewarded appropriately for the risks that it takes. Nonetheless, such an approach does not necessarily eliminate the need for financial resilience licence conditions in the interests of consumers.
16. As noted above, we are still developing our policy in this area and have not decided whether (and if so what) changes to the regulatory regime are required to further the interests of consumers. However, should the CAA consider that any changes to HAL's licence were required to reflect the outcome of our work on financial resilience and ring fencing, these would be implemented as part of the full "H7" price control. Prior to that, the text of any required licence modifications would be consulted on in advance of the statutory consultation to implement the H7 price control.

Our duties

17. In developing this consultation, we have had full regard to our statutory duties under the Civil Aviation Act 2012 ("CAA12"), which are set out more fully in Appendix A.

⁷ See chapter 1 of CAP 1782: Economic regulation of capacity at Heathrow: policy update and consultation ("the March 2019 Consultation"): <http://www.caa.co.uk/CAP1782>

Chapter 1

The December 2017 Consultation

Introduction

- 1.1 This chapter summarises the issues discussed in the December 2017 Consultation, stakeholders' responses to them and summarises our latest thinking on these matters.

The December 2017 Consultation

- 1.2 The December 2017 Consultation set out our early thinking on possible developments to HAL's licence to protect consumers from the risks that they may face from HAL experiencing financial distress. The December 2017 Consultation built on the recommendations of a KPMG report on financial resilience⁸ and reviews of both HAL's financing platform and the approaches taken by economic regulators.⁹
- 1.3 The December 2017 Consultation:
- noted the rules in HAL's financing platform and their focus on protecting bondholders rather than consumers;
 - made it clear that any changes we introduce must have clear benefits and not impose undue costs on HAL and consumers (so, for example, must not precipitate a refinancing of HAL by cutting across the arrangements in HAL's existing financing platform);

⁸ This report recommended that the CAA explore the use of debt indexation, gearing caps, credit ratings and cash balance obligations. See:

<http://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=8452>

⁹ We reviewed the approaches taken by Ofwat, Ofgem, ORR and the CAA (in relation to its economic regulation of NATS (En Route) plc ("NERL") under the Transport Act 2000). See: <https://www.caa.co.uk/Commercial-Industry/Airspace/Air-traffic-control/Air-navigation-services/NATS-En-Route-plc-NERL-Licence/>

- proposed that any changes should be designed to ensure that HAL has sufficient resources to operate its business and be financially resilient, while mitigating the risks and consequences of financial distress;
- noted the advantages of promoting stakeholder confidence in the long-term stability of regulatory arrangements;
- explained that HAL's board should retain primary accountability for financial stability; and
- said that financial resilience conditions should be consistent with other regulatory policy objectives and implemented in a timely way.

1.4 We also identified a “long list” of potential measures for further consideration.^{10,11}

Stakeholder views

- 1.5 The common thread of those stakeholders' responses that addressed financial resilience was to support rigorous cost-benefit analysis of any changes.
- 1.6 HAL's response was based on the premise that the best way to ensure that it is financially resilient is for the regulatory framework to compensate it appropriately for the risks it faces. While it welcomed the CAA's desire not to cut across its financing platform, it took the view that any duplication of the rules in the financing platform would be redundant and therefore costly. It said that the CAA should look at its financing platform and the licence together as a package to avoid the risk of diverging regulatory and financing obligations and/or obligations with an adverse effect on its financing arrangements.

¹⁰ These were (i) limited additional restrictions on the disposal of assets; (ii) a new obligation to maintain a corporate credit rating (iii) stronger sufficiency of resources obligations; (iv) enhanced compliance certification; (v) enhanced ultimate controller obligations; (vi) enhanced information provision; and (vii) cash/dividend lock up provisions.

¹¹ The December 2017 Consultation also observed that the protections in HAL's licence are less extensive than in other economic regulation regimes. See footnote 16 to paragraph 1.25 for our views on the relevance of the approaches used in other sectors to our analysis.

- 1.7 HAL suggested that the existing obligations in its licence and financing platform are already adequate to protect consumers, drawing particular attention to the:
- licence obligations requiring HAL to inform the CAA of any changes to the credit rating obligations in its financing platform and provide annual sufficiency of resources certificates; and
 - obligations in its financing platform creating restrictions on its ability to pay dividends etc. in the event of specified financial ratios not being met.
- 1.8 On specific measures, HAL commented that:
- an obligation to hold a corporate credit rating would be unnecessary, expensive and confusing given the requirements in its financing platform for it to maintain credit ratings for its listed instruments;
 - dividend lock up obligations could be problematic because it uses dividends from its regulated business to service debt elsewhere in its corporate structure;
 - extending HAL's obligation to obtain undertakings from its ultimate controllers to its shareholders might discourage future investment; and
 - enhanced information provisions might be appropriate, if specified in an appropriate focused way.
- 1.9 Airline representatives had concerns that creditors' objectives may differ significantly from those of the CAA in protecting consumers and supported proposals to move towards a more complete ring fence. However, they urged the CAA to take care not to disturb HAL's financing arrangements or its ability to raise debt.
- 1.10 One airline supported the CAA's approach, but emphasised the need to consider the impact of any changes on affordability and financeability. It considered that:
- a corporate credit rating requirement might promote a cautious approach by HAL; and
 - a dividend lock-up could be a way of ensuring that HAL contributes to managing construction risk through its cash flows instead of paying dividends.

- 1.11 Gatwick Airport Limited considered that HAL was already subject to a strong incentive to remain financially resilient in its financial platform and cautioned against a direct read across of rules from other regulated sectors. It also noted that, even in financial distress, HAL would be likely to generate positive cashflows.
- 1.12 Another stakeholder, supported the CAA's view that bondholders' and consumers' interests are not necessarily aligned and, drawing on the collapse of Carillion, was concerned that an orderly administration of HAL might not be possible if it got into financial distress. It supported the development of protections that would not reduce bondholders' security.

CAA views

The importance of financial resilience rules in protecting consumers

- 1.13 Consumers can suffer detriment when service providers experience financial difficulties, including because financial distress can cause disruption to services and investment.
- 1.14 The importance of the services provided by regulated companies strengthens consumers' interest in avoiding these detriments. In HAL's case, the substantial market power it enjoys as operator of Heathrow airport emphasises the importance of both HAL itself and its financial health to consumers. Capacity expansion will bring additional financial, operational and construction challenges for HAL to manage.¹²
- 1.15 Regulatory frameworks across many sectors address the risk of consumer detriment arising from financial distress by promoting financial resilience. Common aims of these arrangements are to:
- provide an obligation (or strong regulatory incentive) for businesses to maintain sufficient resources and operate in a financially prudent and robust manner; and

¹² These could arise from: the amount of equity and debt that HAL will need to raise to finance expansion; or construction and operational risks from developing new capacity.

- facilitate the mitigation of problems if they arise, including through providing the regulator with suitable information to enable it to identify emerging issues and respond to them.
- 1.16 These frameworks seek to promote these aims in different ways, including:
- prudential rules and capital adequacy rules applicable in financial services markets; and
 - ring fencing licence conditions in other regulated sectors.¹³
- 1.17 These arrangements do not, however, seek to eliminate the possibility of financial distress because this acts as a significant commercial discipline on the company, its board and shareholders to act prudently. Any attempt to do so would be likely to require unacceptably onerous or expensive obligations and may risk creating perverse incentives.
- 1.18 Rather, these arrangements seek to:
- ensure that responsibility for the ongoing management of the business remains with boards of directors and shareholders as they are best placed to understand and manage long and short-term risks; while
 - reassuring the regulator and consumers that the regulated company will in most circumstances remain in a position to finance its activities and timely action can be taken to mitigate problems if they arise.
- 1.19 As a result, these rules (whatever their form) have not affected the ability of the owners of regulated businesses to exercise their ownership rights. Similarly, these rules have not unduly limited the range of financial structures deployed by regulated businesses and have clearly not adversely affected businesses' ability to raise finance.
- 1.20 Further, any such arrangements would not provide any substitute for the need to set HAL's price control in a way that is consistent with the CAA's statutory

¹³ Financial resilience rules often work in conjunction with a "special administration" regimes that allow the affected entity to operate during an administration, keeping the assets and regulatory licence together, until it can be sold to new owner or would down in an orderly manner. No such regime applies to HAL because it is not provided for within the relevant legislation.

duties, including taking careful account of how risks are allocated and how risk management is rewarded. As HAL has suggested, this approach to setting price controls contributes to financial resilience, but we are clear that, as in other sectors subject to economic regulation, it does not necessarily eliminate the need for financial resilience licence conditions. As discussed above, the CAA considers that financial resilience rules should complement its approach to setting the price control. For example, in relation to financeability testing, we set out further detail of our views on the relationship between financeability testing and financial stability rules in the March 2019 Consultation,¹⁴ so those views are not repeated here.

- 1.21 As we discussed in the December 2017 Consultation, HAL's existing licence conditions may not provide a sufficiently robust set of protections for consumers in the context of HAL's specific circumstances. So, it is appropriate for us to consider options for developing licence protections further to address issues relating to financial resilience and ring fencing.

Taking a proportionate approach

- 1.22 We note the points that HAL has made about not duplicating the protections provided by its existing financing platform, and recognise that the ring fencing arrangements that are associated with these arrangements may provide some indirect protection to consumers from the way it protects bondholders as both bondholders and consumers have a common interest in HAL avoiding financial distress. Nonetheless, it is not clear that these arrangements are sufficient to protect consumers. This is because they were designed to protect, and are only enforceable by, bondholders, who may have a different focus (payment of interest and repayment of capital on their loans) from consumers (continuity of provision of quality services at an affordable price).¹⁵

¹⁴ See chapter 1 of CAP 1782 at <http://www.caa.co.uk/CAP1782>

¹⁵ For example, the financing platform contains restrictions on HAL's activities, a restriction on disposal of assets, restriction on creation of security other than that required under the financing platform, and provisions to limit the amount of debt held and to drive the maintenance of credit ratings for its bonds.

- 1.23 The different interests of bondholders and consumers may be brought into sharp focus if financial distress occurs. This could happen if a problem (trigger event or event of default) under the financing platform were to be resolved by bondholders giving consent to actions by HAL that were not in the interests of consumers. For example, HAL might seek a waiver of a trigger event by bondholders through offering to make deep cuts to its operating expenditure that could have a significant impact on the quality of the service provided to consumers. By contrast, another approach, such as suspending dividends, shareholders making equity injections and/or considering whether a restructuring of HAL's debt finances might provide a better long-term solution to the issue that had arisen in the interests of all stakeholders (including bondholders). Given this possibility, and the challenges of capacity expansion, it is not appropriate for the CAA to rely solely on the contractual relationship between HAL and its lenders to protect consumers.
- 1.24 We agree with respondents that identifying options for proportionate changes to HAL's licence in this area requires us to assess whether the benefits any changes may bring will outweigh their costs. As discussed earlier in this chapter, we also agree that any provisions for HAL should be developed in its individual circumstances, including taking account of the potential for them to have a negative impact on its financing platform and the costs HAL faces in raising debt. Our approach to developing options seeks incremental benefits over those already provided by the financing platform without conflicting with it. It will be a tailored approach that both recognises:
- the potentially divergent interests of different stakeholder groups (bondholders and consumers); and
 - the importance of HAL's financing platform and the advantages of not cutting across those arrangements.
- 1.25 While this will involve considering whether it would be appropriate to curtail HAL's freedom of action in specific and limited circumstances where this may be

needed to protect consumers, we consider that the options outlined in this paper are unlikely to create significant costs for HAL.¹⁶

1.26 As the options considered in this working paper would, if adopted, be included in HAL's next "full" price control ("H7") to cover the construction of new capacity, our assessment of them remains at a relatively early stage. Our final assessment of suitable measures will consider both the appropriateness of individual measures and an assessment of any suite of protections we may propose in the context of the price control as a whole.¹⁷ We also agree with the comments made by HAL that it is important to support financial resilience by developing the price control in a balanced way where risks are identified and HAL is rewarded appropriately for the risks that it takes and our approach in relation to financial resilience is designed to complement this work.¹⁸

Further analysis conducted by the CAA

1.27 Since the December 2017 Consultation, we have conducted further analysis of the individual measures which we identified for further consideration. This assessment is more advanced for some options than for others.

1.28 In the December 2017 Consultation, we categorised potential licence conditions relating to financial resilience into the following interlinked categories:

- "specific" provisions to provide greater assurance the licensee has sufficient resources;

¹⁶ While comparisons with other sectors may be relevant because of the importance of Heathrow to consumers and the significant levels of debt HAL currently bears (and intends to raise as part of the financing of new capacity), differences in approach between HAL's licence and those other sectors do not, of themselves, provide a reason justifying the creation of new obligations in HAL's licence. We have, however, used conditions observed in other sectors as a "cross check" to help us to assess the appropriateness and proportionality of possible new obligations. As a result, the approach that we will take is unlikely to be the same as that observed in other sectors, although it may use or adapt some similar conditions or mechanisms.

¹⁷ As discussed in the December 2017 Consultation, other aspects of our work will consider related provisions. For example, the question of whether we should put in place a licence condition requiring HAL to deal with all parties on an arm's length basis and normal commercial terms will be taken forward in the context of procurement, and consideration of whether there is merit in obligations in relation to cross subsidies, and the nature of HAL's regulatory accounts will be taken forward in the context of our work on regulatory accounting.

¹⁸ See further the discussion of financeability testing in chapter 1 of the March 2019 Consultation.

- “conduct of business” provisions to provide greater assurance the licensee’s assets are not diverted/exposed to undue risk; and
- “general oversight” provisions to give the regulator clearer sight of the licensee’s financial position and help to mitigate the effects of financial or operational stress should it occur.¹⁹

1.29 Our current thinking on the options identified in the December 2017 Consultation is set out in the following chapters. Having narrowed the potential options under consideration further, we now categorise these into two types of provisions:

- (i) to provide greater assurance that HAL will have sufficient resources to operate its business in a financially prudent and robust way (see chapter 2); and
- (ii) to mitigate the impact of financial distress if it occurs, including through the provision of information to the CAA to enable it to respond to any developing issue (see chapter 3).²⁰

1.30 Where appropriate, these chapters also address stakeholders’ main comments on the specific options discussed in the December 2017 Consultation.

Views invited

1.31 Views are invited on any of the issues raised in this chapter, and especially on our broad approach to developing options for financial resilience and ring fencing conditions for HAL.

¹⁹ See the December 2017 Consultation at paragraph 4.17.

²⁰ The December 2017 Consultation indicated that we would not consider the following areas further at this stage: (i) requirement to maintain a minimum cash balance; (ii) restriction on creating security over assets and prohibition on cross default obligations; (iii) dividend policy regulation; (iv) requirement for sufficiently independent directors; (v) requirement to maintain a listed financial instrument; (vi) requirement for approval of HAL’s finance documents. We confirm that we do not intend to develop proposals in these area at this stage.

Chapter 2

Options for ensuring HAL has sufficient resources

Introduction

- 2.1 This chapter sets out our current thinking in relation to the following options we identified in the December 2017 Consultation:
- gearing caps;
 - prohibitions on disposal of assets;
 - an obligation to hold an investment grade credit rating; and
 - sufficiency of resources obligations.
- 2.2 Each of these options may reduce the likelihood of financial distress by giving greater assurance that the licensee manages its business so that it has sufficient resources to carry on its business in an appropriate and prudent way.

Gearing Cap

- 2.3 In this section, we assess the merits of a gearing cap and conclude that, at present, the introduction of such a mechanism would not be appropriate.
- 2.4 A restriction on the level of gearing that a licensee may take on is a risk management tool to provide assurance that its levels of debt do not threaten its financial stability. For these reasons, similar tools are used in bond documents²¹ (including HAL's financial platform) and are considered by credit rating agencies.²²

²¹ Albeit that the purpose in these documents is to seek to ensure that, in a default, sufficient value remains in the company for senior creditors to sell the company while it retains significant value.

²² The CAA caps NERL's gearing in its licence at condition 5(24): See: [https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airspace/Air_traffic_control/Licences/NERL%20LICENCE%2015%20\(Jun%2018\).pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airspace/Air_traffic_control/Licences/NERL%20LICENCE%2015%20(Jun%2018).pdf). However, it should be noted that this cap was introduced in very different circumstances from those applicable to HAL.

2.5 However, setting a gearing cap holds significant challenges both generally and in HAL's particular circumstances, as it already has a relatively high level of gearing permitted by its financing platform.²³ These challenges include:

- identifying an appropriate level at which to set the cap, including the risk that a cap set at the wrong level may increase the cost of capital by requiring a greater (and more expensive) equity contribution;
- that a "hard rule" could remove an element of management and shareholder discretion over, and responsibility for, the company's financing and stability;
- the risk that such a cap might be seen as implicitly approving a particular level of gearing by the CAA, thereby diluting the CAA's policy that HAL's choices as to how it finances itself are the responsibility of HAL's directors and shareholders;
- the risk that any such rule might need to allow for the possibility of HAL obtaining CAA consent for higher gearing, creating additional burdens and uncertainty; and
- the need to manage the relationship with HAL's existing debt levels, including avoiding creating a licence breach which could be a trigger event under the financing platform.²⁴

2.6 While there may be ways of managing these issues,²⁵ other tools appear better suited to managing the risks of excessive levels of debt, such as the appropriate use of credit rating requirements. So, we do not propose to consider a gearing cap further.

2.7 Further detail of our current thinking on issues relating to gearing is set out in the March 2019 Consultation.

²³ See Heathrow's financing platform: Common Terms Agreement at Schedule 3, paragraph 1.

²⁴ For example, a cap could either be set at a comparatively high level (especially when compared with the "nominal" gearing level we propose to use in calculating the weighted average cost of capital), or require progressive de-leveraging by HAL over time.

²⁵ Such as creating a "tapering" gearing cap which sought to lower HAL's gearing over time.

Restricting the disposal of assets

2.8 In this section, we assess the merits of a prohibition on HAL disposing of its assets and conclude that, at present, the introduction of such a mechanism would not be appropriate.

2.9 Prohibitions on regulated companies disposing of their assets are generally aimed at ensuring that the assets which are funded by charges on consumers continue to be available for the provision of services to those consumers. This tool is widely used in economic regulation and extends to restrictions on the creation of security over both physical assets and non-physical assets (including income streams) so that the licensee's resources are also protected from falling into the hands of creditors. These obligations back up more general sufficiency of resources obligations by controlling asset disposals between annual certificates of sufficiency of resources. They also support special administration arrangements that are found in a number of sectors subject to economic regulation, but are not part of the statutory framework for the economic regulation of airports.

2.10 HAL's financing platform contains:

- fixed charges over all of HAL's significant assets, including shares held by HAL; and
- a floating charge over all of HAL's assets.

These severely limit the scope for an effective obligation prohibiting disposal of assets, since we would have to issue derogations for these arrangements or jeopardise HAL's existing and prospective financing. We do not consider this to be an appropriate or proportionate approach in the circumstances of capacity expansion.

2.11 Having considered this issue further, and in order to pursue our policy aim of not taking an approach that could undermine the delivery of capacity expansion by making it harder for HAL to raise finance, we consider that a better approach would be to consider options that provide better assurance that HAL's sufficiency

of resources obligation and certification requirements are robust. These matters are discussed later in this chapter.

An obligation to hold an investment grade credit rating

- 2.12 Credit ratings provide objective third party assurance of a company's financial position. Investment grade credit ratings are also needed to maintain access to investment grade finance, thereby reducing borrowing costs and, therefore, costs to consumers. As a result, an obligation in HAL's licence requiring it (or a group company) to hold an investment grade credit rating could help bolster the credit rating obligations in HAL's financing platform and ensure that HAL has sufficient resources and manages its business in a financially robust way.
- 2.13 HAL's financing platform contains separate credit rating requirements for the Senior "Class A" and Junior "Class B" bonds issued under it.²⁶ Although consideration of HAL's financial strength is a factor in the assessment of the credit rating for HAL's listed instruments, these ratings reflect the specific credit risk of the bond issues, taking into account the provisions of the financing platform. As such, neither of these rating requirements reflect a "pure" view of the credit risk or financial strength of either HAL or the companies within the banking ring fence created by the financing platform.²⁷
- 2.14 We consider that there may be merit in the licence containing an obligation for an investment grade credit rating and that this might be for HAL itself, as licensee, to be so rated. This would appear not only to provide a further incentive for HAL to run its business in a financially prudent and robust way, but would also provide useful information to the CAA to highlight the need to address any increase in the risk of financial distress.

²⁶ HAL's financing platform sets trigger events in relation to the senior and junior bonds separately: for the senior bonds it is set as a downgrade below a long-term credit rating of BBB+ or equivalent rating by at least two ratings agencies, and in relation to the junior bonds, it is set as a rating falling below investment grade by at least two ratings agencies: see Common Terms Agreement, schedule 3, paragraph 2.

²⁷ These bonds are issued by Heathrow Funding Limited and Heathrow Finance plc, companies which exist to finance HAL.

- 2.15 If the option of creating an obligation on HAL to maintain an investment grade credit rating were adopted, it would be focussed solely on the financial strength and stability of HAL, without consideration of the complexities created by the financing platform, or the relative priorities of particular classes of bondholders. It would also have the benefit of recognising the importance of credit ratings in the regulatory regime, giving both HAL and investors confidence that the CAA will, in setting price controls, continue to recognise the advantages of HAL being able to continue to access investment grade financing.²⁸
- 2.16 However, given that HAL's financing depends on a structure that is wider than just HAL itself, we are also considering whether a such a rating might more appropriately be focussed on another entity, such as Heathrow SP Limited, as holding company of both HAL (indirectly) and Heathrow Funding Limited.
- 2.17 Stakeholders have suggested that a credit rating obligation might:
- be expensive, unnecessary and create confusion, especially if the company rated does not itself issue bonds;
 - create a risk of inconsistency between any issuer rating and the issue ratings of the bond issues; and
 - prompt an unduly cautious approach by HAL to financing.
- 2.18 We consider that these issues do not render it inappropriate for us to continue considering the introduction of an obligation on HAL to maintain an investment grade credit rating for the following reasons:
- the credit ratings of the bonds are largely dependent on the financial strength of HAL which would also underpin an issuer or other appropriate rating;
 - with appropriate transparency, stakeholders should readily be able to distinguish the role and purpose of each rating;

²⁸ See chapter 1 of the March 2019 Consultation for a discussion of our current thinking on the use of credit ratings as part of our work on financeability.

- retaining access to investment grade financing is essential to reduce the costs of debt finance, rather than being unduly prudent or cautious; and
- the costs of such a rating are unlikely to be significant in the context of HAL's financing costs.

2.19 We see a credit rating obligation as complementing an approach to setting HAL's price control that recognises the importance of credit ratings.

2.20 If a credit rating obligation were to be accompanied by a curtailment of HAL's rights to pay dividends or make other restricted payments (as discussed in chapter 3) in the event that the required investment grade credit rating were to be lost, we see such an obligation as having the potential to promote mitigating actions by management in the event that an investment grade credit rating were to become at risk. For these rules to work together effectively (and their application not to inadvertently trigger adverse consequences under HAL's financing platform), any licence obligation would be designed so that the loss of the investment grade credit rating would not constitute a licence breach, but to act as a "switch" to activate any rules curtailing HAL's ability to make dividend and certain other payments (as discussed in more detail in chapter 3).

2.21 As for whether the condition should apply to HAL or another company in the group, such as Heathrow SP Limited, we note that Ofwat has, for some time, accepted a "corporate family rating" covering the regulated business and an associated financing company in the discharge of obligations to hold an investment grade credit rating.²⁹ However, we recognise that a corporate family rating may raise other challenges (such as the extent to which markets find such ratings useful and therefore facilitate access to investment grade credit, the possible volatility of the rating itself and whether the rating is available from a sufficiently wide pool of rating agencies).

2.22 In this context, we also recognise that there may be merit in a simpler approach that promoted consistency with HAL's financing platform. This would be to focus

²⁹ Ofwat has recently consulted on formalising this approach across the water sector for those companies that are financed using a group financing company. See <https://www.ofwat.gov.uk/wp-content/uploads/2018/11/Consultation-on-strengthening-the-regulatory-ring-fencing-framework.pdf>.

on a requirement that HAL should maintain access to investment grade finance. Specifically, this might, for example, be to refer to an existing rating requirement in the financing platform, such as that required for the Senior “Class A” bonds. This requirement would run in parallel with, but be independent from, any obligation in the financing platform. It would, however, potentially provide an approach that used a relatively stable credit rating that was well known and understood by the market and represented a standard to which HAL already holds itself. However, any such approach would need to consider how appropriate future proofing should be addressed (for instance to take into account changes to the financing platform that HAL might negotiate with bondholders).

- 2.23 In this context, if we decide to continue with the development of an obligation to hold an investment grade credit rating, we will consider how the CAA can best tailor its approach HAL’s particular circumstances.
- 2.24 As a result, we consider that the potential for a regulatory obligation to maintain an investment grade credit rating is worthy of further exploration.

Sufficiency of resources

- 2.25 We consider that it is core to our aims of incentivising financial robustness and mitigating the risk of financial distress occurring that HAL has a robust obligation to have sufficient assets to operate the airport to an appropriate standard, taking into account any capital expenditure projects where substantial progress has been made.
- 2.26 We have indicated that we do not consider that the best way to achieve this is through either a minimum cash balance requirement,³⁰ or a restriction on asset disposals (see above). We are, however, keen to ensure that the sufficiency of resources obligation applicable to HAL, while currently wide (applying to resources “without limitation”), should clearly and transparently cover each of cash and liquidity facilities, as well as operational assets as well as all other

³⁰ See the December 2017 Consultation at Appendix F.

assets. In addition, while HAL already has a licence obligation to maintain sufficient resources to operate its business, the existing obligation is silent on the standard of operation that the assets should support.³¹ We consider that this leads to a risk that it could be interpreted so as to mean a very low standard which would not be in the interests of consumers.

2.27 To address these issues, we consider that the present obligation could be clarified and built on in the following ways:

- to specify that “sufficient resources” includes (i) cash, financial facilities and access to liquidity as well as other financial resources, and (ii) operational and physical assets; and
- to ensure internal consistency within the licence, by making clear that these assets must be maintained to enable HAL not just barely to provide airport operation services at Heathrow, but to do so in accordance with the licence. This clarification might also require that any forecast projects or material capital expenditure projects where substantial progress has been made should also be taken into account when making the assessment. We consider that this clarification should be carefully designed in order to ensure that it would not extend the obligation to requiring HAL to deliver substantial increases in new capacity, such as the third runway and associated development (which should be provided for and incentivised by HAL’s main price control).

2.28 We consider that these additions to HAL’s existing obligation would:

- provide greater clarity over what is meant by “sufficient resources”;
- provide more appropriate assurance over HAL’s access to cash and liquidity than could be provided by a minimum cash balance obligation; and
- ensure that the licence was internally consistent.³²

³¹ This obligation is set out in Condition E2.1 of HAL’s licence and states that:

“The licensee shall at all times act in a manner calculated to secure that it has available to it sufficient resources including (without limitation) financial management and staff resources, to enable it to provide airport operation services at the airport.”

³² Both on its own and when supported by annual certification requirements, as discussed in the next chapter.

- 2.29 We do not consider that this would add any substantial regulatory burden on HAL, given that:
- access to sufficient cash and liquidity, along with operational resources is implicit in its existing obligation;
 - it is required to comply with the obligations in its licence in any event; and
 - would not place an indirect obligation on HAL to deliver substantial increases in new capacity. Rather, it would ensure that if HAL were to be delivering new capacity, it should have sufficient resources to do so.

2.30 We do not consider that a change such as this is likely to be disproportionate, as HAL should also have suitable compliance procedures to satisfy itself on these matters at present: such changes would not add significantly to this burden.

Views invited

- 2.31 Views are invited on the options for possible changes to HAL's licence discussed in this chapter and, in particular, on:
- our view that it is not appropriate to consider either a gearing cap or prohibition on disposal of assets;
 - the option of introducing a credit rating obligation, the appropriate company in the HAL group that might be rated, and the form of any such obligation; and
 - the option of clarifying HAL's existing sufficiency of resources obligation expressly to cover cash, financial facilities and access to liquidity, as well as operation of the airport in accordance with its licence.

Chapter 3

Options for mitigating the impact of financial distress and providing information

Introduction

3.1 This chapter sets out our current thinking in relation to the following options we identified in the December 2017 Consultation:

- compliance certification;
- targeted curtailment of HAL's ability to make dividend and other payments, but not payments to service debt obligations that support the regulated business (which we have referred to previously as "cash lock up" provisions);
- ultimate controller undertakings; and
- enhanced information provisions.

3.2 Each of these options is aimed at further mitigating the impact that financial difficulties would have on the licensee and consumers, including by facilitating early intervention by the CAA in the circumstances of potential financial distress.

Compliance certification

3.3 Given the challenges that capacity expansion will bring, it may be appropriate to make incremental changes to clarify the existing certification obligations to clarify and improve both of them and bolster the evidence accompanying those statements.

Content and form of compliance certificates

3.4 Annual certification that the licensee has sufficient resources, together with the required supporting evidence, mitigates the likelihood and impact of financial distress by:

- providing assurance to the regulator that the management of the licensee is actively considering whether the business is financially robust; and
- requiring it to inform the CAA if this is not the case, better enabling it to develop an appropriate response if an issue arose.

3.5 We consider that the challenges that the expansion of Heathrow brings may warrant some enhancement to the existing certificates. While consideration of the following issues is implicit in the existing certificates, there may be some merit in enhancing them:

- expressly to include consideration of cash and liquidity requirements;³³ and
- to give greater individual focus to each of financial and operational resources.

3.6 As with the sufficiency of resources obligations, we do not consider that it would be appropriate to require HAL to certify that it is delivering expansion: rather the aim is for HAL to provide assurance that it has the resources it needs.

3.7 These changes could be achieved fairly simply by:

- annual certificates making specific reference to cash and liquidity; and
- reworking the existing certificate to ensure that HAL's board have explicitly given each of financial and operational resources sufficient consideration.

3.8 This could also better facilitate the directors drawing the CAA's attention to, for example, particular operational issues, such as a constraint in the availability of some important input into airport operation, (for example, firefighting equipment).

3.9 Given that we do not intend to create a restriction on HAL's ability to dispose of its assets, we consider that there may also be merit in requiring re-certification in the event of major disposals or prior to material distributions to shareholders if those were to occur a significant time (such as six months) after the latest annual certificate.³⁴

³³ As discussed in the previous chapter, we see this as a more appropriate safeguard than an obligation to maintain a specific level of cash balance or other liquidity reserve.

³⁴ For example, it might be appropriate for directors to provide a simpler certificate that they were not aware of

- 3.10 We have considered HAL's comments that board certification of its final business plan gives the CAA significant comfort. While such a certificate is important in the context of the price control review it does not provide an appropriate level of ongoing assurance. Similarly, we do not consider that HAL's view that the information it is required to publish to the financial markets is an appropriate substitute, because, as with the financing platform as a whole, this information is about satisfying the needs of investors rather than providing assurance to the CAA for the benefit of consumers.
- 3.11 Strengthening the certification requirements in the ways described above would appear to be relatively straightforward and would not, on its face, require significant additional compliance work from HAL. Rather, it would ensure that the CAA is provided with appropriately focussed assurance that HAL has sufficient resources to carry out its activities on an ongoing basis and we intend to consider it further.
- 3.12 Especially if the requirement to provide sufficiency of resources certificates were to be accompanied by a curtailment of HAL's rights to pay dividends or make other restricted payments in the event that it were unable to prove a "clean" certificate (see below), such certification has the potential both to promote mitigating actions by management and to stand in place of investigatory and enforcement action by the CAA. To achieve this, any licence obligation could be designed so that the provision of a certificate that was not "clean" would not constitute a licence breach, but would act as a "switch" or "trigger" to activate rules in the licence curtailing HAL's ability to make dividend and certain other payments (as discussed in more detail below).

Supporting evidence

- 3.13 We consider the evidence that HAL is required to provide in support of its annual certification should provide adequate assurance that the directors have considered all the relevant issues thoroughly prior to each certificate. Building on the existing requirements for statement of the factors that the directors have

any material changes that might affect the position of HAL since the last annual certificate.

taken into consideration, changes could include requiring explicit consideration of factors relevant to:

- any forecast projects or material capital expenditure projects where substantial progress has been made;³⁵
- any past or contemplated disposals or refinancing;
- cash reserves and liquidity;
- dividend policy;
- the outcomes of appropriate stress testing; and
- compliance processes.

3.14 To the extent that HAL would be required to provide the output of stress testing, we consider that, while such stress testing should be flexible to take account of HAL's circumstances as they change over time, such testing should also retain a sufficiently common approach from year to year, wherever possible, to allow reasonable comparisons to be made with respect to HAL's performance over time. We consider that it is most likely to be appropriate for the board of HAL to determine what stress tests are appropriate for it to use in developing the evidence base to support its certification as it is best placed to assess this issue and has primary responsibility for the financial stability of HAL.

3.15 While providing supporting evidence may place some incremental burden on HAL, we do not consider that this will be particularly significant since HAL should have the relevant policies and procedures in place to support its existing certification requirements in any event. We also think that the certification process can be used by HAL to provide a positive opportunity for it to conduct a formal forward looking annual "health check" on its own business. As such, this should, if anything, give greater assurance to investors than at present.

³⁵ The form of words used would need to be carefully chosen to make clear we are not requiring certification of development of new capacity.

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

- 3.16 As we have noted on a number of occasions, the CAA's policy is not to develop policy options which would interfere with HAL's debt financing arrangements as we do not consider that the time and financial costs or management distraction this would cause is likely to be in the interests of consumers.
- 3.17 However, so that our policy of promoting and incentivising HAL to conduct its business in a financially resilient and robust manner can be sufficiently effective, appropriate mitigation measures may be needed, provided that they are carefully designed not to interfere with HAL's financing arrangements.³⁶
- 3.18 While certification and information provisions can go some way towards achieving this, by providing greater assurance and a trigger for investigative or policy development work, we do not consider that these tools are likely to be adequate in every circumstance.
- 3.19 In particular, as we have seen in other industries, financial distress can develop quickly, particularly where investor confidence is affected, or in the event of a market-wide shock. In these circumstances, while the CAA could launch an investigation or develop new policy, the procedural safeguards of CAA12 mean that these steps may not be capable of being taken at a sufficient pace to deal with a fast-moving situation. At the same time, HAL's board might come under pressure from shareholders, for example, to pay a dividend in circumstances where it was facing financial difficulties.³⁷
- 3.20 Any step we take in this area should only lead to a limited and targeted curtailment of HAL's freedom of action and should be designed not to affect

³⁶ In this context, we note that HAL's financing platform contains a restriction on HAL entering into any agreement restricting its ability to pay dividends beyond those contained in the financing platform. However, as the licence is not an "agreement" (nor indeed, does HAL agree, or otherwise to consent to modifications to the licence under the licence modification procedure set out in CAA12), we do not consider that the CAA's ability to introduce appropriate rules into HAL's licence in this area would cut across HAL's financing platform.

³⁷ This issue has manifested itself elsewhere in the past in the form of the dividend paid by Railtrack in May 2001, prior its collapse in October that year.

payments to service debt obligations that support the regulated business since this would cut across HAL's financing arrangements. Any rules in HAL's licence curtailing its ability to make dividend or other restricted payments should apply only in circumstances where a problem is manifesting itself in specified ways such as:

- where HAL is not able to provide a "clean" sufficiency of resources certificate; or
- if any investment grade credit rating required under the licence were lost or under review for downgrade to a level below investment grade.

3.21 HAL's licence does not currently contain such rules. We understand that, in certain circumstances, a breach of its existing bond covenants can trigger a cash lock-up, but that is focused on the interests of bondholders.

3.22 While rules curtailing HAL's ability to make dividend and other payments in specified circumstances could not be guaranteed to provide sufficient mitigation to prevent financial distress in all circumstances, such rules would seek to preserve, as far as possible, the financial position of the company, limiting the scope for shareholders to prioritise their interests over those of consumers until the position can be resolved. As the curtailment of HAL's freedom of action would be subject to oversight by the CAA, rather than bondholders, they could also help to ensure that consumers' interests are not prejudiced in circumstances where they diverge from those of bondholders.³⁸ This may protect the company from being subjected to the pressure described above and could provide a "breathing space" for both HAL's management and the CAA to develop an appropriate response.³⁹

3.23 The triggering of rules curtailing HAL's ability to make dividend and other payments would not be a breach of HAL's licence and, therefore, would not lead to enforcement action. To the extent that the possibility of dividend curtailment incentivised shareholders to avoid dividend curtailment being triggered, we

³⁸ See paragraph 7 of the Executive Summary and chapter 1.

³⁹ Lock ups are regularly used in other sectors. See, for example, NERL's licence at Condition 5, paragraph 25.

consider that this may provide an additional incentive in favour of financial stability.

- 3.24 Rules of this kind are observed in other regulated sectors without obviously restricting the ability of companies in those sectors to raise finance. As such, they are not obviously disproportionate.
- 3.25 To achieve this, we consider that the most practicable tool is likely to be to create rules providing for a targeted curtailment of HAL's ability to make dividend and other payments to prevent the licensee's resources from being used for specified transactions in defined, limited circumstances. As we have noted above, this approach has a parallel in the finance platform which restricts dividends and debt repayments where a trigger event has occurred,⁴⁰ although the aim of those rules is different, since the financing platform aims to ensure that assets available to bondholders are protected.
- 3.26 HAL expressed concern in response to the December 2017 Consultation that a crudely designed lock up could create additional problems if it prevented cash from being passed to group companies to enable them to satisfy their obligations under the financing platform or other group indebtedness. We agree that this concern is valid and that any targeted curtailment of HAL's ability to make dividend and other payments must be carefully designed to avoid unintended consequences. In particular, it is unlikely to be in consumers' interests for the provisions of HAL's licence to precipitate default by other group companies on their loan obligations, particularly those arising under the financing platform. In the context of HAL's existing group financing structure, this approach would mean that HAL's licence would not prevent the group continuing to be able to observe its obligations in relation to the bonds issued not only by Heathrow Funding Limited, but also Heathrow Finance Limited and ADI Finance 2 Limited.
- 3.27 To address this, we consider that an appropriate approach might be to prohibit a limited set of transactions from being undertaken by HAL in specified

⁴⁰ See Common Terms Agreement, Schedule 3, Part 2.

circumstances. The types of payment that we consider could be appropriate to be covered by such a focused restriction would be likely to include:

- the transfer, lease, licence or lending of any sum or sums, assets, rights or benefits to any affiliate, except for certain specified transactions; and
- the declaration or payment of dividends.

3.28 Noting HAL's comments about the upstreaming of dividends to service debt obligations further up the corporate structure, and in order to avoid inappropriately cutting across HAL's financial platform or creating other unintended consequences, we consider that this approach should define a set of transactions that would not be caught by this restriction. Appropriately drafted, this approach should fully address HAL's concern, while still providing appropriate protection for consumers. Appropriate exceptions to this rule would appear to be:

- payments properly due for goods or services received under arm's length contracts on normal commercial terms that were entered into prior to the restriction being triggered;
- transfers, leases, licences or loans of assets rights or benefits, under arm's length contracts on normal commercial terms where the consideration due is payable wholly in cash and paid in full at the time of the transaction;
- costs, expenses, scheduled repayments and payments of interest due on loans entered into prior to the licence modification introducing the restriction coming into force in HAL's licence;⁴¹ and
- payments for tax relief not exceeding the benefit received, so long as these are not made before the tax would have been due.

3.29 If these were not considered clear enough, specific carve outs could also be created for payments made in respect of sums due under HAL's financing platform in order to give further assurance that such a provision would not conflict with it.

⁴¹ Care will also be needed to ensure that related parties are not able to circumvent this by putting in place loan obligations to facilitate extracting funds from within the lock up if it were triggered.

- 3.30 To provide assurance to the CAA that this obligation is being respected, there may also be value in requiring certification by HAL's directors that its payments comply with the licence when making any relevant distribution at a time when the restriction on payments had been triggered. We would also need to ensure that any provisions dealt appropriately with any risk that HAL might seek to put in place arrangements to circumvent any such lock up through arrangements with related parties.

Ultimate controller undertakings

- 3.31 If HAL faces financial distress, it is appropriate to seek to ensure that other group companies do not contribute to the problems it faces. In addition, the provision of information to enable the CAA to take steps to mitigate the situation may require us to obtain information from affiliates of HAL.
- 3.32 To facilitate this, HAL's licence contains an obligation for it to obtain a "good behaviour" undertaking from its ultimate controller to ensure that it and HAL's affiliates will not cause HAL to breach its licence and will provide the CAA with information they hold.
- 3.33 The December 2017 Consultation expressed our concern that the present drafting of HAL's obligation may not be clear enough to achieve these aims. In response, HAL expressed concern that the CAA may be seeking to extend the scope of the definition of "ultimate controller" to its shareholders and that this could impact investment.
- 3.34 Given the nature of our concerns, we do not consider that a change of the kind HAL is concerned about would be justified. However, as the term "ultimate controller" is not defined in HAL's licence (unlike in other sectors, where it can capture shareholders) we consider that there may be merit in clarifying that the existing obligation does not apply to shareholders by defining the "ultimate controller" to make clear that it is the "top" holding company of HAL's group.⁴² We do, however, consider that there may be merit in refining the drafting of

⁴² This could be achieved relatively simply by making clear that the ultimate controller would be a holding company of the Licensee which is not itself a subsidiary of another company.

existing obligations to make it clearer that the ultimate controller will undertake to ensure that group companies will provide information required by the CAA.

- 3.35 Alongside this, we are considering raising the profile of the ultimate controller undertaking within HAL's corporate group by adding an annual requirement to provide the CAA with a schedule of the ultimate controller undertakings in place, and confirmation that HAL has written to its ultimate controller in the preceding 12 months reminding it of the terms of the undertaking it has given. We consider that this would create only a small administrative burden on HAL but could bring a renewed focus on the undertaking and importance in HAL's licence compliance processes within the group as a whole.

Monitoring and information

- 3.36 At present, the information that HAL is required to provide to the CAA is limited and, for the most part consists of annual regulatory accounts requirements and sufficiency of resources certificates. The only obligation that HAL has in relation to matters that may emerge in relation to the functioning of the financing platform appear to be limited to circumstances in which HAL or a linked company is seeking advice from an insolvency practitioner.⁴³
- 3.37 In order to facilitate our monitoring of HAL's financial health and develop a response to developing issues in a timely manner, we consider that there may be benefit in HAL being obliged to inform the CAA about issues arising under the financing platform in the same way it informs bondholders. Such measures could build on the existing obligation and include requiring HAL to notify the CAA of:
- trigger events or events of default occurring under the financing platform;
 - any matter requiring creditor consent (such as acceleration or enforcement of security and waiver of any loan event of default); and
 - planned material changes to the financing platform (rather than just changes to credit rating requirements as at present).

⁴³ See Condition E2.5 of HAL's licence.

3.38 Enhanced information obligations could also require:

- regular meetings with the CAA; and
- access to HAL's senior management

in the circumstances of, and on matters relating to, the matter notified (trigger event etc.).

3.39 The additional compliance burden on HAL is likely to be relatively low because we anticipate that any notifications will occur only exceptionally, if at all, and would relate to notifications it would be making to its bondholders in any event. A greater burden (from management engagement with the CAA) would be limited to where an important issue had arisen, justifying the greater regulatory oversight. In this context, we note that this approach would appear to tie in with the provision in the financing platform for the borrower security trustee to participate in discussions with the CAA regarding the ramifications of a trigger event and its remedy.⁴⁴

Views invited

3.40 Views are invited from stakeholders on any of the issues raised in this chapter and, in particular, on:

- enhancements to HAL's certification obligations and the evidence to support those certificates (including the issues that should be included in any stress testing);
- the use and design of a targeted curtailment of HAL's ability to make dividend and other payments;
- refining HAL's ultimate controller undertaking obligation; and
- new requirements on HAL to provide information.

⁴⁴ See Schedule 3, Part 2, paragraph 8 of the Common Terms Agreement.

Appendix A

Our duties

1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
2. CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
5. In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
 - the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and

- the Better Regulation principles.
6. In relation to the capacity expansion at Heathrow, these duties relate to the CAA's functions concerning the activities of HAL as the operator at Heathrow.
 7. CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.
 8. We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.