



**Economic regulation of Heathrow: policy update
and consultation**

Online seminar

1 July 2020

Welcome

- Thank you for joining our first online seminar.
- Our focus today will be a high level overview of what we regard as the most important issues.
- We want to hear from you if you think that there are important things that are missing or require further clarification, and how best we can engage with stakeholders on the detail of issues as we go forward.
- Consultation responses are due 18 August, and where appropriate we would be happy to host further discussions, in addition to receiving written responses.
- As this seminar is a new approach we would like your feedback on what goes well and what we might do better in the future.



Context

- The industry has faced unprecedented challenges and changes in the past few months – we are changing as well.
- RAB-based building approach to the regulation of HAL remains appropriate, but with some adaptations to the assessment of the individual building blocks.
- In this consultation we focus on 4 key issues:
 - consumers interests;
 - financeability and WACC;
 - capex incentives; and
 - early costs
- We have proposed some changes to these policies, and we have considered how our thinking translates into the requirements for HAL in developing its Revised Business Plan (RBP).
- We have also set out our initial views on next steps for the H7 programme

Overview



- Given the impact of the Covid-19 pandemic, and the Court of Appeal decision regarding the Airports National Policy Statement, we have refocused our work on the economic regulation of HAL.
- We will focus on a “two runway airport” for HAL’s next price control (H7), which will commence from 1 January 2022.
- Setting the H7 control will not be a “business as usual control” due to these challenges, and we will respond by:
 - considering changes to the regulatory programme and timetable,
 - using scenarios to explore how uncertainty might impact air traffic volumes, airport costs and revenues, and
 - a more flexible and interactive process and timeline, with continuing emphasis on the importance of Constructive Engagement between HAL and airlines.

Consumers remain at the heart of the regulatory process



- Consumer insights should continue to inform HAL's approach so that the RBP and outcome based regulation (OBR) framework reflect the evolving needs, priorities and preferences of consumers.
- Relevant recommendations from the Consumer Challenge Board's Initial Business Plan (IBP) report should be implemented.
- The CAA will advocate for consumers, and be assisted by advice from the CAA Consumer Panel.

Key areas of focus

- Develop an OBR strategy over the short term, recovery period and longer term that delivers on consumers' and airlines' core priorities.
- Consider relevance of existing consumer evidence and build on this with new research where appropriate.
- Demonstrate a clear link between consumer insights and future scenarios.

Financeability and cost of capital

Financeability

- We are conscious that current circumstances are creating financial pressure on HAL
- It may be difficult to identify levels of airport charges that easily support both HAL's financeability and an affordable level of charges for airlines
- While the level of capex will be much lower without undertaking expansion, HAL will continue to have a very substantial RAB to finance as well as its ongoing investment
- Current circumstances suggest that a higher level of gearing than assumed in Q6 is unlikely to be appropriate
- Given the pausing of expansion and the current level of uncertainty we no longer see a persuasive case for exploring longer-term commitments for some building blocks
- We maintain the positions we signalled in CAP1876 in respect of calibrating the price control, equity financeability, and tax

Cost of capital

- We have published an independent report by Flint Global, which updates our previous view on the cost of capital
- This takes into account the CoA judgement and CMA Provisional Findings for RP3, but not the impact of the Covid-19 pandemic
- Further work will need to be undertaken over the coming months to understand this impact

Flint recommendations	Lo	Hi
Gearing	52.5%	60.0%
Risk free rate	-2.10%	-2.10%
Equity beta	0.96	1.35
TMR	5.0%	6.0%
Cost of embedded debt	1.48%	1.80%
Cost of new debt	-0.48%	0.12%
Vanilla cost of capital	3.1%	4.6%

Capex efficiency incentives

- For expansion, our policy objective was to create appropriate incentives for capital efficiency, promoting the overall efficiency and affordability of the programme
- The challenges facing the sector reinforce the importance of efficiency and value for money, though we now consider that an evolutionary approach would work best
- We set out in the consultation the criteria and broad approach we intend to adopt for capex incentives – summarised below. HAL and airlines will have a key role as we develop the approach

Approach in Q6	Broad approach in H7
Core and development framework with vital role for airlines	Similar to Q6, retain core and development framework with vital role for airlines
<i>Ex post</i> assessment of inefficient capex at end of period	<i>Ex ante</i> incentives on over/underspend linked to quality of deliverables, with <i>ex post</i> reviews only by exception
<i>Ex ante</i> financing cost incentive (around 13% on average)	<i>Ex ante</i> incentive rate to be higher than Q6, with adjustment for financing costs
Trigger payments penalise HAL for late delivery of projects	Trigger payments to be more targeted and symmetrical
Charges reflect development and core capex allowances, updated during period	Similar to Q6, charges reflect development & core capex allowances, updated during period
Gateway process and governance at portfolio and project levels	Similar to Q6, but with enhanced governance at portfolio and project levels

Early expansion costs

In light of HAL's decision to pause its work on expansion, we plan to simplify our policy on early costs as a number of aspects of our previous policy proposals no longer appear appropriate

These include recovery caps, enhanced reporting requirements, risk sharing arrangements and a new licence condition on governance arrangements.

Costs that HAL has incurred up to the end of February 2020 (~£500 million) should be added to the RAB unless there is evidence of inefficiency or misallocation.

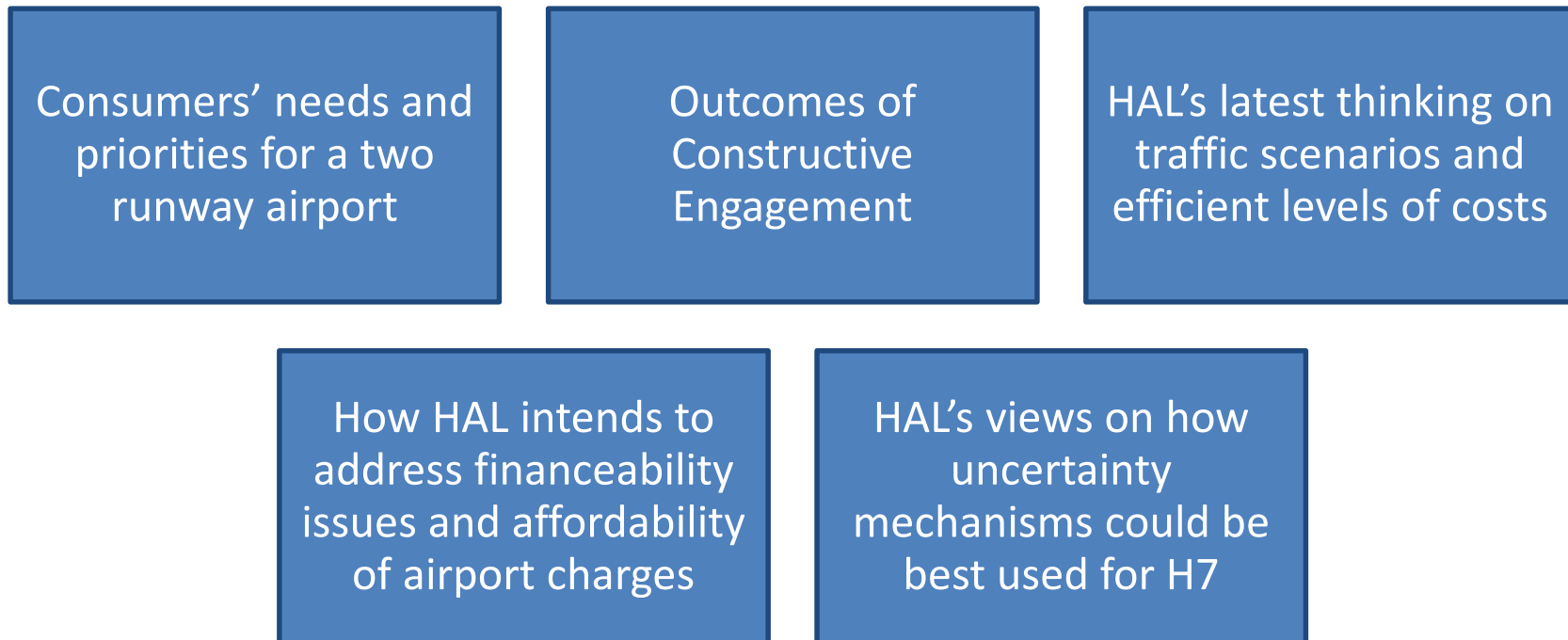
We intend to complete our work on efficiency and allocation of costs over the coming months. The recovery of early costs through airport charges will not start until 2022 and will be subject to affordability and financeability tests.

If expansion recommences in the future, we would expect HAL to consult on detailed, evidence based, robust, and properly costed budgets for both early costs and the wider programme.

HAL's revised business plan

- HAL's initial business plan (IBP) was published in Dec 2019.
- Given the change in circumstances, the IBP is out of date. HAL has committed to producing a revised business plan (RBP) in Autumn 2020.
- To assist HAL in producing the RBP, we have developed updated guidance. We will work with HAL and airline stakeholders over the coming months to enable HAL to interpret and develop this guidance in a way that best supports the production of a high quality RBP

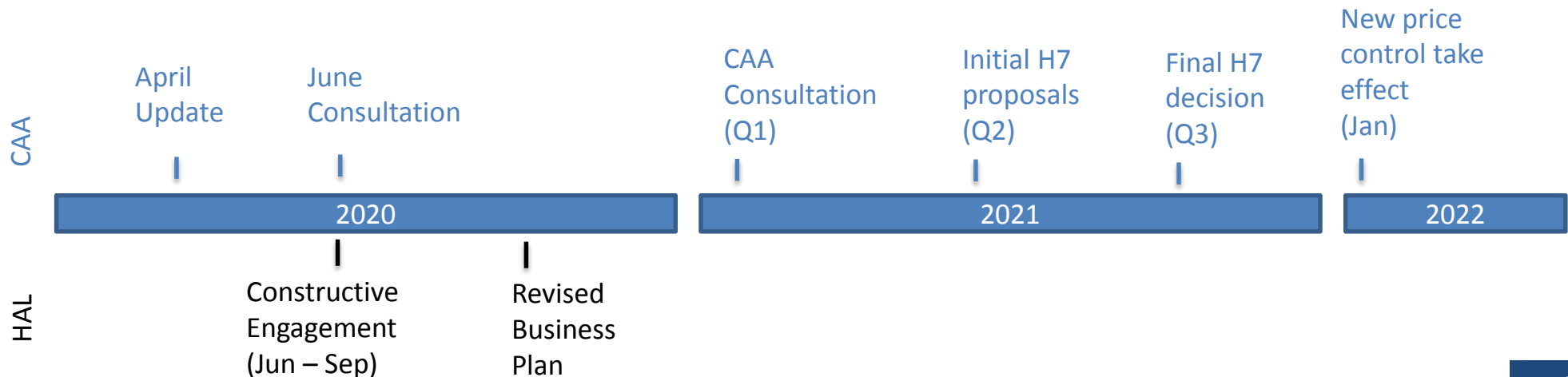
A high quality RBP should reflect:



H7 programme next steps

- We look forward to engaging with stakeholders during this consultation period
- We will issue two further working papers over the summer on capital efficiency issues
- We will be proactive through Constructive Engagement with a particular focus on ensuring this process takes account of the interests of consumers and we will augment our contribution to CE with a series of targeted workshops
- We propose to clarify the key stages of the final period of the H7 review following our assessment of HAL's RBP later this year, when we expect that some of the present uncertainty will have reduced.

Indicative timeline for H7



Key consultation questions

- We remain happy to discuss our consultation in more detail with any stakeholders.
- **Please e-mail responses to economicregulation@caa.co.uk by no later than 18 August 2020.** We cannot commit to take into account representations received after this date.
- **We welcome views on all the issues raised in the consultation, in particular, the issues set out in the executive summary and those highlighted in chapters 1 to 4:**
 - the key elements of our approach to developing the H7 programme, as set out in the summary of chapter 1, including our proposed approach to furthering consumers' interests;
 - how we can best continue to engage with HAL and other stakeholders to ensure that HAL has the best opportunity to develop a meaningful and high quality RBP;
 - the criteria and broad approach to capex incentives identified in chapter 3;
 - how best to improve capex governance arrangements;
 - the approach adopted by Flint and summarised in chapter 4 for estimating cost of capital for H7 prior to the impact of the covid-19 pandemic being felt; and
 - how we should best take account of the impact of the covid-19 pandemic on HAL's cost of capital.

We would welcome further bilateral discussions about the issues in the June consultation, or to follow up on more detailed questions.

To arrange, please contact jon.clyne@caa.co.uk