CAP2098 - Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment

4th March 2021

This response to the consultation is submitted by Heathrow Hub Ltd/Runway Innovations Ltd. (HHL), promoters of the Heathrow Extended Northern Runway (ENR) scheme.

1.0 The CAA's approach

1.1 CAP1966 stated HAL had *"not provided comprehensive evidence as to why existing regulatory arrangements are not sufficient to protect quality of service and investment"* (para. 17), *"not fully explored issues around financeability and whether shareholders should provide additional funds given their previous decisions to increase and maintain HAL's gearing significantly above the assumptions used in setting its price controls"* (para 18) and *"not provided sufficient information to warrant short term regulatory intervention"* (para. 19).

1.2 The current consultation now concludes "*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]

1.3 It therefore puts forward a number of options for regulatory intervention, but states that *"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."* [2]

1.4 We consider there is a lack of evidence to justify this fundamental change in the CAA's position.

2.0 The CAA's duties

2.1 HAL's January 2021 Investors and Insurers Update asserts that the *"CAA has duty* (sic) *to ensure Heathrow can finance its activities."* [3]

2.2 The CAA's secondary duties include the need to *"secure that HAL is able to finance its regulated activities,"* [4] a summary of the Civil Aviation Act's requirement that the CAA *"must have regard to … the need to secure that each holder of a licence under this Chapter is able*

[1] Para. 1.2 CAP2098
[2] Para. 21 *ibid*
[3] https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-presentations/jan-21-investors-and-insurers-update.pdf
[4] Paras. 18 and 1.19(iii) CAP2098

to finance its provision of airport operation services in the area for which the licence is granted." [5]

2.3 Our interpretation is that regulatory oversight is intended to ensure that HAL has itself taken appropriate steps to adequately finance its licensed activities – not, as HAL appear to suggest, that the CAA has some unspecified and unlimited responsibility for ensuring HAL is able to secure financing.

2.4 HAL raise the spectre of declining service quality, postponed re-openings or cancelled investment if its claim for a RAB addition is rejected, [6] and states protecting capital investment is *"in the interest of consumers."* [7]

2.5 The consultation notes *"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."* [8]

2.6 HAL give examples of deferred investment, both implemented [9] and proposed, [10] which may be of some benefit to consumers, assuming their scope and cost have been agreed through the airline consultative process. However, in our view they do not begin to justify any RAB adjustment. The question must be asked as to whether deferral of these projects would have any material impact on consumer's choice of Heathrow, taking into account both current cost pressures on every part of the aviation industry and whether any of the claimed benefits can be measured in a meaningful way.

2.7 Our previous response to CAP1966 questioned HAL's attempt to value users time [11] which appears to remain the sole attempt at providing monetised evidence to support its claim. However, the Systra Willingness to Pay Survey, on which HAL rely and which appears to use values inconsistent with Webtag, does not appear to have been published.

2.8 HAL's November 2020 response to CAP1966 states *"consumer research is clear that users expect a cleaner, easier and more reassuring airport experience."* [12] However, it is not clear if that research presented consumers with options, for example the personal financial consequences of minor improvements to elements of the airport experience that might represent only a very small proportion of their overall journey time.

2.9 HAL's response adds *"the key point, which the CAA has not addressed, is that small delays over millions of customers amounts to a very large loss of consumer value,"* and *"an average delay per passenger of 10 minutes in total over each pinch point in the airport journey amounts to over £3bn of lost consumer value."* [13] Presumably HAL recognise the very different values of time for business and leisure passengers, the latter being the vast

[5] Para. 1 (3) (a) Chapter 19, Civil Aviation Act 2012
[6] Response to CAP1966, HAL November 2020
[7] Para. 2.56 CAP2098
[8] Para. 5 *ibid*
[9] Para. 64 Response to CAP1966, HAL November 2020
[10] Para. 71 *ibid*
[11] Para. 2.23 Response to CAP1966, HHL November 2020
[12] Para. 73 Response to CAP1966, HAL November 2020
[13] Para. 111 *ibid*

majority. [14] However, we are unable to assess if the reference to an average 10 minutes delay simply assumes the 'delta T' in DfT's most recent report [15] or represents detailed analysis of real time operations across all Heathrow's terminals throughout an operating year. It is also not clear if the unit value of time is assumed to be constant across all journeys and whether the average delay is the aggregate of a number of small individual time savings, and if so the quantum of each.

2.10 There is also a wider question of how or even whether to value small time savings. The first national study on the subject concluded that small time savings should have a lower unit value, while the second found that individual time savings of five minutes or less did not have any value. This was subsequently questioned in a further study, but which did conclude *"there is no doubt that the data strongly indicates that a lower unit utility attaches to small time changes."* [16] These concerns are particularly relevant to air passengers, where small, perhaps disaggregated, time savings within the airport terminal may be perceived as having a low or no utility value in the wider context of a time critical airport access journey, minimum check in time, flight time, baggage and immigration procedures on arrival and onward journey to a final destination.

2.11 HAL's response also states *"Webtag values … are likely to underestimate the impact* (of time savings) *at airports."* [17] No evidence is provided to support this claim, which appears counter-intuitive and is difficult to understand since Webtag includes a specific aviation appraisal module. [18]

2.12 HAL suggest that deferred investment means that Heathrow will be disadvantaged compared to competitor airports who *"continue to invest to adapt the service they provide to meet altered consumer expectations post-Covid."* [19] HAL provide no evidence of any such investment, or whether this refers to airports in the UK, Europe or further afield. In any case, the consultation rightly concludes *"it seems very unlikely that such expenditure could have a material impact on passengers' or airlines' choices of airport, especially in the context of Heathrow's existing strong advantages."* [20]

2.13 Clearly, consumers benefit from the combination of Heathrow's location, strong demand, hub status and airline network effects. These, together with its capacity constraints and the disincentive for airlines to relocate to other airports in the London system, determine Heathrow's Substantial Market Power (SMP) and therefore give rise to the need for economic regulation.

---

[14] 25.2% Business, 74.7% Leisure passengers, Table 2.1, 2019 Passenger Survey Report, CAA https://www.caa.co.uk/Data-and-analysis/UK-aviation-market/Consumer-research/Departing-passenger-survey/2019-Passenger-survey-report/

[15] Para. 8.4,Understanding and valuing impacts of transport investment: Value of travel time savings consultation response, DfT 2016

[16] Para. 4.3.6 Updating Appraisal Values for Travel Time Savings, Institute for Transport Studies, University of Leeds for DfT June 2010 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/251995/updating-vtts-phase-1-dft-006.pdf

[17] Para. 111 Response to CAP1966, HAL November 2020

[18] TAG Unit A5.2 Aviation Appraisal, May 2018 DfT https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/940851/tag-a5-2-aviation-appraisal.pdf

[19] *ibid*

[20] Para. J6 CAP2098A

2.14 HAL provides no evidence that limited investment by other airports (which in any case seems highly unlikely in current circumstances) would have any material impact on those competitive advantages.

2.15 We therefore welcome the CAA's view that *"overall, we do not consider constraints on investment warrant any intervention ahead of the H7 price control."* [21]

2.16 In passing, we also note that HAL refer to the loss of *"nearly all of our infrastructure projects expertise"* with the result that *"we have lost a significant amount of institutional capability and capacity."* [22] We would refer to our response to CAP1964 which noted that such *"expertise"* had failed to prevent significant inefficiencies in both the cost and programme of capital projects. There is therefore an opportunity to fundamentally change the way in which projects are managed and delivered in the future.

3.0 The detail of HAL's claim

3.1 It is not clear how HAL has arrived at its claim. Its recent Investor Reports show monthly cash burn reducing from £240m in June 2020 to £159m in December 2020, [23] presumably at current prices and including the capex included in its current price control. HAL's claim also presumably excludes consideration of the increased charges introduced from 1st January 2021. [24] Reports suggest these will add £8.90 to each existing passenger charge. [25]

3.2 The CAA's final determination of HAL's claim will have far reaching consequences, not only because of the fundamental principles to be considered but also because HAL's claim is unknown in quantum, unlimited in duration and increased from £1.8bn in HAL's July 2020 submission to an estimate of £2.8bn (at 2018 prices). [26] Furthermore, *"the actual final adjustment could be higher or lower than this depending on outturn traffic volumes in 2021."* [27]

4.0 The principles of HAL's claim

4.1 We believe that the CAA's principal duty means that HAL's recourse should be to its shareholders, and not to consumers.

4.2 Indeed, since the consultation was published, HAL's 2020 Results confirm it now has "*sufficient liquidity to meet all our forecast needs until at least April 2022 under the extreme stress-test scenario of no revenue, or well into 2023 under our current traffic forecast. This includes forecast operational costs and capital investment, debt service costs, debt maturities and repayments."* [28]

4.3 The consultation confirms *"the extent to which shareholders have sought to support HAL is important"* and that there is a *"need to be certain that HAL and its shareholders are doing all*

---

[21] Para. H2 *ibid*
[22] Para. 70 Response to CAP1966, HAL November 2020
[23] https://www.heathrow.com/company/investor-centre/reports/investor-reports
[24] General Notice, Tariffs effective from 1st January 2021, HAL 4th February 2021
[25] https://www.headforpoints.com/2021/02/09/exceptional-regulatory-charge/
[26] Para. 11 CAP2098
[27] Para. 2.15 *ibid*
[28] Results for the year ended 31st December 2020, HAL 24th February 2021
https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-SP-Limited-Q4-2020-results-release-final.pdf

that can reasonably be expected." [29] We address the *"equity injection,"* [30] *"additional debt finance"* [31] and *"£2.5bn in funding including a £600m capital injection"* [32] at para. 4.12 below.

4.4 The terms of any new or further debt and equity must be considered in the context of what was, even before the pandemic, a heavily indebted, highly geared business with a complex and obscure corporate structure. Furthermore, in terms of quantum, a £600m equity injection is a fraction of the dividends taken out in recent years and substantially less than, say, the €2.75 billion equity injection provided by shareholders in International Airlines Group in September 2020. [33]

4.5 There appears to be very little transparency, beyond standard accounting disclosures, regarding the inventory of swap contracts and any accompanying foreign exchange hedges that HAL has put in place. We do know that it has reduced cash interest from £467m on Class A bonds in 2020 to £28m in 2021. [34] However, whilst this (and the inflation on non-retail non-aeronautical income from £285m to £462m) offers cashflow relief in 2021, these contracts will at some stage have to be paid for and must be a relevant consideration in the CAA's decision making.

4.6 In the absence of clarity as to the terms on which new funding has been secured, there is a risk that Heathrow's operating business is being loaded with an ever greater and potentially unsustainable debt burden, creating even more serious challenges in the future. HAL's November 2020 consultation response notes that the spread across its October 2020 bond transactions was much higher than other regulated utilities in current market conditions. [35]

4.7 On the basis of past and current behaviours, it is reasonable to assume that short term solutions at the expense of long-term financial sustainability would simply see HAL once again seeking regulatory relief in the future.

4.8 It must also be a material consideration that HAL's shareholders, including some of the world's largest sovereign funds, have derived considerable, some would argue disproportionate, benefits from past decisions as to gearing and dividends.

4.9 The consultation acknowledges that *"HAL's present choice to adopt a leverage model brings with it a considerably higher level of gearing compared with the assumption we used for the financing of the notional company at the Q6 price control review."* [36] *"If HAL considers that it can achieve a lower cost of capital by adopting higher leverage, it is at liberty to do so: but the corollary of this is that HAL must bear the consequences if its cost of capital is higher than what would be the case under the notional assumption."* [37]

---

[29] Para. 1.14 CAP2098
[30] Para. 1.13 *ibid*
[31] Para. 2.33 *ibid*
[32] Results for the year ended 31st December 2020, HAL 24th February 2021
[33] https://www.iairgroup.com/investors-and-shareholders/the-iag-share/2020-capital-increase
[34] P.19-20 Heathrow SP Ltd & Heathrow Finance PLC Investor Report Dec 2020
[35] Para. 223 Response to CAP1966, HAL November 2020
[36] Para. E14 CAP2098A
[37] Para. E15 *ibid*

4.10 HAL state *"the actual level of gearing of a company should have no bearing on the approach to regulation adopted by a regulator."* [38] We believe this is highly questionable, as is HAL's statement that *"companies generally operate at an efficient level of gearing."* [39]

4.11 The level of gearing that has clearly contributed to HAL's current financial stress is *"the result of choices made by HAL and its shareholders"* and was estimated in October 2020 to reach 93.3% by the end of that year. [40]

4.12 This did not take into account the subsequent *"equity injection"* of £750m into the regulated entity (Heathrow Finance and Heathrow SP), with the result gearing fell slightly to 91.7% at Heathrow Finance. We note that gearing at Heathrow SP and Heathrow Finance are different, the consultation's reference to 60% increasing to around 70% in 2021 [41] applying to the former. However, it is gearing at the latter which is the most important.

4.13 It is also relevant to note that this equity injection was delivered from another corporate structure between the Topco and the regulated entity, where it was in fact borrowed from external funders and will subsequently be repaid by diverting remitted dividends when they are resumed. This further underlines the stark contrast between HAL's shareholders reluctance to commit permanent capital of their own, while insisting on embedding permanent additions to its RAB.

4.14 In the course of Q6, HAL also removed almost all equity to pay nearly £4bn of dividends. [42] We estimate roughly £2bn of this represents over-distribution if Heathrow were benchmarked to the higher-yielding comparable entities in the UK stock market, or if that overdistribution is mapped with the rise in Heathrow's own debt. This is a material consideration in considering HAL's claim which the consultation does not appear to address.

4.15 We also note the Risk Factors in HAL's funding prospectuses have consistently identified *"health scares, epidemics or pandemics across the globe."* [43] It is difficult to understand the rationale for specifically identifying this risk if, as HAL argue, "*it is not appropriate for a regulated company to be expected to bear downside impacts that occur less frequently than once every 20 years.*" [44]

4.16 If HAL were to succeed in its claim, it would not only be made immune from the consequences of its financial decisions, but positively rewarded through the increased level of returns from a larger RAB.

4.17 HAL's assumption that economic regulation will stand behind it, even where its financing decisions have clearly contributed to its current challenges, appears to extend far beyond what could reasonably be considered consistent with the CAA's principal statutory duty.

4.18 Indeed, it appears entirely inconsistent with the Civil Aviation Act 2012, the explanatory notes to which confirm *"CAA would not be required to adjust regulatory decisions in order to*

---

[38] Para. 210 Response to CAP1966, HAL November 2020
[39] Para. 76 *ibid*
[40] Para. D.19 CAP1966A, CAA October 2020
[41] Para. 2.36 CAP2098, CAA February 2021
[42] Response to CAP1966 British Airways November 2020
[43] For example, p.13 Heathrow Funding Ltd Base Prospectus 2016
https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/offering-related-documents/archived-documents/funding/2016-Heathrow-Funding-base-prospectus.pdf
[44] Para. 141 Response to CAP1966 HAL November 2020

take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions." [45]

4.19 It is therefore welcome that the CAA acknowledges *"the potential dampening of incentives on HAL to manage its finances prudently that intervention might cause, especially as this could result in consumers implicitly underwriting HAL's highly-leveraged financial structure"* and concludes *"it is not clear that this approach would be in consumers' interests."* [46] Full consideration of these issues, to ensure clarity and transparency, would appear to be essential to the performance of the *"better regulation principles specified in section 1(4) CAA12."* [47]

4.20 The CAA has correctly assessed the problem, of protecting consumers interests by avoiding credit downgrades, and has proposed a proportionate RAB adjustment, but the question of why we are here – in leverage terms – remains.

4.21 In our view, and taking into account growing uncertainty over future traffic forecasts, there is a risk that even a proportionate RAB adjustment simply defers the inevitable - that Heathrow's finances are unsustainable when considered on any reasonable metric and on any realistic forecast, and that the consumers interest is best, indeed can only be served by taking what we fully recognise are difficult regulatory decisions.

5.0 The proposed remedy

5.1 It is of course indisputable 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."* [48]

5.2 However, every other UK airport faces proportionally even greater losses of revenue and traffic, effectively demonstrating Heathrow's continuing, and effectively now increased, market power. HAL's January 2021 investor presentation confirms the *"numerous airlines choosing to restart their operations at Heathrow, supporting a faster recovery at Heathrow and increasing our London market share."* [49]

5.3 HAL's debt is ultimately held by bondholders and it is, or should be, their decision as to how and whether to support Heathrow's operating business. That continues to be the case with the UK's other airports. [50]

5.4 The consultation confirms *"that shareholders could remedy the issues with HAL's RAR covenant by making a suitable injection of new equity finance."* [51] Alternatively, it would seem appropriate - and preferable - that a rights issue is considered similar to the way in which IAG strengthened its balance sheet.

5.5 The CAA has already established that a RAB adjustment of £200-600m might discharge their responsibilities in protecting consumers, and a rights issue of a similar size would have the

[45] Civil Aviation Act 2012, Explanatory Notes, Section 36(a)
[46] Para E11 CAP2098A
[47] Para. 1.20 CAP2098
[48] Para. 1.6 *ibid*
[49] Page 8 Investor & Insurers update, HAL January 2021
[50] e.g.: MAG https://www.magairports.com/media/1696/mag-investor-presentation-fy21-h1-vfinal.pdf
[51] Para. E12 CAP2098A

same effect. Topco could possibly avail themselves of a Government Guaranteed Loan, as have both IAG and Rolls Royce, to another entity in the corporate structure outwith the regulatory perimeter to inject as equity into Heathrow, to be repaid, as per the previous transaction in the autumn of 2020, from dividend payments when they are resumed.

5.6 If HAL's shareholders rejected either option, it would send a clear signal that regulatory intervention, effectively requiring consumers to assume unquantifiable financial risks that were rejected by shareholders, could simply not be justified.

5.7 The CAA's August 2019 Working Paper considered issues of financial resilience and ring fencing, albeit in the context of the NWR expansion scheme. It concluded *"if HAL were to experience financial distress, the interests of bondholders (who are primarily interested in the repayment of their loans) and consumers (who will be interested, for example, in continuity of service and the longer term benefits of expansion) may diverge. Significant adverse impacts on consumers could arise from this.*" [52]

5.8 We suggest this shows a similar presumption in HAL's favour to that of almost ten years ago when BA's then Chief Executive stated *"the CAA has tended to give the balance of any judgement in favour of HAL's shareholders rather than the passenger."* [53] This also aligns with some of our more recent responses to previous consultations - for example the CAA's view that the consumer benefits of early delivery of Heathrow expansion outweighed other considerations of cost and risk, [54] and the perverse incentives inherent in the current regulatory model which fail to penalise inefficiency and gold plating.[55]

5.9 Even longer ago, the CAA considered the impact of Ferrovial's purchase of BAA in 2008. It recognised that regulation could not prevent change of ownership or acquiring companies from carrying high levels of debt and concluded that its policy was to therefore prevent the risks associated with such leverage from being transferred to the passenger. [56]

5.10 At that time the CAA confirmed *"for the avoidance of doubt, and as the CAA stated in its May 2006 policy update, the CAA does not consider that financial distress, per se, would justify re-opening price controls, nor a scaling back or deferral of the investment programme that users effectively pay for through their charges. It follows that – at the limit – the CAA would be prepared to let any one of the regulated airports fail. To do otherwise would be to transfer risk from equity and debt investors to users, contrary to the CAA's policy approach. In taking this stance, the CAA is confident that there would be strong incentives, stemming from the relatively high fixed costs (and low variable costs) of the Heathrow and Gatwick operations, on any receiver (or administrator) of an airport to maintain continuity of supply, thus providing some comfort to users that service would, even in those extreme circumstances, be maintained. None of this should be interpreted as the CAA taking a view*

[52] Para. 7 CAP1832, CAA August 2019

[53] Foreword by Keith Williams, Response to the CAA's Final Proposals for Economic Regulation at Heathrow Airport from April 2014, British Airways November 2013 https://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294974960

[54] *"The CAA has interpreted this duty by consistently assuming that the consumer benefits of expansion outweigh NWR programme and cost risk"* – Para. 6.24, HHL/RIL response to CAP1819 and CAP1825, 20th August 2019

[55] "T*he risk that incentives may be gamed or may have unforeseen consequences"* and *"the regulatory regime applicable to HAL does not contain a general obligation to promote economy and efficiency across the full range of HAL's activities"* – Para. A.4.11 extracts from CAP1825, HHL response to CAP1964 17th November 2020

[56] Paras. E15 and E61 onwards, Economic Regulation of Heathrow and Gatwick Airports 2008-2013, CAA decision March 2008 https://webarchive.nationalarchives.gov.uk/20140605050545/http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf

that the regulated airports will fail – or are more likely to fail – in the future than they were in the past. Instead, the purpose of this document is merely to lend clarity to the CAA's regulatory policy if such circumstances were to arise." [57]

5.11 We assume this remains the CAA's policy.

5.12 However, we recognise Heathrow's importance to the UK economy and its unique capacity constraints. Our Extended Northern Runway (ENR) scheme provides the solution, not only for the UK, but also to HAL's financial challenges by providing its shareholders with a growth strategy that justifies their continued support for the business.

5.13 In sharp contrast to HAL's NWR scheme, it is low cost, deliverable and affordable, helps meet the UK's zero carbon target by reducing the airports' environmental impacts, assists airlines economic recovery by permitting only a gradual release of new capacity as and when environmental limits are met and reduces the airports noise impacts on local communities, particularly in the most sensitive early morning and late evening periods.

5.14 It is perhaps worthy of note that HAL's application for a RAB increase of at least £2.8bn is equivalent to almost two thirds of the cost of phase 1 of ENR in current prices. In addition, HAL are of course separately claiming over £0.5bn for their abortive costs in developing NWR prior to February 2020.

6.0 Heathrow expansion

6.1 We believe it is important that regulatory decision making considers the wider context of HAL's business, for example the highly inefficient capital investment in 'Business as Usual' projects as well as its proposed North West Runway scheme.

6.2 We note HAL's response to CAP1966 uses expansion in attempting to put further pressure on the CAA. It states *"in the event of no adjustment, Heathrow would not be able to finance expansion. Additional Government aid or significant pre-funding would be required to enable it to go ahead. Avoiding an adjustment therefore risks permanently undermining the financeability of expansion and therefore the well- understood benefits of increasing the UK's hub airport capacity."* [58]

6.3 However, the reality is that the NWR business case relied entirely on the assumption that its full capacity of 740,000 ATM's would be fully utilised within two years of a runway opening. [59] This was always unachievable, while our previous responses to consultations show beyond any reasonable doubt that, even before the impact of covid-19, the scheme was financially unaffordable and practically undeliverable.

6.4 HAL's response to CAP1966 refers to CAP1871 and states "*the CAA estimated the impact of a year's delay* (in delivering the NWR scheme) *to be in the range £0.9bn to £2.5bn per annum. It is a relevant consideration that the expected harm from such a delay thus significantly outweighs the annualised impact of any adjustment."* [60]

---

[57] Para. E69 *ibid*
[58] Para. 98 Response to CAP1966, HAL November 2020
[59] Para. B2.6 Response to CAP1964, HHL November 2020
[60] Para. 114 Response to CAP1966, HAL November 2020

6.5 However, our response to CAP1940 noted there was no attempt to consider the relative merits of continuing to incur the cost, now almost certainly abortive, of progressing an unaffordable and undeliverable scheme compared to a delay to ensure that expansion would indeed deliver consumer benefits. [61]

6.6 Our response to CAP1964 discussed the significant consumer disbenefits should HAL be allowed to recover over £0.5bn of costs incurred on the NWR scheme, and the even greater disbenefits should it actually be taken forward.

6.7 HAL's January 2021 Investor and Insurer update confirms the Supreme Court's December 2020 decision that the Airports NPS is lawful but fails to recognise that NWR is politically undeliverable.

6.8 Government refused to join the 2020 Appeal against the Court of Appeal's judgement quashing the Airports National Policy Statement (ANPS) and following the Supreme Court's judgement, the Secretary of State for Housing, Communities and Local Government wrote to the Mayor of London on 29th January 2021. This states, *"having considered your Intention to Publish version of the plan and the implications of the Supreme Court ruling on the Airports National Policy Statement for your London Plan, I can confirm that I have no further matters to raise with you."* The Plan, as now formally adopted, states *inter alia* "*the Mayor will oppose the expansion of Heathrow Airport unless it can be shown that no additional noise or air quality harm would result, and that the benefits of future regulatory and technology improvements would be fairly shared with affected communities."* [62]

6.9 In the unlikely event HAL do seek to reactivate its NWR scheme, there could therefore be no possible justification for costs being passed on to consumers.

[61] Para. 8.3 *et seq* Response to CAP1940, HHL August 2020
[62] Policy T8 London Plan 2021

7.0 The impact on competition

7.1 The consultation considers *"the likely impact (if any) on competition in airport operation services and the consequences for competition of any action we might take"* [63] and appears to suggest that allowing an increase in the RAB, regardless of quantum, would have no material impact on competition. [64]

7.2 HAL's July 2020 claim stated *"the RAB adjustment"* (a minimum of £2.2bn, an upper limit redacted) *"was expected to increase charges by about £1.20 per passenger, or about 5%, from 2022"* [65] while HAL's November 2020 submission (presumably reflecting the increased claim of £2.8bn) states *"the impact of our proposal will increase charges by between £1.80 and £3 for H7."* [66]

7.3 However, the current consultation's estimates appear very different. CAP2098A summarises HAL's – we believe highly questionable - assumptions as to cost of capital, depreciation, capex, opex, traffic and non-aeronautical revenues. [67] However even using these optimistic figures, the CAA's analysis, using the same assumptions for scenarios with and without RAB adjustment (and presumably assuming a £2.8bn claim), shows a range of charges between £32.38 and £43.19 at 2020 prices. [68]

7.4 Assuming 2019 aeronautical revenues per passenger of £22.64, [69] this represents a very large increase when Heathrow's charges are already the highest of any airport in the world. [70] The effect of any increase, let alone of this magnitude, is potentially very serious when airlines face existential challenges. We would argue that the level of charges is a matter of national importance, particularly at a time when the UK uniquely faces the twin challenges of recovering from covid-19 and Brexit.

7.5 Our response to CAP1966 [71] noted Heathrow's unique commercial advantages are the result of a legacy of historical accidents which combine to provide the consumer benefits that result in its market power. The consultation suggests that a RAB adjustment would not result in any competitive benefit over other airports because of *"Heathrow's existing strong advantages. For passengers, these include a convenient location with easy access to London and a wide choice or airlines and routes."* [72]

7.6 Hence, it effectively assumes nothing could change the 'pull' exerted by Heathrow's market power, even *"HAL's charges being higher than they otherwise would be"* and allowing *"HAL to continue spending money where other airports cannot."* [73]

---

[63] Para. 1.19 CAP2098
[64] Para. J5 CAP2098A
[65] Para. 4 CAP2098
[66] Para. 18 Response to CAP1966, HAL November 2020
[67] Para. E20 CAP2098A
[68] Table 5 Appendix F *ibid*
[69] Results for year ended 31st December 2019, HAL February 2020
[70] Chart 49, Cost and Commercial Viability: Funding and Financing Update, PwC for Airports Commission, July 2015 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440179/cost-and-commercial-viability-funding-and-financing-update.pdf
[71] Para. 2.31 Response to CAP1966, HHL November 2020
[72] Para. J6 CAP2098A
[73] *ibid*

7.7 Similarly, that nothing would 'push' airlines to other airports, as *"Heathrow is the UK's only major hub, take-off and landing slots are valuable assets that airlines wish to retain, and many airlines are able to charge premium fares on routes to and from Heathrow."*

7.8 We note various consultants' reports consider the perceived effect of scarcity rents on a 'Heathrow premium', with conclusions apparently reflecting the settled views and motivations of the commissioning client. [74] For example, HAL relied in part on a report it commissioned from Frontier Economics [75] in attempting to justify its assertion that the substantial increase in charges required to finance its NWR scheme would be offset by lower fares as a result of increased capacity. [76] Those assumptions were directly contradicted by a report which BA/IAG commissioned from RBB Economics. [77]

7.9 We suggest any reference to a 'Heathrow premium' should therefore make clear the absence of any consensus as to the existence, value or attribution of scarcity rents. It is also relevant that independent research confirmed *"BA's point regarding competition in transfer markets is a valid one"* and *"BA at Heathrow is among the hub carrier (sic) that faces the most competitive constraints of all European hub carriers."* [78]

7.10 Taken at face value, the result of the CAA's assumptions is that Heathrow's SMP is effectively immune from changes in the very external factors which are responsible for its market power. This risks some or all of these becoming self-reinforcing. By effectively insulating Heathrow from the market forces that are fundamental to the viability and performance of other airports, including what may be fundamental changes accelerated by the pandemic and the UK's zero carbon target, the regulatory intervention which HAL request would, if granted, at least maintain but potentially increase Heathrow's market power.

7.11 Any intervention which seeks to secure Heathrow's financial sustainability, while all other UK airports in the same highly competitive market face similar, if not greater challenges, (despite what in many cases might be considered more prudent financial management), would appear fundamentally anti-competitive.

7.12 In our view, the scale and unlimited nature of HAL's claim, the absence of evidence, the unique privileges afforded by economic regulation and the competition issues which arise from the similar, or greater challenges faced by other, non-regulated airports means there can be no case for regulatory intervention which would inevitably result in increased costs to consumers.

---

[74] For example - A critique of published reports regarding scarcity rents at Heathrow airport, FTI Consulting for CAA, October 2018, http://publicapps.caa.co.uk/docs/33/CAP1722b%20FTI%20Consulting%20-%20Report%20to%20CAA%20on%20Scarcity%20Rents%20-%20Final%20-%2030%20October%202018.pdf

[75] Estimating the congestion premium at Heathrow, Frontier Economics for HAL, May 2019 https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/Estimating%20the%20congestion%20premium%20at%20Heathrow.pdf

[76] P.68 Initial Business Plan, HAL, December 2019

[77] The effect of congestion at Heathrow Airport, RBB Economics for BA/IAG, February 2019 https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/CAP%201722%20RBB%20report%20-%20the%20effect%20of%20congestion%20at%20Heathrow%20-%20SUMMARY%2019%20FEB%202019.pdf

[78] Para. 1.5.2 Review of submissions: Competition impacts, SEO Economic Research for the ITF, April 2015 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/439174/strategic-fit-review-of-consultation-submissions-airline-and-airport-competition-impacts.pdf

7.13 It would also appear contrary to the CAA's strategic objective to *"improve choice and value for aviation consumers now and in the future by promoting competitive markets, contributing to consumers' ability to make informed decisions and protecting them where appropriate,"* [79] as well as having the potential wider consequences identified by the CMA.[80]

7.14 In weighing the merits of HAL's claim in the context of competition issues, we recognise that *"price cap regulation can mean that HAL could face a more limited range of possible outcomes (on both the downside and the upside) than many airports that are not subject to economic regulation."* [81] However, the public record of HAL's inefficiency, financial fragility and disproportionate shareholder returns shows fundamental inequivalence of risk and reward.

7.15 Almost ten years ago, BA suggested the CAA's Final Proposals for Q6 would result in HAL shareholder yields of up to 11% simply by hitting settlement targets, rising to well over 30% if outperformed, as indeed has been the case. The sale of an 8.65% stake in FGP Topco to USS for £392 implied a premium to RAB of c.13% and an equity premium of c.65%, illustrated the generous settlement.[82]

7.16 Since then, HAL shareholders have received around £4bn in dividends, which, as discussed earlier, represents around 100% over-distribution versus comparable peers.

7.17 It therefore appears that HAL's request for an adjustment to the RAB conflicts with the principles in a regulatory framework that is intended to balance the interests of consumers with the airport's owners and should be resisted by the CAA, at least unless or until a substantial and transparent injection of fresh equity has been committed by its shareholders.

[79] Para. 5 Memorandum of Understanding between the Competition and Markets Authority and the Civil Aviation Authority on the use of concurrent powers under consumer protection legislation, CMA June 2015

[80] Para. 4 *ibid*

[81] Para. J7 CAP2098A

[82] British Airways response to the CAA's Final Proposals, November 2013 https://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294974960