Consumers and Markets Group

Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment

CAP 2098

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About this document

In October 2020, we published a consultation[1] document in response to the request made by Heathrow Airport Limited ("HAL") in July 2020 for the CAA to change its approach to the calculation of HAL's regulatory asset base ("RAB") to take account of the impact of the covid-19 pandemic.

This update and consultation document provides our latest views on HAL's request and our developing thinking on whether HAL's price control framework should be changed in response to the circumstances created by the covid-19 pandemic. In particular the document sets out:

- our framework for identifying and assessing options for intervention;
- the assessment of options, including HAL's proposal for a RAB adjustment, in the light of this framework and the views of HAL and airlines in response to the October 2020; and
- our next steps and timetable for dealing with these matters.

Views invited

We welcome views on all the issues raised in this document and, in particular, the questions highlighted in the summary.

Please e-mail responses to economicregulation@caa.co.uk by no later than 12 noon on 5th March 2021. Given the short timetable for next steps on decisions for interventions ahead of the H7 price control, we do not expect to able to take account of late responses.

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 Stewart Carter (stewart.carter@caa.co.uk).

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[1] See Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment (CAP1966) (the "October 2020 Consultation"): www.caa.co.uk/CAP1966

Summary and introduction

Introduction

1. This update and consultation document follows on from the October 2020 Consultation on HAL’s request for an adjustment to its regulatory asset base (“RAB”) to help deal with the circumstances created by the covid-19 pandemic.

2. The entire aviation sector has experienced a severe and unprecedented downturn in passenger demand and revenues as a result of the covid-19 pandemic. Passenger numbers fell dramatically at Heathrow airport in the spring of 2020 and were 83% lower at Heathrow airport in December 2020 compared with December 2019. The path of recovery is highly uncertain. The financial impact is being felt by all companies within the aviation sector, including airports, airlines and their suppliers, as well as these companies’ employees and investors.

3. Across the aviation sector, companies and their investors have taken, and are continuing to take, significant and often difficult steps to support the liquidity of their businesses during these challenging times. HAL has sought and obtained waivers on certain aspects of its debt financing arrangements, suspended dividend payments, reduced its operating costs (including cutting staff numbers and salaries), reduced its capital expenditure programme, and has obtained additional liquidity, including by raising new debt finance and making a capital injection from the wider group to support the regulated operating company.

4. In addition to the steps set out above, on 27 July 2020 HAL made a request to the CAA for a significant upward adjustment to its RAB from 2022 to help protect it from the consequences of the covid-19 pandemic. The RAB is a key parameter that we use in setting HAL’s price control. In broad terms, it represents the value of the investments that HAL has made in its regulated business that have not yet been fully recovered through airport charges. We use it as the basis for setting the allowances for regulatory depreciation and returns in HAL’s price controls. In simple terms, and all else equal, increasing HAL’s RAB at the start of 2022 would allow it to increase charges to airlines in future years above the level that

they otherwise would have been at. In HAL's July 2020 request, the RAB adjustment was expected to increase charges by about £1.20 per passenger, or about 5%, from 2022.

5. In setting the last main price control covering the period 2014 to 2018 ("Q6"),[2] we said that we could reopen these arrangements to deal with exceptional circumstances. Bearing this context in mind, HAL has said that making this RAB adjustment would be consistent with our primary duty to consumers, as it would allow HAL to make additional investments and improve services to consumers in the short term and reduce HAL's financing costs in the longer term. HAL considers this would put downward pressure, or limit upward pressure, on its prices compared with HAL's investors bearing these risks.

The October 2020 Consultation

6. We assessed HAL's request in accordance with our statutory duties. These include:

- our primary duty to further the interests of consumers, where appropriate by promoting competition; and
- our other duties, including to have regard to HAL's financeability.

7. We considered a wide range of issues, including whether intervention is warranted given the regulatory settlement for the Q6 price control and the commercial deal between HAL and airlines for 2020 and 2021, which did not include any further provisions for exceptional events.

8. Our assessment mainly focused on whether urgent intervention is justified as we will, in any case, undertake a wider review of HAL's price control arrangements in 2021 for the H7 price review period (which we plan to apply from 2022), including considering any adjustment for the impact of covid-19 in 2020 and 2021. We also considered whether the proposed adjustment appeared to be proportionate. We concluded that the evidence that HAL had provided at that time fell short of that required robustly to justify its claims that "urgent

[2] The approach adopted for Q6 was subsequently extended to 2019 and then by a commercial deal between HAL and airlines for 2020 and 2021.

support/action is necessary" and that any such support should be in the form and of the scale in HAL's request (i.e. a £1.8 billion upward adjustment to HAL's RAB).

9. In addition, we noted that:

- if, in response to the consultation, HAL provided further evidence of short term difficulties, including in relation to its incentives to invest or financeability, we would assess this evidence carefully; and
- if circumstances turned out to be particularly difficult, there could be very significant pressure on HAL's financeability and continued ability to provide investment and reasonable levels of service. If these difficulties looked likely to emerge, it would be important for us to adopt a suitable process that would allow us not only to consult stakeholders, but also to be able to react quickly to protect consumers' interests and consider what changes to the regulatory framework might be appropriate either in 2021 or as part of the H7 price review.

10. We also noted that airlines objected strongly to HAL's proposal and suggested that:

- HAL has been too slow to introduce efficiency savings and should seek additional support from its shareholders given that its problems, in part, arise from the high level of gearing it has adopted;
- the returns made by HAL's shareholders during the Q6 price control period have been excessive and no further assistance is warranted; and
- regulatory intervention would be inconsistent with the Q6 regulatory framework, which was based on the assumption that HAL would be responsible for managing volume risks.

Responses to the October 2020 Consultation

11. HAL has provided further information in support of its proposals for a RAB adjustment. It said that:

- investors had a clear expectation that the price control would be reopened in the event of exceptional circumstances;

- not making a substantial adjustment would undermine regulatory consistency, increase the cost of capital and harm financeability;
- as a result of lower traffic forecasts since its original submission, using the same approach means its proposed RAB adjustment has increased from £1.8 billion to around £2.8 billion;
- its charges in H7 would be lower if the RAB adjustment were made (by around £7 per passenger) due to the lower cost of capital and because it would allow HAL to reprofile the recovery of regulatory depreciation;
- with the RAB adjustment, HAL expected consumers to benefit from better services and greater capacity in 2021-22 and beyond (for example through quicker reopening of terminals) as it would allow it to increase capex by £218 million and opex by £9 million; and
- CAA has wrongly treated the RAB adjustment as a balance sheet issue and other regulators have been quicker to respond than CAA, where HAL contends it is mainly an issue of aligning the balance of risk and reward with the Q6 price control.

12. The airlines and other respondents opposed the RAB adjustment and have suggested it is not appropriate or in the interests of consumers, including for the reasons summarised in paragraph 9 above.

Identifying a framework to assess the case for intervention

13. Since the October 2020 Consultation, we have further developed our own approach to considering the issues around the impact of covid-19 and appropriate intervention. We have assessed three broad approaches to guiding the development of possible regulatory interventions:

   a) focusing on compensating HAL for the impact of the exceptional circumstances and the reduction in passengers/revenues on its price control activities;

   b) using a framework based on our 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; and

c) relying broadly on the allocation of risks that was made in setting the Q6 price control, noting that HAL was remunerated at the market average cost of equity and was paid an additional premium in the form of a "shock adjustment" to the traffic forecast to manage volume risk.

14. While it is very clear that the impact of the covid-19 pandemic on the aviation sector generally, and Heathrow airport in particular, represent exceptional circumstances, this does not, in itself, constitute an automatic reason to focus only on compensating HAL for the reduction in passenger numbers. Therefore, we have concluded that approach (a) as summarised above would be too narrow and would not properly reflect our broader statutory duties, including to protect consumers.

15. By contrast, approach (c) with its focus on the approach to risk allocation that was used to set the Q6 price control appears to give relatively little weight to the genuinely exceptional circumstances created by the covid-19 pandemic and the wide-ranging impacts associated with the present very difficult circumstances.

16. We have adopted approach (b) as it has a focus on our primary duty to further the interests of consumers and allows for consideration of a broad range of issues and possible ways of intervening, not just focused on RAB adjustments. It is also consistent with what we said at the Q6 price control review that the price control could be reopened in exceptional circumstances and we would consider such a request in the light of our statutory duties and the circumstances prevailing at the time.

Developing the assessment framework

17. At the centre of our assessment framework is our primary duty to further the interests of consumers.[3] In performing this duty, we must have regard to the matters set out in our "secondary duties".

18. The most important of our secondary duties in the current circumstances appear to us to include the need to:

[3] Consumers include both passengers and cargo owners.

- secure that reasonable demands for airport services are met;
- promote economy and efficiency on the part of HAL;
- secure that HAL is able to finance its regulated activities; and
- have regard to the principles of "better regulation" set out in CAA12.

19. Consideration of how best to address these duties has led us to focus on the following key objectives in deciding how best to deal with the challenges created by the covid-19 pandemic for consumers and HAL:

- we should seek to protect consumers from any undue increases in the estimates of the cost of equity finance that we use in setting HAL's price control, since such increases would tend to increase prices to consumers at the next price control review and make the funding of investment much more difficult;
- in a similar vein, we should seek to protect consumers by ensuring that the regulatory framework is consistent with HAL being able to raise efficient, investment-grade debt finance;
- we should have regard to the overall affordability of HAL's regulated charges, both now and in the future; and
- the regulatory framework should also support efficient investment and appropriate levels and quality of consumer service, both in the short and longer-term.

Identifying policy options

20. Since the October 2020 Consultation, we have seen further reductions in the short term traffic forecasts for Heathrow airport as a result of the covid-19 pandemic and additional travel restrictions. With traffic recovery continuing to be highly uncertain and potentially more gradual than previously expected, we are seeing further challenges to HAL's financial performance.[4] We have also

[4] From HAL's investor reports, the passenger forecast for 2021 has reduced between June and December 2020 from 63 million to 37 million. All else equal, this reduces HAL's cash flows and increases HAL's gearing, though we note it has taken steps to offset or mitigate some of these impacts. (Source: Heathrow (SP) Limited and Heathrow Finance plc Investor Report, June 2020 and December 2020.)

received HAL's revised business plan (RBP), which sets out its views on the importance of the RAB adjustment to supporting affordable levels of charges and supporting its financeability from 2022.

21. As a result of the continuing significant impact of the covid-19 pandemic and the importance of the RAB adjustment to HAL's future plans, we have not considered a "no intervention" option. At a minimum to protect the interests of consumers, we need to consider how best to address the objectives above as part of the H7 price review. In addition, it is important we should consider interventions ahead of the H7 price review and take action where this is justified by clear benefits for consumers.

22. With the objectives from paragraph 19 in mind, we have identified the following broad packages of possible policy measures and interventions.

Package 1: No intervention before H7, but consider interventions at H7

Package 1 would involve no immediate regulatory intervention, but we would consider the key issues around HAL's cost of capital, the appropriate profile of charges and the incentives for investment and quality of service later in 2021, as part of the H7 price control review. This would include consideration of whether some adjustment for lost revenues in 2020 and 2021 would further the interests of consumers. We would consider these issues in the round as part of our work to develop new price control arrangements for HAL.

Package 2 – Targeted intervention now and consider further intervention at H7

Package 2 allows both for consideration of issues at the H7 price review and for more immediate regulatory intervention now, ahead of the H7 price control review.

The triggers for the more immediate interventions could include:

- HAL's financeability, because of the very significant pressure on its financial position and the potential for issues with HAL's financeability to create difficulties for consumers, for instance because of possible disruption to investment or quality of service, but recognising the important role of shareholders in taking appropriate actions to support the business;

- the impact on HAL's cost of capital (if there are clear advantages in taking regulatory action ahead of the H7 price review) consistent with appropriately managing risks and avoiding undue increases in the cost of finance that would feed through to higher prices for consumers; and/or
- other shorter term issues linked to ensuring HAL maintains an appropriate level of investment and quality of service.

It is important to note that there are significant challenges with calculating the size and scale of any intervention of this type, ahead of considering the appropriate intervention as part of the H7 price review under package 1.

<u>Package 3 – Application of H7 traffic risk-sharing approach to 2020-2021</u>

This package would also involve considering immediate interventions consistent with package 2, but would go further in that we would also commit now to introduce a reconciliation for 2020 and 2021 on the same basis as any forward-looking risk sharing arrangements for passenger traffic that are introduced for the H7 price review. We are currently developing options for such risk sharing for further consultation as part of the H7 price review. This mechanism will be important to manage risks given the high uncertainty around the speed of traffic recovery and it will link with other parts of the price control, such as the cost of capital.

<u>Package 4 – HAL's proposed risk-sharing arrangements for 2020-2021</u>

This package would involve introducing the RAB adjustment as suggested by HAL, which would involve committing now to a substantial adjustment to compensate HAL for the regulatory depreciation it has not been able to recover in 2020 and 2021, with an additional adjustment to be made later and based on the shortfall in revenue that HAL experiences over both 2020 and 2021.

Preferred approach

23. In this document we have narrowed down the options, to provide greater certainty on our next steps. On balance, we consider that package 1 and package 2 would be appropriate to consider further in deciding how we should respond to the issues raised by covid-19 and the objectives we set out above.

We are seeking views from stakeholders on our approach, with the intention of reaching final decisions on these matters in March 2021.

24. Package 1 has a number of advantages, as many of the issues that we have identified for consideration would be best considered in the round as part of the H7 price review. This reflects the important links between any RAB adjustment, the cost of capital, future charges and HAL's financeability. These should be assessed in the round to make sure that charges remain affordable and HAL faces a reasonable risk and reward package in H7.

25. Package 2 builds on this by allowing us to act now if there are issues which are more urgent that we should deal with as soon as practicable. We consider that in principle there are reasonable arguments why an earlier intervention in 2021 may provide benefits to consumers, such as through higher investment and service quality, although we recognise that there are challenges in identifying how any such intervention should be calculated. We are consulting further on whether these issues should be addressed in 2021 and, if so, how these might be best addressed and any regulatory interventions calibrated.

26. Both packages 3 and 4 would involve us committing now to the principle of a potentially large adjustment to HAL's RAB. Neither of these approaches, when looked at in the round, appears to focus sufficiently at this time on furthering the interests of consumers, which is our primary statutory duty nor to be proportionate in the light of that primary duty. We consider that appropriate calibration of package 1 or package 2 could seek to resolve the issues that the present circumstances raise for the interests of consumers and would likely provide a more considered and proportionate way of addressing these issues.

Next steps and views invited

27. Views are invited on the matters discussed in this consultation by 12 noon on 5th March 2021. Key issues for consultation include:

- whether we have identified an appropriate framework to assess the case for regulatory intervention in HAL's price control arrangements, given the exceptional circumstances created by the impact of the covid-19 pandemic;

- the detail of our preferred framework and whether we have considered an appropriate range of regulatory interventions for assessment;
- our assessment that package 1 and package 2 represent the best way forward. This means that we would consider the issues and appropriate intervention in the round as part of the H7 price review, while considering (for decision around end of March 2021) whether we should make an intervention ahead of the H7 price review; and
- the case for the early interventions (i.e. ahead of the H7 price control review), which we are considering under our package 2 of regulatory interventions, and how any such interventions should be calibrated to further the interests of consumers.

28. We will consider the views of respondents and any further evidence that is provided and intend to issue a further statement of these matters around the end of March 2021.

Our duties

29. 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.

Structure of this document

30. The structure of this consultation document is as follows:

- chapter 1 sets out the updated framework for assessing the issues raised by HAL's submission and created by the impact of the covid-19 pandemic;
- chapter 2 sets out the potential packages of options for intervention, our current assessment of these packages, and our preferred packages and options;
- chapter 3 sets out next steps, including the further statement we intend to make around the end of March 2021 and analysis to support our decisions at the H7 price review; and
- the appendices cover further information on the details of our assessment of HAL's proposal.

Chapter 1

Assessing the case for regulatory intervention

Introduction

1.1 In the October 2020 Consultation, we focused on assessing the case for HAL's proposed RAB adjustment and whether such an intervention would be proportionate. Since then, we have developed our own framework based on our statutory duties, which we have used to:

- assess the broad range of issues raised by the impact of the covid-19 pandemic; and
- consider the most appropriate package of options to address those issues.

In this chapter we set out this updated framework.

1.2 The first part of this chapter sets out our approach to considering whether we should re-open the current price control. We conclude that in the exceptional circumstances of the covid-19 pandemic it is appropriate for us to re-open the price control and both assess the issues created by these exceptional circumstances and consider whether we should make adjustments to HAL's price control arrangements in the light of these difficulties.

1.3 The second part of this chapter explains our assessment framework for possible interventions. This assessment framework is based on our statutory duties, including the need to further the interests of consumers and the other factors the statutory regime requires us to consider, including the principles of better regulation. From this, we have identified four key objectives that can be used to assess how we can best further the interests of consumers.

Re-opening the Q6 price control

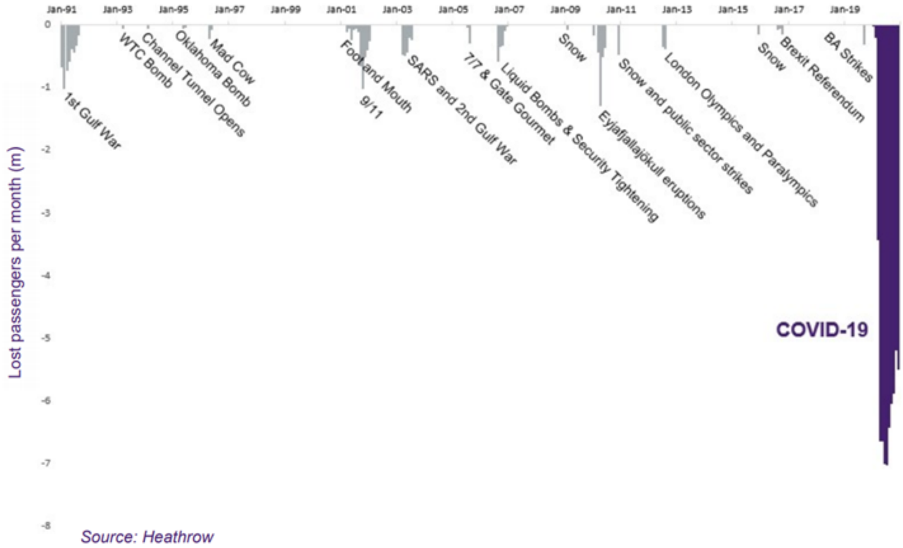
1.4 In determining whether it is appropriate for us to re-open the price control, we have considered:

- what we said in our Q6 price control proposals on re-opening in exceptional circumstances; and
- whether, and to what extent, the impact of covid-19 has been above and beyond that which could reasonably have been anticipated at the time at which the Q6 price control was established.

1.5 In Figure 1, we set out information from HAL that illustrates the impact of the covid-19 pandemic on:

- traffic levels compared with previous passenger shocks; and
- HAL’s revenues compared with the projections of revenue made at HAL’s last price control review.

Figure 1: Impact of covid-19 on HAL passenger volumes and revenue



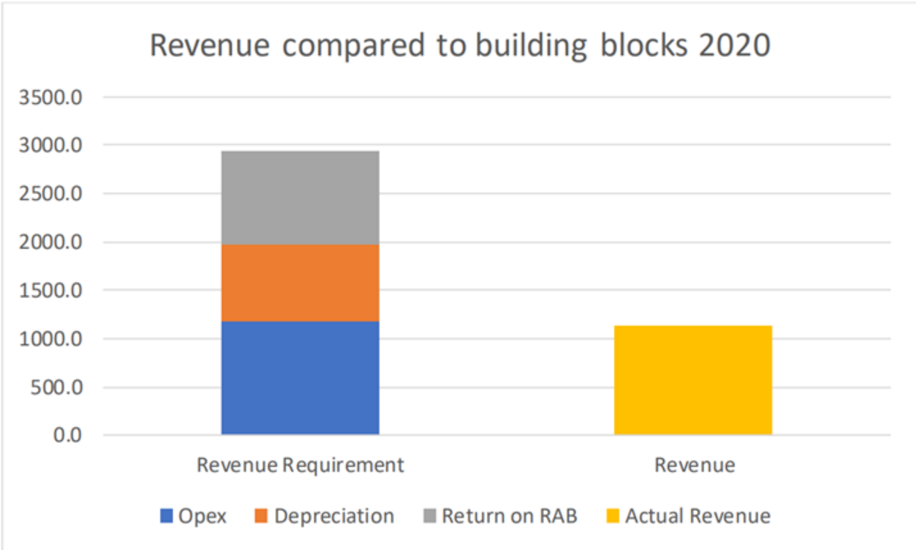


Figure 1 - Revenue in 2020 compared to building blocks

Sources: HAL, Heathrow H7 Revised Business Plan Summary, December 2020; and Heathrow's response to CAP 1966, November 2020

Note: The passenger shock chart reflects HAL's view on traffic levels and forecasts from its December 2020 submission.

1.6 This information shows that the circumstances created by the covid-19 pandemic are clearly exceptional, particularly when compared to previous traffic shocks. Moreover, the impact on HAL's revenue is clearly outside of HAL's control.

1.7 In the Q6 price control proposals we said that the price control could be reopened in exceptional circumstances and we would consider such a request in the light of our statutory duties and the circumstances prevailing at the time.[5] The current events are clearly exceptional, outside HAL's control and beyond the levels of historical traffic shocks experienced by HAL. Therefore, we consider that there is a reasonable expectation that we should properly consider what interventions would further the interests of consumers in accordance with our statutory duties under CAA12.

1.8 We consider this means that, having decided to re-open the price control, we need to consider the case for and the form, size and timing of any intervention, to ensure we act consistently with our statutory duties. It is important to note that we:

- set out no clear expectation as part of the Q6 settlement as to what, if any, specific actions we would take if we were to re-open the price control; and
- made no explicit commitment to protect HAL from the impact of extreme traffic shocks.

1.9 On the timing of making decisions on this intervention, we set out in the October 2020 Consultation that our starting point is that options are best considered as part of the H7 periodic review. This would enable us to consider the issues in the round taking into account the on-going uncertainty around the speed of recovery in passenger numbers, and the links between any intervention and the rest of the price control package.

1.10 While we consider that this position is still appropriate, we have kept an open mind when assessing the options for intervention and the potential need to take earlier action ahead of the H7 price review if the need for this action can be clearly demonstrated and evidenced. This has been informed by consideration of the impacts of recent developments as a result of further Government restrictions in the UK and abroad, which have worsened the short to medium term outlook for HAL since the October 2020 consultation.

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[5] Specifically, in the final proposals for Q6 (CAP1138), the CAA explicitly stated (at paragraph A12) that:

"*HAL may request that its price control be reopened at any time. The CAA would consider such a request in the light of its statutory duties under the circumstances prevailing at the time*."

1.11 As well as considering whether there has been an exceptional event, we have considered whether, and to what extent, HAL has done (and is doing) everything that it could reasonably have been expected to do to mitigate the impact of the covid-19 pandemic in the circumstances in which it finds itself.

1.12 We are aware that HAL has taken significant steps to reduce costs across its operations and to protect its financial position, including:

- a number of measures to reduce opex;
- reduction to capex;
- raising further debt to improve liquidity and negotiating waivers on key aspects of its debt financing arrangements; and
- suspended dividends and a capital injection from the wider Group to support the regulated operating company.

1.13 As noted above, in response to the pandemic, HAL has already committed £750m of additional equity funding to the regulated operating company in the form of a capital injection as set out in its December 2020 and January 2021 investor reports.[6] Nonetheless, there may be further steps for shareholders to take in order to support the business, consistent with the actions of, for example, other airports and airlines that have been severely affected by the impact of the covid-19 pandemic. While these comparisons are complicated by, for example, different circumstances and levels of state support, we have not seen evidence that other major airports are currently seeking to recover losses to the same extent as HAL.[7]

1.14 The extent to which shareholders have sought to support HAL is important because, in our role as regulator, we have a primary duty to further the interests of consumers. Since any regulatory intervention will likely shift the financial burden of dealing with the impact of the covid-19 pandemic from

[6] See PowerPoint Presentation (heathrow.com) and PowerPoint Presentation (heathrow.com)

[7] In appendix D we consider how large international airports that have been used as comparators for Heathrow have responded to the impact of Covid-19 on their businesses.

HAL and its shareholders to consumers, we need to be certain that HAL and its shareholders are doing all that can reasonably be expected. So, in considering possible regulatory interventions, we will need to consider what actions could be taken, and should have been taken, by HAL itself including by its shareholders. We consider this further in our assessment of options in Chapter 2.

Assessment framework and objectives

1.15 Since it is our view that it is appropriate to re-open the price control, we need to develop an approach to identifying and assessing options for regulatory intervention. We set out below a framework for identifying the appropriate approach to assessing issues, identifying possible options for intervention and then assessing those options. This allows us to consider the most appropriate overall approach, rather than just responding to HAL's specific proposal.

1.16 We have considered three broad approaches to guiding the development of possible regulatory interventions:

a) focusing on compensating HAL for the impact of the exceptional circumstances and the reduction in passengers/revenues on its price control activities;

b) using a framework based on our 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; and

c) relying broadly on the allocation of risks that was made in setting the Q6 price control, noting that HAL was remunerated at the market average cost of equity and was paid an additional premium to manage volume risk.

1.17 We consider that approaches (a) and (c) would represent too narrow a focus and so do not properly reflect our statutory duties in the exceptional circumstances of the covid-19 pandemic and the wide-ranging impacts associated with the present very difficult circumstances.

1.18 We have adopted approach (b), which we consider is the most appropriate approach under the circumstances since it will allow us to:

i) establish the extent to which options enable the CAA to discharge its statutory duties, the primary duty of which is to further the interests of consumers;

ii) consider a broader range of issues raised by the impact of the covid-19 pandemic beyond the immediate impact on passenger volumes and revenues; and

iii) consider HAL's request for a RAB adjustment alongside other options for regulatory intervention.

1.19 In developing our approach to assessing options for regulatory intervention, our starting point has been our statutory duties. The actions we take should be justified by reference to our primary duty to further the interests of consumers. As part of this, we also need to consider the likely impact (if any) on competition in airport operation services and the consequences for competition of any action we might take.[8] We also must have regard to the matters set out in our secondary duties. Here, the matters which appear to be most important to the consideration of possible regulatory interventions are the need to:

i) secure that all reasonable demands are met for airport operation services at Heathrow airport;

ii) promote economy and efficiency on the part of HAL in its provision of airport operation services at Heathrow airport; and

iii) secure that HAL is able to finance its provision of airport operation services at Heathrow airport.

1.20 Furthermore, in developing our assessment framework we have had regard to the “better regulation” principles specified in section 1(4) CAA12. This is

[8] Our initial assessment is that intervention will not have a significant impact on competition, although the present environment means there is some uncertainty around this assessment. We consider this further in Appendix J.

important because, even if we consider that there may be an issue which requires action, we must consider our actions in the context of these principles which include that actions should be targeted only at cases where action is necessary and carried out in a way which is transparent, accountable, proportionate and consistent.

1.21 Consideration of our duties leads us to identify four main areas of potential customer harm as a result of the impact of the covid-19 pandemic that should be the focus of any regulatory intervention. These are:

i) we need to protect customers from undue increases in airport charges that could arise if the cost of equity finance and HAL's cost of capital increase unduly (since the impact of the covid-19 pandemic may increase the perception of risks and level of return necessary to compensate investors for these risks in the future);

ii) we need to protect customers by enabling HAL to be able to raise debt efficiently, so it is able to finance investment efficiently. In previous documents, we have set out that this means HAL should be able to raise investment-grade debt finance;

iii) we should promote affordable charges in H7 and beyond. While affordability is always an important consideration, this is particularly important in supporting recovery of the aviation sector more widely; and

iv) we should seek to protect and appropriately incentivise the delivery of efficient investment and service quality levels.

1.22 In carrying out our assessment, we must have regard to the "better regulation principles". These are that regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent. We should also target regulatory activities at cases in which action is needed. In applying our assessment framework, and in considering regulatory interventions relative to our objectives, we will be mindful of these principles.

1.23 In Figure 2, we set out the key questions and four objectives to address the main areas of consumer harm above, which we have used to structure our assessment of the options in Chapter 2. We consider that any regulatory interventions that are put in place in response to the issues raised by the covid-19 pandemic should meet these objectives.

Figure 2: Summary of assessment framework and objectives

Primary duty	Secondary duties	Question to include in assessment
Furthering the interests of consumers	Securing that HAL is able to finance its provision of AOS	How to support: • ongoing efficient debt and equity financing of HAL? • an efficient cost of capital at H7? • regulatory consistency, including consistency with the notional financing structure from Q6?
	Securing that all reasonable demands for AOS are met	How to support: • sufficient investment and level of service quality? • a recovery in passenger numbers?
	Promoting economy and efficiency on the part of HAL	How to support: • affordable charges to consumers? • efficient capex and opex? • appropriate actions by shareholders? How to incentivise appropriate behaviour by HAL? Are there appropriate customer protections in place?
	The "better regulation" principles specified in CAA12	How to: • target action where it is needed • minimise unintended/adverse consequences? • act consistently with other regulatory precent? • further consumer interests in a proportionate manner?

Key objectives

- Protect consumers by avoiding undue increases in the cost of equity finance
- Protect consumers from difficulties with raising debt
- Promote affordable charges in H7
- Protect efficient investment and service levels

Source: CAA

1.24 We have used this framework to assess possible options for regulatory intervention to deal with the issues created by the impact of the covid-19 pandemic. These are discussed in detail in the following chapter.

Chapter 2

Assessing the options for regulatory intervention

Introduction

2.1 In chapter 1, we identified that the circumstances of the covid-19 pandemic are clearly exceptional and that, in these exceptional circumstances, we consider it is appropriate to re-open HAL's current price control. In doing so, we need to establish the appropriate level and timing of any regulatory intervention that would be consistent with our statutory duties and meet the four key objectives identified in chapter 1. This means establishing whether we should:

- intervene in the short-term;
- commit to intervene in a particular way at the H7 price review; or
- simply commit to assess appropriate intervention only as part of the H7 price review.

2.2 CAA12 grants us a broad discretion to further the interests of consumers, taking into account our secondary duties. To assist in the discharge of our duties, we identify a number of different possible options for the level and timing of regulatory intervention, including HAL’s proposal. We group these into four broad “packages” of options for intervention. In our assessment, we consider the costs and benefits for consumers of these packages of options.

2.3 In this chapter we assess these different packages of options against the objectives identified in chapter 1 and set out a narrower set of packages that we are consulting on further, with a view to reaching decisions in March 2021.

2.4 As part of this process, we have considered the arguments and evidence put forward by HAL and other stakeholders, including the responses to the October 2020 Consultation. In addition, we requested further information from HAL and airlines where we considered we needed further evidence to support our analysis. We note that a significant amount of the evidence on a range of issues is, necessarily, qualitative in nature, and we have considered all this evidence in reaching the decisions and views set out in this document. We include further detail on our assessment in the appendices to this document.

Option to commit now to making no intervention

2.5 In developing packages of options, we considered whether we should consult on a decision now that interventions we make at the H7 price review would be purely for forward-looking risks, and that there should be no interventions now or as part of the H7 price review in relation to the impact of the covid-19 pandemic for the period 2020 and 2021.

2.6 Our view is that this would not be consistent with our statutory duties and the interests of consumers. There has been a deterioration in the outlook for the aviation sector since our October 2020 consultation and there is a high degree of uncertainty around the speed of traffic recovery. In addition, HAL has submitted a revised business plan (RBP) that assumes we allow its proposed RAB adjustment for our assessment.

2.7 At a minimum, we consider that we need the flexibility to consider appropriate interventions once we have properly assessed HAL's RBP and the circumstances and information available during the H7 price control review, in order to protect the interests of consumers. This includes, for example, assessing whether intervention is needed to support affordable charges in the H7 period and to give appropriate support to debt and equity financeability so that investment can be financed efficiently. Making a decision now that there should be no intervention would remove this flexibility.

2.8 The packages we consider below (packages 1 to 4) would all allow consideration of the issues created by covid-19 at the H7 price review, but some of these packages would provide more flexibility than others.

Packages of intervention options

2.9 In considering options for intervention in respect of the impact of the covid-19 pandemic, we have a choice whether to commit now to implementing that option (in part or in full) or deferring the decision on whether to implement that intervention until H7.

2.10 We outline below four packages of intervention options that include:

- assessing whether and how to intervene as part of the H7 price review ("package 1");
- intervening in 2021 ahead of the H7 price review, in response to short term issues, and then assessing further intervention as part of the H7 price review ("package 2"); or
- committing to intervening in 2021 ahead of the H7 price review, in response to short term issues, and also committing now to make further interventions in a particular way as part of the H7 review ("package 3" and "package 4").

2.11 <u>Package 1 – No intervention before H7, but consider interventions at H7</u>

Package 1 would involve no immediate regulatory intervention but we would consider the key issues around HAL's cost of capital, the appropriate profile of charges and the incentives for investment and quality of service later in 2021, as part of the H7 price control review. This would include consideration of whether some adjustment for lost revenues in 2020 and 2021 would further the interests of consumers. We would consider these issues in the round as part of our work to develop new price control arrangements for HAL.

2.12 <u>Package 2 – Targeted intervention now and consider further intervention at H7</u>

Package 2 allows both for consideration of issues at the H7 price review and allows for more immediate regulatory intervention now, ahead of the H7 price control review.

The triggers for such intervention could include:

- HAL's financeability (because of the very significant pressure on its financial position and the potential for issues with HAL's financeability to create difficulties for consumers, for instance because of possible disruption to investment or quality of service), but recognising the important role of shareholders in taking appropriate actions to support the business;
- the impact on HAL's cost of capital (if there are clear advantages in taking regulatory action ahead of the H7 price review) consistent with appropriately managing risks and avoiding undue increases in the cost of finance that would feed through to higher prices for consumers; and/or
- other shorter term issues linked to ensuring HAL maintains an appropriate level of investment and quality of service.

We note that any RAB adjustment made ahead of the H7 price review would not have an impact on charges until the H7 period. In principle, we could also make an adjustment now and recalibrate later as part of the H7 review, though we would need to consider the impact on regulatory certainty and predictability of taking this approach.

It is important to note that in the analysis and assessment we have completed to date we have experienced significant challenges with calculating the appropriate scale of any intervention of this type, ahead of considering the appropriate intervention as part of the H7 price review under package 1.

2.13 Package 3 – Application of H7 traffic risk-sharing approach to 2020-2021

This package would also involve considering immediate interventions consistent with package 2, but would go further in that we would also commit now to introduce a reconciliation for 2020 and 2021 on the same basis as any forward-looking risk sharing arrangements for passenger traffic that are introduced for the H7 price review. We are currently developing options for such risk sharing for further consultation as part of the H7 price review. This mechanism will be important in the allocation and management of risks given the high uncertainty around the speed of traffic recovery and it will link with other parts of the price control, such as the cost of capital (because it should reduce HAL's risks).

2.14 <u>Package 4 – HAL's proposed risk-sharing arrangements for 2020-2021</u>

This package would involve introducing the RAB adjustment proposed by HAL, which would involve committing now to a substantial adjustment to compensate HAL for the regulatory depreciation it has not been able to recover in 2020 and 2021, with an additional adjustment to be made later and based on the shortfall in revenue that HAL experiences over both 2020 and 2021.

2.15 In its response to the October 2020 Consultation, HAL continued to request that we make a broad adjustment to its RAB to provide compensation for a significant proportion of its revenue losses from 2020 and 2021. HAL's proposed mechanism, which HAL benchmarked against traffic risk-sharing mechanisms at other airports and for NERL, would result in an estimated RAB adjustment of £2.8 billion (2018 prices). This has increased from £1.8 billion in HAL's July 2020 submission as traffic volumes for 2020 and forecasts for 2021 have reduced since HAL's July 2020 submission. The actual final adjustment could be higher or lower than this depending on outturn traffic volumes in 2021.

Discussion of intervention options

2.16 We set out below a discussion of the packages of intervention options and our assessment of whether they meet each of the objectives identified in chapter 1. This discussion is arranged by each objective, where we first set out the issue and potential detriment to consumers and then our assessment of how this potential detriment could be mitigated by each of the packages of interventions. In making this assessment, we consider to what extent each package of intervention options is likely to further the interests of consumers and meets our statutory duties.

2.17 We note that the intervention options that we assess are not necessarily additive and could achieve multiple objectives. For example, any RAB adjustment intended to protect consumers by avoiding an undue increase in the cost of equity could also support HAL in raising cost efficient debt finance and, so, help in ensuring the costs of financing investment would be affordable.

Objective 1: Protect consumers by avoiding undue increases in the cost of equity finance

2.18 The reasonable expectations of investors are important to consider as either acting inconsistently with such expectations or inappropriately could increase perceptions of regulatory uncertainty. This in turn could lead to a higher cost of capital and, so, higher airport charges. This would tend to have an adverse impact on the interests of consumers.

2.19 It is, therefore, important to consider how investors' perceptions of risk can be managed in future, given the impact of the covid-19 pandemic, while minimising overall costs to consumers. On this basis, we consider that there is a strong case for the introduction of traffic risk sharing ("TRS") arrangements as part of the H7 price control to manage future risks. The form and calibration of any prospective TRS mechanism has yet to be developed and consulted on with stakeholders. Even so, we consider that an appropriately specified TRS mechanism has the potential to limit investors' exposure to exceptional future traffic shocks substantially, and hence to limit the impact of the covid-19 pandemic on HAL's cost of capital in the future. But we recognise that careful consideration will need to be given to the precise design of a TRS and therefore the impact on cost of capital, and ultimately the impact on charges paid by users.

2.20 For this future TRS mechanism to be effective in managing risks and avoiding undue increases in the cost of equity, it is important that:

- investors see these future regulatory commitments as being credible; and

- we do not undermine reasonable investor expectations through decisions we take on intervention in respect of the impact of covid-19 in 2020 and 2021

in order to support continued access to cost effective debt and equity finance.

2.21 HAL has argued that investors will not view any future traffic risk sharing mechanism as being credible and consistent if it is not also applied retrospectively to the traffic shock of 2020 and 2021. HAL has also argued that this was level of protection was expected as part of the Q6 price control arrangements.

2.22 We disagree with HAL that introducing a TRS mechanism would have no mitigating impact on investors’ forward-looking perception of risk. We also disagree that this clearly formed the basis of reasonable investor expectations at the time of Q6 price control. We provide further details on our assessment of the impact of the covid-19 pandemic on the cost of equity in Appendix C and further details on investor expectations in Appendix D.

2.23 At the same time, we acknowledge that it is possible that the credibility and consistency of any TRS mechanism might be bolstered by some compensation for retrospective losses in relation to the impact of the covid-19 pandemic. We do not consider there is a simple or straightforward way to assess what level of compensation might ensure that future TRS arrangements are seen as credible. We have, therefore, started to explore different ways that we could try to measure reasonable investor expectations and the corresponding intervention that is implied in each case.

Options to make interventions at the H7 price review (under package 1) and ahead of the H7 price review (under package 2)

2.24 As noted above, we have considered options for intervention at the H7 price review to ensure that future TRS arrangements are seen as credible.

While this work in ongoing, we have started to assess a number of possible approaches, including:

- assuming that investors based their expectations solely on the risk sharing arrangements that were explicitly in place during Q6/iH7. This approach would imply no expectation of compensation for traffic-related losses, but it would require an injection of equity by shareholders to restore notional levels of gearing. We could allow HAL to recover an estimate of the efficient direct costs associated with issuing new equity through a modest increase in its RAB;
- assuming that investors expect that the cost of restoring notional gearing to Q6 levels (60%) will be shared between consumers and HAL's shareholders. This could assume, for example, that the shareholders of the notional company expect to forgo dividends for a prolonged period to restore notional gearing in a timely way during H7, with charges to consumers funding the remaining balance; or
- assuming that investors expect that we will intervene to fund under-recovery of specific revenue building blocks in 2020 and 2021. An appropriate assumption here might be that investors expect we would protect the notional company debt costs in 2020 and 2021, as it is in consumers' interests that the notional company should be able to meet its debt obligations to remain financeable, even in exceptional circumstances.

2.25 To calibrate these options, we would also consider to what extent any regulatory intervention should also reflect the outperformance by HAL during the Q6 price control period. We consider this is relevant, as it contributes to the overall returns earned by investors over the whole regulatory period in which the current traffic shock occurred. However, we not yet updated the estimates of outperformance made in the October 2020 Consultation in response to the feedback from stakeholders.

2.26 We provide further details on these options and initial estimates on the adjustments in Appendix I. We will continue work on this analysis, which is complex and difficult, as part of the H7 price control review. We consider this to be a reasonable approach given the potential benefits from this intervention relate to a more efficient cost of capital for H7, rather than direct benefits for consumers in 2021.

2.27 In summary, we will, therefore, consider potential interventions at the H7 price review to protect consumers by avoiding undue increases in the cost of equity finance, under package 1 and package 2.

Options to commit ahead of the H7 price review to particular interventions (under packages 3 and 4)

2.28 To ensure that our forward-looking statements regarding TRS in H7 will be seen as credible, it could be argued that investors would reasonably expect us either to:

- apply the same approach to TRS for 2020-2021 as we do for the H7 period (as set out in package 3); or
- apply an approach to TRS that has been benchmarked against approaches to TRS applied to other international airports and for NERL (as suggested by HAL, as set out in our package 4).

2.29 However, we have concerns with these approaches. Firstly, we are concerned around the proportionality of these adjustments and whether such large adjustments are required to provide the benefits to consumers. While we consider it may be plausible that the application of a TRS mechanism in H7 would be seen as more credible if we took action in response to the impact of the covid-19 pandemic for 2020 and 2021, we do not consider that this benefit can only be gained by:

- adopting exactly the same approach on both a forward-looking and retrospective basis; or
- applying a mechanical threshold-based approach based on experience in other industries or countries.

We review evidence on cost of equity, investor expectations and regulatory precedent in Appendices C, D and K respectively and these matters warrant further consideration at the H7 price control review.

2.30 We are concerned that it would not be reasonable to commit now to such large to the RAB adjustments before completing the broader work on the H7 price review. We consider that our statutory duty to secure that HAL is able to finance its provision of airport operation services AOS can be satisfied by means of properly considering these issues at the H7 price control review.

2.31 We are also concerned that these approaches are not transparent in how they account for either cost savings made in 2020 and 2021, or outperformance made by HAL during Q6. We will consider these issues and views from stakeholders in our work for the H7 price review.

2.32 In summary, we consider that package 3 and package 4 do not appear to be proportionate interventions to achieve this objective. We will further consider the issues around cost of equity, investor expectations and regulatory precedent as part of reviewing interventions under package 1 and package 2 at the H7 price review.

Objective 2: Protecting consumers from the consequences of HAL experiencing difficulties with raising debt

2.33 During 2020, HAL has managed to raise additional debt finance successfully, even while the recovery of the sector has been highly uncertain.[9] However, we recognise that there could be very difficult circumstances in 2021 from prolonged reductions in traffic and uncertainty over recovery in traffic levels. These could put further pressures on HAL's ability to comply with its debt covenants and on its credit ratings. We note that HAL's credit rating has already been downgraded as a result of the impact of the covid-19 pandemic and deterioration in its credit metrics.[10]

[9] For example, in paragraph 223 of HAL's response to CAP1966, HAL stated that "In October, Heathrow raised £1.4 billion equivalent across three public bond transactions in Euro, Sterling and Canadian dollars".

[10] S&P downgraded Heathrow Funding Limited's Class A and Class B debt in April 2020 (see S&P (2020), "Heathrow Funding Ltd. Class A Debt Downgraded To 'BBB+'; Class B Debt Downgraded To 'BBB-'; Outlooks Negative", April) and Moody's downgraded Heathrow Finance's issuer rating in November

2.34 These issues could mean it is in consumers interests for us to take action in the short term, to protect HAL's ability to finance investment and so that its cost of debt finance and cost of capital do not increase unnecessarily (which could put upward pressure on airport charges). We examine these issues further below.

HAL's credit rating

2.35 We have focussed on the performance of a notional financial structure for HAL against key credit metrics. This is important, as:

- it is consistent with the approach we have used in setting HAL's price controls;
- HAL's actual credit rating is at least in part driven by financing choices made by its by management and shareholders; and
- in general it should not be for consumers to underwrite any costs caused by the consequences of HAL's financing decisions.

2.36 From our review of credit ratings, we do not consider that a regulatory intervention is needed urgently. Further, a RAB adjustment would not necessarily be an effective means in the short-term of supporting a particular credit rating or to allow HAL to continue to access investment grade debt finance. This is based on our findings summarised below that:

- for credit metrics based on cash-flows used by rating agencies, our analysis shows that making an adjustment to the RAB would not have a material impact on these metrics in 2021 as prices would not be reset during that year;
- for credit metrics based on gearing, RAB adjustments would have a more direct and significant impact. We estimate that notional gearing will increase from 60% to around 70% in 2021 due to the impact of the

2020 (see Moody's (2020), "Moody's downgrades Heathrow Finance's ratings to Ba2/B1 from Ba1/Ba3; outlook remains negative").

covid-19 pandemic (based on HAL's RBP).[11] Nonetheless, a 70% level of gearing is still consistent with the reference levels required for investment grade credit ratings;[12] and

- we recognise that rating agencies also place substantial weight on qualitative factors, which will include regulatory certainty and predictability around HAL's exposure to future risk, including both traffic related risk and other risk. Therefore, consistent with meeting objective 1 above, it will be important that we are able to demonstrate that there is a reasonable risk-reward package as part of the H7 price review and that the arrangements or TRS are credible.

2.37 These findings are set out in more detail in Appendix E.

HAL's debt covenants

2.38 In the exceptional circumstances of the covid-19 pandemic there may be a case for looking more broadly at financial issues than the approach that we used in setting HAL's Q6 price control and considering actual as well as notional financial structures. Nonetheless, in doing so, we would need to be clear that we were acting consistently with our statutory duties and furthering the interests of consumers.

2.39 We note that HAL has forecast that it will not breach its covenants in 2021, even without a RAB adjustment.[13] We also note that HAL has very limited headroom to deal with further downsides, such as from even lower than expected traffic. For example, we observe that Heathrow's Group regulatory asset ratio (RAR) covenant was forecast in December 2020 to have headroom of less than 1% by the end of 2021 in the absence of a

[11] The gearing level in 2021 in HAL's PCM is 60.0% under its Base Case and 70.7% under the No Adjustment scenario.

[12] For example, in its August 2019 report for Heathrow Funding Limited, S&P stated that "*We could also lower the ratings if group leverage increases from current levels of less than 70% in terms of debt to RAB for the Class A debt, or less than 80% debt to RAB for the Class B debt*."

[13] HAL (2020), "Economic regulation of Heathrow: response to its request for a covid-19 related RAB adjustment (CAP1966): Heathrow's response", November, paragraph 237.

RAB adjustment or further contributions from HAL's shareholders.[14] Further details of our assessment of these matters is set out in Appendix E.

2.40 As the outlook for traffic appears to have deteriorated further since December 2020 (as a result of further UK "lockdown" and travel bans), there is a reasonable likelihood that, absent a RAB adjustment, HAL may need to take additional actions in 2021 to ensure it does not breach this covenant. We also recognise that there could be significant costs for consumers in the short-term arising, for example, from future reductions in opex and capex, and hence reduced service levels, if HAL were seek to substantially reduce costs to prevent further upward pressure on its gearing.

2.41 This leads to a difficult challenge in deciding on and calibrating an appropriate short term intervention under package 2. The issues above highlight that making interventions in the short term could help to provide additional headroom on the RAR covenant, alleviating short term concerns around financeability and providing HAL with additional flexibility around making additional investments in 2021 that improve services to consumers. If this was done by making all or part of an intervention that we were going to make at the H7 price review earlier, then this would not impose additional costs to consumers.

2.42 However, an important principle in setting the Q6 price control was that HAL is responsible for its actual financing and any associated risks or costs should be borne by HAL and its shareholders. Therefore, we need to be careful in calibrating any intervention ahead of the H7 price review so that:

- consumers do not inappropriately bear the costs of HAL's financing choices; and
- HAL continues to face strong incentives to maintain a resilient financial structure in the future.

[14] HAL's December 2020 Investor Report forecasts a Group RAR of 92.8%, which is less than 1% below the Trigger level of 93.5% for FY2021.

Options for making an intervention ahead of the H7 price review based on short term challenges (under package 2)

2.43 Under objective 1, we considered potential options for calibrating an adjustment in relation to the cost of equity, which could be made as part of the H7 price review. We could look to bring forward all or part of any such adjustment in 2021, which would provide additional headroom and help alleviate short-term financeability concerns.

2.44 We have not sought to model or estimate the extent of headroom that would be needed in 2021, as this depends on uncertain outcomes for traffic and further actions taken by HAL. However, we note that for illustration, an adjustment to the RAB of around £200 million to £600 million would provide additional headroom of around 1% to 3% on the RAR covenant in its financing platform and gearing credit metrics. This would seem to be a significant uplift in the headroom in HAL's December 2020 investor report. At this stage it is not clear that there would be a rationale for going any further to deal with issues around HAL's group RAR covenant.

2.45 In summary, we will, therefore, consider as part of a decision in March 2021 whether we should make an intervention ahead of the H7 price review, as part of package 2. Nonetheless, the reasoning set out above suggests that we would need to establish at least an "in principle" case for a cost of equity adjustment in order to consider bringing forward some or all of this adjustment to help relieve pressure on HAL's group financial position. In calibrating any short term adjustment we would also need to consider the role of HAL's shareholders and whether they should inject equity to help remedy these difficulties.

2.46 We will consider representations and further evidence from stakeholders on the benefits for consumers from making an early intervention ahead of the H7 price review.

Options for making an intervention ahead of the H7 price review based on allowed regulatory depreciation (under package 4)

2.47 HAL has proposed two adjustments to its RAB equivalent to its allowed regulatory depreciation in 2020 (around £800 million) and 2021 around £800 million). HAL has indicated that these earlier interventions would support it in securing further waivers in respect of compliance with its financing platform covenants and support it in avoiding further downgrades in its credit rating.

2.48 As set out above, we do not consider that a substantial RAB adjustment in 2021 would be effective in alleviating short-term pressure on key credit metrics or financing platform covenants relating to cash flows. We also note that any intervention in the short-term to alleviate pressure on HAL's ability to comply with the RAR covenant in its financing platform is likely to be an order of magnitude smaller than HAL's proposed adjustment. We are also concerned that the adjustments for regulatory depreciation in 2020 and 2021 (adding to £1.6 billion) could be higher than any total intervention we would make as part of the H7 price review. If this difference to the H7 intervention was not clawed back, it would lead to additional costs to consumers in the longer term. Nonetheless, for the H7 period, under packages 1 and 2, we would need to make sure we set the price control in a way that allowed the notional company to continue to access investment grade debt finance, to keep overall costs to users lower than they would otherwise be.

2.49 In summary, therefore, we would not propose to make an intervention ahead of the H7 price review for HAL's regulatory depreciation under package 4.

Objective 3: Promoting affordable charges in H7

2.50 HAL's RBP is underpinned by its proposed RAB adjustment, which it considers is essential to providing affordable charges for H7. HAL's RBP states that it requires a RAB adjustment to enable it to smooth regulatory depreciation over the H7 period and reduce per passenger charges by around £7. This seems to be driven by two main factors:

- that the RAB adjustment it proposes allows a significant proportion of depreciation to be postponed in H7; and
- the RAB adjustment would lead to a lower cost of capital in the future.

2.51 We are currently reviewing the RBP as part of the H7 price review process. From an initial review, we are unclear why a RAB adjustment is needed to facilitate reprofiling of regulatory depreciation during H7. Our view is that operating cashflow appears to be the principal constraint on reprofiling depreciation. We have also examined the impact on charges and found that these are highly sensitive to the assumptions and, under some sets of assumptions, charges could be higher with the RAB adjustment. We provide further details on this assessment in Appendix F.

2.52 That said, we agree that regulatory depreciation could be an important lever at H7 to manage charges and affordability while the sector is recovering and, at this stage, we do not want to constrain the tools we have to support an affordable level of charges in H7.

Options for intervening to manage charges at the H7 price review (under packages 1 or 2)

2.53 As part of the H7 price review, we would consider whether there should be an adjustment that would support the re-profiling of regulatory depreciation, and hence charges, in H7. It is not clear that any more immediate action is required for package 2 in relation to ensuring an appropriate profile of charges across the H7 price control period and beyond.

2.54 In summary, therefore, we will examine as part of the H7 price review whether we should make an intervention to reduce charges that would otherwise be higher, under packages 1 and 2.

2.55 Bearing in mind the concerns we have expressed above about the analysis in HAL’s RBP, we have not seen a clear necessity for a RAB adjustment to allow the profiling of regulatory depreciation at the H7 price control review.

As a result, these considerations do not appear to support regulatory interventions under packages 3 or 4.

Objective 4: Protect efficient investment and service levels

2.56 HAL has said that, without a RAB adjustment ahead of H7, it will not be able to carry out particular capital and operating investments in 2021 and 2022 that are in the interests of consumers. HAL has identified around £218 million of additional capex and around £9 million of additional operating expenditure that it would plan to spend in 2021 if it were to receive its proposed RAB adjustment at this stage. HAL says that failure to incur this expenditure could have the effects of:

- reducing the resilience of its services;
- reducing the levels of service quality delivered; and
- delaying the timely reopening of terminal capacity when demand increases.

2.57 We have considered these issues carefully in determining how best to further the interests of consumers, and whether intervention ahead of the H7 price review appears to provide additional benefits to consumers.

2.58 Both HAL and airlines can provide the helpful insights on the investment needed and the impact of investment on service quality. We have, therefore, carried out a high-level review of the evidence from HAL (including additional evidence that it provided) and we have also considered the views of airlines on this evidence.[15]

2.59 From our review we have found that there does not seem to be a clear case that consumers will receive additional benefits under this objective proportionate to making a substantial intervention ahead of the H7 price

15 We sent further questions to HAL in late November 2020 and received responses in December 2020. We shared an extract of these responses with airlines and received feedback in December 2020 and January 2021.

review. Our assessment is summarised below, with further details in Appendix G. In particular, we found that:

- the capex that HAL has proposed has not been through the capex governance and engagement process between HAL and airlines. This is a key part of the regulatory framework to ensure that there is a clear business case for the investment and consumers are receiving value for money. We consider we should be cautious in approving any additional investment that has not been through this process and when airlines have said they do not support this;
- we would expect the benefits to consumers will be highly uncertain, particularly in the light of the lower than expected traffic forecasts and highly uncertain speed of demand recovery. This means it is difficult at this stage to assess whether certain discretionary investments in 2021 are in the interests of consumers. We note, in any case, that any necessary investments would still be incentivised by inclusion of efficient capex in the RAB and the incentives under the price control to meet increased demand and therefore increase revenues. This latter incentive may be particularly strong in the current circumstances;
- we are not clear that HAL would incur this additional capex if the RAB adjustment is less than HAL has proposed. HAL has said in correspondence with us in December 2020 that: *"A smaller adjustment at this stage would likely be interpreted to mean that any recovery would be limited. As such it could be counter-productive in terms of the impact on lenders and CRAs and therefore might not allow any additional expenditure in practice."*
- we do not consider that the adjustment proposed by HAL would be well targeted at protecting efficient investment and protecting service levels or proportionate to the size of any benefits to consumers that might arise from it. Instead, a much smaller intervention would offset the impact of this additional investment on gearing metrics, while a

RAB adjustment would not support significant additional cash-flows required to provide this investment;[16] and

- we note that other mechanisms and processes exist to support service delivery, including regulatory mechanisms such as the current service quality incentive regime (SQRB). We could also take enforcement action where appropriate (although such processes may not lead to a quick resolution of any issues identified).

2.60 Most of the points above relate to discretionary investment. However, based on the statements made by HAL,[17] we have concerns that it may not carry out all of its necessary maintenance investment and be able to react as quickly to reopen terminals if it does not receive the full RAB adjustment, with knock on impacts on the resilience of assets and customer service. This would mean that the regulatory incentives in place may not be sufficient or effective in driving the right behaviours, which might require intervention ahead of the H7 price review.

Options for intervening ahead of the H7 price review to incentivise necessary investment to maintain or improve service quality (under packages 2 or 3)

2.61 We would welcome views from stakeholders on appropriately targeted incentives or interventions we should put in place under packages 2 and 3 to support timely reopening of capacity depending on the recovery of demand, and appropriate maintenance, during 2021.

2.62 We do not consider there is a simple way to calculate the scale of any appropriate intervention and we will consider this further, alongside considering responses to the consultation.

2.63 We do not consider that the full RAB adjustment under packages 3 or 4 would be a proportionate response to address these concerns around necessary maintenance investment that should be made in 2021.

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16 This is discussed in further detail in Appendix E.

Summary of preferred options and timing of intervention

2.64 In our assessment above, we said that we will re-open the price control and that packages 1 or 2 could meet the four key objectives we have set out to further the interests of consumers, in a way that is targeted and proportionate.

2.65 For package 1 this means assessing whether to make an intervention as part of the H7 price review. We consider some of the potential options for adjustments that might prevent unnecessary increases in the cost of equity finance and the cost of capital above, with further details in Appendix I.

2.66 Considering these matters at the price control review would also allow us to take wider issues into account, such as whether there might be alternative mechanisms to a RAB adjustment that would better protect the interests of consumers. For example, we could consider whether any adjustments should be ring-fenced from the rest of the RAB and recovered in a way that is different to normal capex additions.

2.67 For package 2, we would do the same assessment at H7, but we would also make an intervention ahead of the H7 price review in response to short term concerns. We have provided some indicative estimates above of the direct costs to consumers from making an intervention ahead of the H7 price review under package 2 (of £200 million to £600 million). While this is calculated on the basis of meeting objective 2, we note that it could meet multiple objectives, for example supporting any additional necessary investment under objective 4.

2.68 We note that it has been challenging to assess the appropriate early intervention for package 2. This is summarised above with further details in Appendix H. We welcome views from stakeholders on these matters and we will need to carry out further work on the case for and calibration of any intervention under package 2.

2.69 We have identified significant concerns over packages 3 and 4. While we consider these could also meet most of the objectives, the costs to consumers would be significantly higher, without providing clear additional benefits to consumers over packages 1 and 2. As such, we do not consider that either package 3 or package 4 would be proportionate responses to performing our duty to further the interests of consumers.

Chapter 3

Next steps and timetable

Introduction

3.1 In this document we have identified two packages of options for intervention that we consider could further the interests of consumers in a proportionate way. These are:

- package 1, where we would consider what interventions we should make in response to the impact of covid-19 in 2020 and 2021 as part of the H7 price review. In doing so, we would need to consider the objectives and issues set out in Chapter 2 around the efficient cost of capital, financeability, affordability of charges, investment and quality of service; and
- package 2, where, in addition to assessing the appropriate interventions at the H7 price review, we would make an intervention ahead of the price review in response to short term issues. As set out in Chapter 2, this earlier action could, for example, provide additional financial flexibility for HAL on financeability, bringing additional flexibility to provide benefits for consumers, if needed, through additional investment and higher quality of service. However, the analysis and assessment that we have undertaken to date raises challenges over how strong the strength of case for early intervention is. Uncertainty also remains over how any such interventions should be calibrated.

3.2 In this chapter, we set out our planned next steps and timetable for making:

- our decisions on any early intervention in 2021 ahead of the H7 price review, as part of package 2; and
- our decisions on any intervention as part of the H7 price control review under package 1 and package 2.

Next steps on any early intervention ahead of H7

3.3 In order to allow decisions on any early interventions ahead of the H7 price review in a timely way, we are inviting views from stakeholders on this consultation by no later than 12 noon on 5th March 2021.

3.4 During February and March 2021, we plan to do further work to assess the need for, and develop and calibrate, any early interventions under package 2, taking account of responses we receive to this consultation. We will also consider the latest forecasts for traffic levels and HAL's financial position. This information should help us understand the steps we should take to further the interests of consumers and calibrate any early regulatory interventions. We intend to then issue a further statement of these matters around the end of March 2021.

3.5 This relatively tight timetable is driven by the need to retain the flexibility to act in early 2021 in the special circumstances of the covid-19 pandemic. This is consistent with the principles of better regulation, where focused and timely interventions may be a proportionate response to protecting the interest of consumers in the circumstances of covid-19.

3.6 To allow us to make a decision on any early intervention ahead of providing our draft proposals for the H7 price review, we are therefore consulting until early March 2021. As a result, we do not expect to be able to take into account representations received after 12 noon on the 5th March 2021 and so will not be providing additional time for individual stakeholders to respond to this consultation and the questions of whether we should make early interventions and if so on what basis. Nonetheless, as noted below, all stakeholders will have further opportunities to comment on the approach we adopt for the H7 price review, and there will be further consultations as part of that process.

Next steps on any intervention as part of the H7 price control review

3.7 We are currently planning to issue our draft proposals for the H7 price review around July 2021. As part of this, under packages 1 and 2, we would form our view on the appropriate interventions in response to the impacts of covid-19 and the reductions in HAL's revenue in 2020 and 2021.

3.8 To inform our decisions on these matters, we will:

- carry out further analysis to calibrate the appropriate interventions we should make, including refining the methods and indicative estimates we set out in Chapter 2 and Appendix I, as well as, where appropriate, identifying further options for consideration;
- review in detail the further evidence we have received from HAL and other stakeholders on outperformance in Q6 and form a view on how we should take this into account in the calibration of any interventions at H7;
- discuss with HAL the links in its RBP between its proposals for a RAB adjustment and its financeability and the affordability of its charges, to further clarify our understanding of this issue; and
- consider in the round the H7 price control package including our view on any intervention to take account of the covid-19 pandemic, introducing a TRS mechanism for H7 and the cost of capital.

3.9 During this process, we expect to engage further with HAL and airlines on the evidence they have provided.

3.10 The evidence we have to date is that HAL has acted in a way that is consistent with the interests of consumers and its licence obligations. We would expect this to continue as we work on establishing new price control arrangements.

Views invited

3.11 We welcome views from stakeholders on any aspects of this consultation and in particular on:

- whether we have identified an appropriate framework to assess the case for regulatory intervention in HAL's price control arrangements given the exceptional circumstances arising from the impact of the covid-19 pandemic;
- the detail of our preferred framework and whether we have considered an appropriate range of regulatory interventions for assessment;
- our assessment that package 1 and package 2 represent the best way forward. This means that we would consider the issues and appropriate intervention in the round as part of the H7 price review, while considering for decision around the end of March 2021 whether we should make an intervention ahead of the H7 price review; and
- the case for early interventions ahead of the H7 price control review, which we are considering under our package 2 of regulatory interventions, and how any such interventions should be calibrated to further the interests of consumers.