Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488)

Heathrow's response

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1. Executive Summary

1.1.1 We acknowledge the CAA's intention to set a price cap for 2023 in the absence of a Final Decision on the H7 settlement. We have therefore published our decision document on 2023 airport charges setting a charge of £31.57 in line with the proposals in the CAA's consultation document.

1.1.2 It is unacceptable to have no clear complete timeline for the regulatory process and to rely on last minute publications to ensure the right provisions are in place for both Heathrow and its customers. We support the CAA in taking the time needed to set the right outcome for the H7 price control rather than moving to a rushed decision, however, delays to the H7 process and a lack of clear next steps have led to the need for yet another interim cap the level of which will now not be formally decided until into 2023. This lack of clarity impacts all stakeholders and is out of line with good regulatory practice.

1.1.3 In the four months between receiving responses to the Final Proposals in August and the publication of this consultation the CAA's analysis has still not been updated to address the errors in the proposed cap for 2023. As set out in our response to the Final Proposals, the proposed price cap does not take into account the costs of delivering the plan and the agreed service levels.

1.1.4 Since the Final Proposals, changes in external circumstances have rendered the assumptions in the Final Proposals out of date. The gap between a deliverable plan and the price cap set out in the Final Proposals is significant. Our recent December 2022 update to the Revised Business Plan (RBP) highlights the need for an average charge of £40.08 over the H7 period. This is in contrast to the Final Proposals average charge of £24.14 on which the interim cap for 2023 is based.

1.1.5 A cross check to Q6 also highlights the issues with the proposed cap for 2023. Overall, the average H7 charge set out in the Final Proposals is lower than the average charge set for Q6, which is £24.43 in 2020 prices. The proposed cap of £31.57 for 2023 is equal to the 2016 charge in real terms, when Heathrow served over 75 million passengers. Given lower passenger numbers, increased passenger expectations and higher service quality targets, loss of commercial revenue due to the removal of the VAT refund scheme and airside tax-free shopping, and perceived higher risk of operating an airport due to the impact of Covid-19 this charge is too low.

1.1.6 The proposed charge is also too low to support current credit ratings. Based on the notional balance sheet (with only 30% of debt index-linked) it results in FFO/Debt of 5%, well below the minimum 7% level required by S&P. More realistically, with 70% of debt Index Linked to be consistent with Heathrow's actual balance sheet, the notional company FFO to debt is only 2%. This creates a significant risk to the financeability of the notional company and the ability to deliver the capital programme assumed in the Final Proposals.

1.1.7 The lack of a deliverable price control risks Heathrow not having sufficient cashflows to invest in passenger service and resilience and could lead to longer-term impacts on Heathrow's financeability. This will have impacts for current and future consumers at Heathrow. These impacts include:

- Lower baseline service levels due to the inability to invest in key parts of the airport experience such as wayfinding or cleanliness.

- A less resilient operation which cannot sustain service levels in the face of volatile demand or external impacts.

1.1.8 To manage the impact on cashflows of this lower cap, the CAA must implement a true up of the difference between the interim price cap and the required charge for H7 in-year.

1.1.9 In advance of the Final Decision, the CAA must review the evidence we have provided in response to the Final Proposals and take into account the changes in external evidence including 2022 performance and the revised macroeconomic outlook set out in our RBP Update.

1.1.10 This response provides further detail on:

- The required price cap for 2023
- The CAA's proposed licence modifications

2. The 2023 interim price cap

2.1 The proposed 2023 cap does not reflect the costs of delivering the required service levels and investment

2.1.1 As set out in our response of 9 August, the Final Proposals contained a number of errors which mean that the charges proposed for H7 do not reflect the cost of providing the agreed service levels.

2.1.2 In addition, the Final Proposals are now materially out of date. The Final Proposals were built on external data inputs from March 2022 or even before in the case of external passenger forecasts. Since then, there have been significant changes in the external environment which mean that these inputs are no longer fit for purpose.

2.1.3 The delays to the price control also mean that 2022 performance is now available and does not need to be forecast. This provides evidence on key inputs such as the real impact of changes to the VAT scheme or the cost to serve passengers across four terminals which should form the basis of the H7 forecasts.

2.1.4 To ensure these updated inputs and their impact on the H7 price control are clear, we have provided an updated version of our RBP to the CAA which reflects the impacts of these updated inputs on the H7 building blocks. This has led to updated forecasts of passenger volumes, operating costs, commercial revenues and WACC. Adjusting for these inputs leads to an average H7 charge of £40.08 in CPI 2020 prices.

2.1.5 This demonstrates that the charges set out in the Final Proposals and by association the proposed interim cap for 2023 do not represent a deliverable H7 price control which is aligned with current market data or external economic inputs.

2.1.6 The evidence provided in the update to the RBP must be taken into account when setting the Final Decision to ensure that the price control reflects the true costs of providing the required levels of service and investment across the H7 period. This is important to ensure that the CAA is carrying out its duties to current and future consumers and its duty to have regard to Heathrow's ability to finance its provision of airport operating services.

2.2 External factors are putting continued pressure on Heathrow's financeability at a charge of £31.57

2.2.1 As set out, the gap between the proposed interim cap for 2023 and the charge for a deliverable and financeable H7 plan is large. Ultimately if the price control is not financeable this will mean we cannot deliver on the plan agreed to be in the interests of consumers.

2.2.2 Since the Final Proposals, while passenger growth has been strong leading to us revising our traffic forecast for 2023 upwards, there have been material changes which have increased the financeability challenge. In our letter to the CAA dated 9 November we explained that inflation expectations had increased materially[1], and interest rates had risen significantly[2]. The impact of these is to significantly increase interest and accretion costs, reducing Funds from Operations (FFO).

2.2.3 In its assessment of the Final Proposals S&P set out that without a price control which can achieve and FFO/senior debt ratio of 7% it would consider downgrading Heathrow's credit rating.[3] This assessment was undertaken based on the assumptions and economic inputs available in July 2022. A downgrade to Heathrow's credit rating would have wide reaching impacts for our ability to invest and the cost of developing and improving the airport for consumers.

2.2.4 In our letter of 9 November, we set out analysis of our performance against this key credit metric using an updated version of the analysis carried out by S&P in July that showed updating S&P's modelling for a charge of £31.57 would result in an FFO/Net debt of [✂].

2.2.5 Subsequently, the outlook for inflation has worsened.[4] Our current forecast is that FFO/debt for 2023 will be [✂].

2.2.6 The interim price cap consultation document argues that this analysis is wrong or is not relevant in the context of setting the H7 price control because: it is not based on the notional company balance sheet; it only considers a single year's ratio; and it ignores higher cashflow in later years due to higher inflation of the RAB. The consultation document is in error on all three of these points:

2.2.7 Firstly, we note that the gearing of the class A debt, to which this analysis related, is only slightly over 60% (56.5% including an appropriate Covid-related RAB adjustment) and therefore is broadly consistent with the notional company.

2.2.8 In any case, the FFO/Debt is also well below 7% on a notional basis. Based on the December 2022 update, and assuming only 30% of debt is Index Linked (IL), on a notional basis FFO/Debt for 2023 is [✂].

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[1] In the Final Proposals, average RPI for 2022 was expected to be 9.1% and 2023 4.3%%. The view from OEF then (October 2022) was that average RPI for 2022 will be 11.4% and 2023 8.7%. This increase in RPI makes a significant difference to the cost of accretion of our Index Linked debt.

[2] The Final Proposals were based on an interest cost for new debt of 3.6% nominal. Currently the Yield on Heathrow Class A bonds is over 6.5% and they have reached as high as 7.7%. This means that the cost of new debt is over 3% higher than assumed by CAA.

[3] S&P Global, research update, 7 July 2022, https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/credit-ratings/sp/2022_Heathrow_Funding_Remain_On_Credit_Watch_Negative.pdf

[4] The updated view of RPI in 2022 and 2023 in the November OEF was 11.5% and 10.4% respectively.

2.2.9 In reality, Heathrow has a much higher proportion of IL debt at around 70%. Basing the notional balance sheet on this proportion of IL debt results in FFO/Debt for 2023 of [✂].

2.2.10 We are surprised that the document states that we considered the impact of only one year's ratio. We provided evidence to the CAA setting out updated ratios for three years; 2022, 2023, and 2024, consistent with S&P's approach of averaging three years. The average ratio of FFO/Debt for these three years was [✂]. Moreover, the CAA appears to be ignoring the wider context of poor ratios. FFO/Debt was negative in 2020 and 2021 and is 3.9% for 2022. Given this context, ongoing low ratios in 2023 and 2024 should give clear evidence to the CAA that revenues are too low.

2.2.11 The final point made in the consultation document is that higher inflation of the RAB would lead to higher cash-flows in later years and that our analysis ignores this. We are very surprised that the CAA has expressed this view as it is incorrect for a notional company, demonstrating a lack of technical rigour. With debt fixed at 60% of RAB, inflation of the RAB makes no difference to FFO/Debt ratios as both the numerator and denominator increase with inflation in the same way and therefore inflation has no impact on the ratio. This point is therefore based on erroneous analysis of the impact of inflation.

2.2.12 In choosing to ignore the financeability of Heathrow as it has, the CAA is ignoring its primary duty to consumers. If Heathrow were not financeable it would reduce our ability to invest in the airport, reducing resilience and leading to a poorer outcome for consumers. It is not in consumers' interests to set a price control that provides insufficient revenues and means that Heathrow cannot meet the required financial ratios. When making decisions, the CAA must have regard to the way that rating agencies will actually assess Heathrow and the real impact this could have on consumers.

2.3 The difference between the required charge for 2023 and the interim cap should be trued up in year to ensure cash flow requirements are met

2.3.1 The consultation proposes implementing the 2023 interim price cap for the full year and truing up the difference between the proposed interim cap and the cap determined in the H7 Final Decision through the later years of H7.

2.3.2 In principle we agree that it is helpful to provide certainty of the charge for 2023 to stakeholders. However, we cannot support a delayed true up mechanism due to the financeability concerns set out above.

2.3.3 In order to have sufficient cash flows to meet credit metrics, we would need to ensure that the final charge was reflected in cash flows within 2023. Therefore, the CAA must true up the difference between the interim price cap and the higher required charge for 2023 in year, when the Final Decision is implemented. This will ensure that we have the required cash flows to retain an investment grade credit rating and can continue to deliver on our plans.

3. Modifications to Schedule 1

3.1.1 The proposed changes to schedule 1 to remove the measurement of departure lounge seating availability and flight display screens are required to ensure that we can embed the transition to an outcomes-focused service quality regime.

3.1.2 The two measures proposed to be removed are not in scope of the OBR framework in the H7 Final Proposals. Heathrow and the airlines agreed that these measures should be removed through Constructive Engagement in 2020.

3.1.3 Removing the requirement to report on the two measures will allow Heathrow to Focus the QSM survey on the key drivers of passenger satisfaction and understanding how we can better deliver on the outcomes passengers want to see when they travel through the airport.

3.1.4 Given this, we support the proposed changes made in the draft set out in this consultation.