

Heathrow Airport Limited: response to the CMA consultation on approach to COVID-19 in the NERL RP3 redetermination

Date: 1 July 2020
Prepared by: Heathrow Airport Limited
Status: Final

Heathrow: Response to the CMA consultation on approach to COVID-19 in the NERL RP3 redetermination

1. Executive summary

- 1.1 Following the launch of the CMA's redetermination of NERL's RP3 price control (**NERL Reference**), the sudden and unforeseen development of the global COVID-19 pandemic has resulted in overwhelming challenges for the aviation industry. The impacts started to unfold shortly before the publication of the CMA's Provisional Findings (**PFs**) and, as recognised by the CMA's recent consultation on approach to COVID-19 (the **COVID-19 Consultation**), have continued to result in unprecedented falls in the use of aviation services.¹ Although the industry may be starting to see signs of future recovery, these challenges are very much ongoing and it is not clear how long they will last.²
- 1.2 As Heathrow has highlighted throughout the NERL Reference – both in its written submissions and at a hearing with the CMA³ – the CMA's decision will have a material and direct impact on Heathrow, both due to the operational links with NERL and also the parallels that the CAA has drawn for Heathrow's own price control. Like NERL, Heathrow has been severely affected by the impact of the pandemic, and forced to take drastic measures in order to protect its business. It is therefore well-placed to comment in detail on the ongoing effects of the pandemic on aviation.⁴
- 1.3 The COVID-19 Consultation requests views on (i) whether the CMA should not make specific adjustments to its PFs to take account of the impact of the COVID-19 pandemic; and (ii) the period for the price control that will be determined in its final report being limited to three years.⁵
- 1.4 Given the current level of uncertainty in the aviation sector, Heathrow recognises the difficulty that the CMA faces in setting the price control before November and the fact that the PFs were published just as the government's lockdown measures took effect inevitably created challenges for the CMA. However, as set out in the Response to the PFs and Section 2 of this response (the **Consultation Response**),⁶ Heathrow also recognises that the CMA cannot properly fulfil its statutory function and duty to report on whether matters in the NERL Reference "*operate against the public interest*" if the decision in no way takes account of the current and projected future extreme challenges faced by the aviation industry, and therefore for NATS' business, due to the COVID-19 pandemic. In particular, any decision (interim or not) must be taken in line with the CMA's statutory duties to ensure that, *inter alia*, NERL is able to remain financeable in all reasonable circumstances during the period covered by the CMA's decision.

¹ Aviation using NERL's air traffic control services, measured on 20 April 2020, had fallen by around 90% in comparison with 2019 (see Annex 1 of CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020).

² CMA, [Provisional Findings](#), 24 March 2020, para 9 states that "[t]here remains, however, considerable uncertainty about the extent and duration of this impact".

³ HAL, [Heathrow Airport Limited: third party submission in the CMA RP3 redetermination](#), 24 December 2019 (**Initial Submission**); HAL, Additional Submission on 3Di targets, 28 February 2020; HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020 (**Response to the PFs**); Heathrow's hearing with the CMA on 26 February 2020 (**CMA Hearing**).

⁴ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, para 4.1 and 4.2.

⁵ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 26.

⁶ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, para 4.6.

- 1.5 However, as set out in further detail below, Heathrow is concerned that:
- (a) Section 3: the COVID-19 Consultation lacks clarity as to how the CMA intends to approach its cost of capital decision-making in the Final Determination. Heathrow submits that any decision on cost of capital which does not reflect current circumstances and is subject to change cannot be considered conclusive;
 - (b) Section 4: the uncertainty arising from the ex post reconciliation mechanism proposed in the COVID-19 Consultation is insufficient to satisfy the CMA’s statutory duty to ensure that NERL is financeable. Heathrow instead proposes the introduction of an ex ante reconciliation mechanism, which would provide necessary clarity to the business and external parties such that it was “bankable”, i.e. NERL would be able to borrow money based on the future relief from the reconciliation mechanism. One approach that could do this would be a mechanism that added revenue losses to RAB in line with Heathrow’s proposal in the Response to the PFs;⁷ and
 - (c) Section 5: the CMA should recognise and consider recent market data on debt spreads and changes to airport asset beta during the COVID-19 pandemic in considering the financial risks which the aviation industry is currently experiencing and the need for sufficient financial protection for NERL.

2. The CMA must make its decision in line with its statutory functions

- 2.1 The CMA’s overarching duty under the TA 2000 is to investigate and report on whether matters in the NERL Reference “*operate against the public interest*”.⁸ In deciding whether a matter operates against the public interest, the CMA must have regard to the CAA’s duties set out in section 2 of the TA 2000. The CAA’s primary duty is to maintain a high standard of safety in the provision of air traffic services, and the CAA’s secondary duties include ensuring that licence holders will not find it unduly difficult to finance their licenced activities and to further the interests of operators and owners of aircraft.⁹
- 2.2 Heathrow recognises that the impact of the COVID-19 pandemic on NERL has led to fundamental changes to the assumptions underpinning the CMA’s assessment in the PFs and that the uncertain duration of the crisis creates difficulties in setting the current price control. However, the extent of the impact is also a reason why it cannot simply be ignored.
- 2.3 Heathrow notes that in other contexts the CMA has been prepared to vary its initial findings in the course of the procedure before the CMA due to a material change of circumstances,¹⁰ including recent CMA mergers which have had to take into account the ongoing impact of COVID-19 on the analysis.¹¹ Even in the event that the CMA considers that the only way forward is to provide for an interim decision, such an interim decision should only be made in accordance with the CMA’s statutory duties, taking account of all material facts at the time of the decision. There could scarcely be a more

⁷ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, section 4.

⁸ CMA, [Provisional Findings](#), 24 March 2020, para 3.16 – see TA 2000, section 12(1)(a).

⁹ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, section 4.

¹⁰ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, footnote 49.

¹¹ See CMA, [Revised provisional clearance of Amazon / Deliveroo](#), 24 June 2020.

material or relevant fact for the aviation industry at the current time than the effects of the COVID-19 pandemic. In those circumstances, any final decision – even an interim one – must take this into account.

- 2.4 However, Heathrow considers that the CMA has proposed an approach which is not clear (see Section 3) and does not provide for an appropriate reconciliation mechanism (see Section 4). The CMA has stated at a high level that it considers its proposed approach to be in accordance with its statutory duties, but this conclusion lacks clear justification.¹² Instead, Heathrow considers the CMA should consider recent market data to assess the current risks in the aviation industry and design an appropriate ex ante reconciliation mechanism for NERL in line with the CMA’s financeability duty (see Section 5).

3. The CMA’s approach to changes to its assessment of cost of capital is unclear

- 3.1 The CMA’s position in the COVID-19 Consultation regarding how it plans to approach any adjustment to its PFs cost of capital assessment is not clear. On the one hand, the CMA suggests that further intervention is not appropriate:

- (a) the CMA’s overall position in the COVID-19 Consultation is that “*refining [the CMA’s] assessment in detail following our provisional findings would not be appropriate, as it would not allow us to reach more accurate figures for the purpose of the Charge Conditions*”;¹³ and
- (b) in relation to cost of capital, the CMA states that “*we do not consider that it would be appropriate to undertake further analysis on the cost of capital as any changes would still result in a cost of capital which is not based on evidence of, and is/would be largely disconnected from, NERL’s financial circumstances after COVID-19*”.¹⁴

- 3.2 On the other hand, the CMA then suggests that they may intervene further in cost of capital as:

- (a) the CMA states it has “*limited our work ... mainly to correcting inaccuracies identified in our provisional findings*”;¹⁵ and
- (b) the CMA propose to “*further our assessment only in so far as it could be susceptible to having a longer-term impact, irrespective of COVID-19*”.¹⁶

- 3.3 The CMA does not define in the COVID-19 Consultation what factors might be considered “*inaccuracies*” or “*having a longer-term impact, irrespective of COVID-19*”. Heathrow’s Response to the PFs sets out a number of methodological inaccuracies which it considers are errors in the CMA’s PFs including, *inter alia*, that:¹⁷

- (a) inflation: the CMA should put much more weight on the use of RPI for adjusting historical returns to estimate TMR. Heathrow has provided updated evidence

¹² CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 25.

¹³ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 21.

¹⁴ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 21.

¹⁵ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 21.

¹⁶ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 21.

¹⁷ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, section 2.

and analysis of the correct approach to historical breaks in the RPI series in Response to the PFs;

- (b) geometric averages: the WACC should be based on the arithmetic average return; and
- (c) aiming up: the current thinking runs contrary to established practice and ignores the associated welfare benefits, additionally ignoring that the point in the range is not just a question of judgment but rather a calculable parameter (as supported by additional supporting annexes from Oxera).

3.4 It is ambiguous as to whether the CMA is open to further consideration of these inaccuracies in its PFs. In any event, Heathrow submits that any decision on cost of capital which does not reflect current circumstances and is subject to change cannot be considered a conclusive finding on whether the matters in the NERL Reference “*operate against the public interest*”. This is important for Heathrow because the CAA has recently reiterated in its latest June 2020 consultation that Heathrow’s business plan on cost of capital should align with what the CAA refers to as “recent regulatory precedent” which includes the CMA’s decision in the NERL Reference.¹⁸

3.5 In addition, Heathrow notes that many of the substantive issues relating to cost of capital under consideration in the NERL Reference have also been raised in the ongoing PR19 water redeterminations and that this may lead to further reconsideration of these issues.

4. The CMA must ensure its proposals are in line with its financeability duty

4.1 For the reasons explained above, even if the CMA decides to pursue a temporary decision, it must still ensure that it provides sufficient protection for NERL in the interim period until its price control is reset, in line with its statutory duties.

4.2 In response to the CMA’s invitation in the PFs for views on how they should take account of COVID-19 in the Final Determination,¹⁹ Heathrow outlined its recommendations to the CMA that it:

- (a) revises and reassesses the PFs in the light of updated market and financial data and traffic and revenue forecasts for 2020 onwards; and
- (b) introduces a mechanism to adjust NERL’s regulatory asset base (**RAB**) so that any shortfalls in revenue beyond 10% (of the revenues which NERL would have been expected to be entitled to recover based on existing projections) are added to the RAB. This mechanism could be used to recover the shortfall in revenue in 2020 over a much longer period and thereby minimises the short-term impact on charges to airlines.²⁰

4.3 Heathrow explained why it considers its proposals to be in line with the CMA’s overarching duty under the TA 2000 to investigate and report on whether matters in the NERL Reference “*operate against the public interest*”,²¹ including the CAA’s duty

¹⁸ CAA, [CAP1940](#), *Economic regulation of Heathrow policy update and consultation*, 23 June 2020, page 101.

¹⁹ CMA, [COVID-19 Consultation](#), Annex 1, para 2.

²⁰ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, para 4.8 and 4.9 and CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, Annex 1, para 13.

²¹ CMA, [Provisional Findings](#), 24 March 2020, para 3.16 – see TA 2000, section 12(1)(a).

to “secure that licence holders will **not find it unduly difficult to finance activities authorised by their licences**”.²²

4.4 The CMA has currently proposed that, “as part of [the new price control review] the CAA should also conduct a reconciliation exercise, with reference to the actual flight volumes and costs over the period since the start of 2020”.²³ However, the severe impact of the COVID-19 pandemic on NERL’s business means that it will come under immense financial pressure well in advance of any such reconciliation being made. NERL will find it difficult to raise additional finance unless investors can take comfort from the reconciliation mechanism and that means an ex-ante mechanism must be specified in sufficient detail to be bankable. Heathrow therefore considers that much more detail in respect of the reconciliation mechanism than provided in the COVID-19 Consultation is required to give sufficient certainty to ensure the viability and financeability of NERL going forward.

4.5 Heathrow therefore sets out below its key proposals to address this concern:

- (a) The CMA should ensure that a clear ex-ante framework is set up at the outset. The current COVID-19 Consultation only provides that any reconciliation exercise is carried out by the CAA as “a relevant consideration for the CAA in setting the new price control for NERL [...]”²⁴ which may not be completed until 2022. Heathrow recognises that the CMA may choose to leave this question to the CAA; however, in line with both the CMA and the CAA’s statutory duties, Heathrow urges the CMA to, at a minimum, require the CAA to specify in advance the relevant reconciliation mechanism by a specified date.
- (b) Heathrow considers that the mechanism set out in Heathrow’s Response to the PFs²⁵ (or another similar mechanism) would appropriately achieve this objective. As explained in Heathrow’s Response to the PFs, such a mechanism would provide lenders with the necessary assurances that the revenue short-fall can be recovered while appropriately balancing the interests of NERL and its customers, all of whom are materially affected by the current pandemic in the short run.²⁶
- (c) As outlined in Section 5, the CMA should also take account of current market data for debt and equity in recognising the risks currently facing the industry in order to formulate its recommendations for any such reconciliation mechanism.

²² Section 2(2)(c), TA 2000.

²³ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 23.

²⁴ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, para 23.

²⁵ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, Section 4.

²⁶ HAL, [Response to the CMA Provisional Findings in the NERL RP3 redetermination](#), 17 April 2020, para 4.9.

5. The CMA should consider the risks arising from current market data for debt and equity for the aviation industry in assessing its duties

5.1 As set out in the COVID-19 Consultation,²⁷ the CMA is evidently aware of the impact of the COVID-19 pandemic on traffic forecasts and the loss of revenue in the aviation industry. Even if the CMA decides to adopt an interim decision, the CMA cannot ignore this context – current market data on debt and equity should still be taken into account in the CMA’s approach when considering the current risks faced by NERL and therefore the need for protection for the period before its price control is reset.

5.2 Heathrow provides below examples of financial data affecting airports to give the CMA an indication of the current pressures experienced in the aviation industry. Figure 1 illustrates that the asset betas for Groupe AdP (**ADP**) and Fraport AG (**Fraport**) have increased significantly since the beginning of the COVID-19 pandemic which hit European aviation in around March 2020. The graph illustrates a sudden jump in asset beta from approximately 0.6 to around 0.95 and 0.8 respectively.

Figure 1 – ADP and Fraport 2 year asset betas

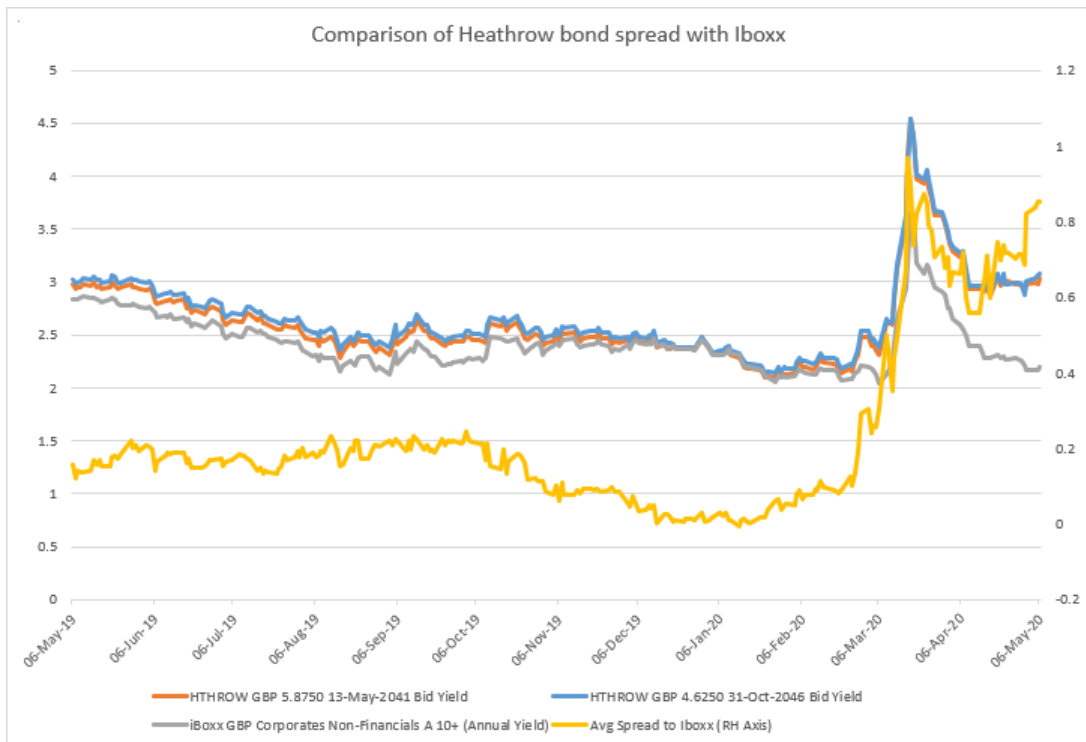


Source: Heathrow analysis

5.3 The COVID-19 pandemic has additionally had a significant effect on Heathrow debt illustrated by the spike in yield on Heathrow debt which can be linked to the current and continuing risks facing airports. As the graph below shows, prior to the COVID-19 pandemic, average spread on Heathrow debt with iBoxx was generally low with a typical spread of 15 basis points over the iBoxx. At the outset of the COVID-19 pandemic, the spread on Heathrow debt over iBoxx spiked dramatically and appears to continue to widen reflecting the ongoing risks faced by airports as compared to the average yields of iBoxx falling to previous levels.

²⁷ CMA, [NATS/CAA Regulatory Appeal: Approach to COVID 19 - consultation](#), 24 June 2020, Annex 1.

Figure 2 – Comparison of Heathrow bond spread with iBoxx



Source: Heathrow analysis

- 5.4 The combination of the impact on debt and equity is such that current market data would lead to an estimate of WACC that is around 3% higher than the WACC calculated in the PFs.²⁸ Whilst the longevity of these impacts is not clear, they are nevertheless significant in the context of a short duration control and they are likely to be a reasonable measure of the opportunity cost of any finance provided to NERL during the pandemic itself.
- 5.5 Heathrow considers that this data highlights the need for the CMA to put in place an ex ante reconciliation mechanism for NERL in the period before its price control is reset – given the current financial challenges faced by the aviation industry, it cannot be appropriate to ignore these significant developments even if the CMA’s price control lasts for a shorter period than it had originally envisaged.

1 July 2020
Heathrow Airport Limited

²⁸ The CMA held that NERL’s WACC was at the mid-point of 2.41% -3.74% (vanilla) – see CMA, [Provisional Findings](#), 24 March 2020, para 12.292.