Economic regulation of NATS (En Route) plc: Initial Proposals for the next price control review (NR23) (CAP2394)

Heathrow's response

Date: 13 December 2022

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Status: Final

1. Introduction

1.1.1 Covid-19 has had an unprecedented impact across the aviation sector. The price controls being set by the CAA for both NERL and Heathrow will have an undoubted impact on the ability of the sector to build back post-Covid to deliver the services passengers want and need.

1.1.2 Given this, it is important that the CAA sets a price control for NERL that allows for all the necessary, efficient costs to deliver the key improvements in infrastructure and to maintain and improve the levels of service provided so the sector can continue to grow and meet the changing expectations of passengers. NERL's operations and investments have an impact on the operations at Heathrow. It is vital for the sector as a whole and for Heathrow that NERL is set up to be a strong and efficient provider of services both for NR23 and going forward into future periods.

1.1.3 It is important to note that, while we understand the NERL process is ongoing and there will be further CAA publications, the Initial Proposals largely use outdated assumptions, such as inflation forecasts from March 2022 OBR. To set a robust price control the CAA needs to use up to date market data and we expect that the CAA will do this going forward.

1.1.4 As with Heathrow's H7 process, the process for setting the NR23 price control has been beset with delays and uncertainty on the timetable. While we support the CAA team in taking the time required to set a robust price control using the most up to date data, it is unacceptable for the industry as a whole that such vital processes do not have a clear timetable and end point. This prolongs uncertainty for all stakeholders at a time where stability is vital. We therefore urge the CAA to set out a clear and achievable timetable for both processes to provide stakeholders with certainty on the next steps.

1.1.5 Our response covers the following areas:

- **NERL's investment plan:** While we are supportive of the flexible approach being taken by NERL to capital investment over the period, we are concerned that a number of key investments are not currently included within NERL's plan. We have engaged with NERL on these matters and continue to advocate for the inclusion of investments in projects to enable enhanced departure performance and delay management and respite, dispersion and simultaneous landing under PBN environments.

- **The NR23 Cost of Capital:** We have concerns with the CAA's approach to the WACC for NR23 and the potential impact this would have on NERL's ability to invest through the NR23 period. The approach being taken to WACC in the Initial Proposals for NR23 also has a significant amount of read across for Heathrow's H7 process. In particular we are concerned with the approach taken to inflation and asset beta. Additionally, the current economic circumstances mean that the proposed Cost of Equity does not make sense when viewed alongside the proposed Cost of Debt. Taken together, this leads to a cost of capital which does not reflect market reality.

2. NERL's Investment Plan

2.1.1 We have engaged with NERL throughout the development of its capital plan. Through this engagement we have been consistent in our support for investment in airspace modernisation, queue and capacity management and arrivals resilience.

2.1.2 Investment by NERL is fundamental for Heathrow's existing and future operations. Any lack of investment at NERL, affecting its ability to deliver airspace services fast and efficiently, has a direct impact on Heathrow's current and future performance. If UK airspace is not fit for purpose, Heathrow will be unable to deliver the outcomes consumers want and need. For this reason, it is important that the NR23 price control allows for investment in the right projects delivering key benefits.

2.1.3 Overall, we are supportive of the flexible 2+5 approach to capital investment being taken by NERL which will allow NERL to react flexibly to changes through the period. As we have seen through recent months, ATM demand has returned at a much faster pace than anticipated, therefore having the flexibility to respond to this changing environment is essential.

2.1.4 However, we have concerns around the level of investment to ease congestion in the London TMA, in particular on departure, which is urgently needed to address future resilience, capacity, delays and associated carbon emissions. In our engagement with NERL, including in our 11 July 2022 response to NERL's interim service and investment plan, we have consistently set out the need for investment in capacity and flow management, in particular in programmes such as enhanced STAM departure delay management, reduced departure separations, and simultaneous approaches.

2.1.5 Heathrow represents a significant amount of the traffic handled by NERL and therefore it is important that the NR23 investment plan is appropriately targeted to prioritise key hotspots and issues present at Heathrow. Prioritising investment in resilience and delay performance will address significant proportions of NERLs objectives. Working together to minimise the delay to the deployment of eTBS pairwise is an excellent example that will significantly help us to address issues in arrivals delay performance; we now need to balance this with investment in departure tools and concepts..

2.1.6 We therefore strongly support NERL's prioritisation of investment in airspace modernisation; redesigning the airspace is one pillar of investment that will support enhanced efficiency in the London airspace, albeit this also needs to be matched with the investment in tools and processes to deliver the required benefits. We are however concerned about the current approach and phasing proposed for airspace modernisation which could risk Heathrow's own airspace change, and lead to the delay in the delivery of key benefits across London, the most congested and carbon inefficient section of UK airspace. It is key that resource and investment priorities are apportioned accordingly to keep the core benefits of quicker, quitter and cleaner journeys from the Airspace Modernisation Strategy (AMS) on track.

2.1.7 Continued funding for the Airspace Change Organising Group (ACOG) and their role to co-ordinate the changes required to achieve the complex design and deployment of the UKs airspace is also welcomed, albeit as noted in our AMS consultation response, it is important that funding arrangements do not lead to inequality in oversight of ACOGs work to co-ordinate and engage across airspace sponsors.

2.1.8 It is also important that NERL has the right resources to both operate efficiently and invest the appropriate time and resources in the development and implementation of new ways of working. It is crucial that NERL are able to invest to retain the number of controllers and support personnel needed not only to run an efficient and safe operation but also to facilitate the significant development and change management requested in the NERL investment programme. Without this we would see delays in development which will impact efficiency and service delivery to future passengers and impact to the planned UK carbon and trade ambitions.

3. Cost of Capital

3.1.1 In setting the WACC for NR23 the CAA must strike the right balance to ensure the WACC is set at an efficient level but at a level which incentivises investment and makes investment financeable. If the WACC is not set at this level it will have an impact on NERL's ability to invest through the NR23 period and, therefore, a direct impact on the services delivered to users and consumers.

3.1.2 As set out in the NR23 document, the CAA has sought to be consistent in its approach for both NR23 and H7. In regard to cost of capital, this means that some of the errors included in the Final Proposals for H7 have been repeated in the Initial Proposals for NR23. In particular, the Initial Proposals for NR23 are continuing to apply an erroneous approach to the treatment of inflation and asset beta.

3.1.3 The Initial Proposals use a short-term approach to inflation forecasts to deflate the nominal cost of debt. As set out in Heathrow's response to the Final Proposals for the H7 price control, this is approach is:

- Not in line with precedent; and
- Inconsistent with financing principles.

3.1.4 In line with the H7 Final Proposals, the Initial Proposals for NR23 do not provide any justification for this choice of approach and the departure from regulatory precedent. Instead, the change appears to be an opportunistic attempt to adjust the regulatory regime in the case of high inflation when no such changes were made when inflation was forecast to be negative.

3.1.5 The current market conditions also lead to larger implications for the Initial Proposals on cost of capital. Current market conditions are leading to a higher cost of debt. This means that, as seen in other sectors, the allowed cost of equity is now similar to or even lower than the cost of debt for many regulated businesses. This is clearly inconsistent with the risk being taken by equity in the companies. For its Final Proposals on NR23 and next steps on H7, the CAA must review this balance and ensure it is consistent.

3.2 The approach to inflation is out of line with regulatory precedent

3.2.1 As set out in our response to the CAA's Final Proposals on H7 and the accompanying report from Oxera[1], the approach to inflation taken by the CAA is out of line with its own previous regulatory practice and precedent from the CMA.

[1] Oxera, H7 asset beta and inflation, August 2022

3.2.2 The issue of inflation treatment was discussed in the PR19 CMA appeals. As set out by Oxera, Yorkshire Water, one of the appellants, argued that, because inflation at the time of the appeals was known to be below target in the first year of PR19, a lower inflation estimate for the price control is needed to recover the nominal cost of capital in full, and to avoid weakening of interest coverage ratios. However, the CMA decided against adopting short-term inflation for the PR19 price control, explaining that the real cost of capital should not be based on *'what could prove to be temporarily distorted figures'*. The CMA also noted that, using a longer-term estimate is the '*fairest way to calculate the real cost of capital at this time'*.

3.2.3 The CMA also found that, '*a stable approach to the cost of capital over regulatory periods is consistent with investors making long-term financing decisions*' when discussing the selection of RPI assumption in the Bristol Water 2015 re-determination. It adopted an approach that focused on data over a longer horizon, concluding that, '*the use of only short-term RPI projections risks given insufficient weight to underlying trends in the real cost of debt over time*.'

3.2.4 Changing the approach to regulation also exposes the regulated business to asymmetric regulatory risks. Evidence shows that the CAA and other regulators have stuck to a long-term approach. Below we highlight two examples of this:

- Ofwat PR09 – at the time of Ofwat's PR09 final determination (late 2009), outturn RPI inflation was negative, and had experienced steep declines. This created a higher degree of inflation uncertainty heading into the price control period. Ofwat continued to set a 2.5% assumption for RPI in light of this, noting that '*Annual measures of RPI may be volatile, as is currently the case for forward projections. We have therefore assumed the nominal interest rate includes a longer-term view of inflation'*.

- CAA Stansted Q5 – At the time of the Q5 decision for Stansted the CAA was conscious that economic uncertainty was making it more difficult to interpret inflation data. The CAA specifically noted that the latest Treasury survey of independent forecasts at the time was reporting an annual RPI inflation forecast of minus 1.9 per cent. Despite noting this very low short-term inflation forecast, the CAA did not update the inflation assumptions that fed into their building block approach.

3.2.5 In summary, in previous situations where forecast inflation was expected to deviate from long-run trends, the CAA and other regulators have stuck to a long-term approach. Deviating from this approach when inflation is high creates asymmetric regulatory risk.

3.3 The approach to inflation is inconsistent with financing principles

3.3.1 Financing decisions in regulated companies are made over the longer-term meaning that the RAB is usually financed by long-term debt. This means that investors will put more weight on a longer-term view of inflation when making these decisions than the short term approach set out in both the Initial Proposals for NR23 and the Final Proposals for H7.

3.3.2 This point was recognised by the CAA in setting the cost of capital for Heathrow and Gatwick airports in Q6:

Ideally the choice of inflation assumption needs to reflect the future inflation expectations at the same point in time as the market data on the bond and cover the period of time to that bond's maturity.[2]

3.3.3 On this basis, the approach taken by in the NR23 Initial Proposals is inconsistent with the financing of regulated companies and therefore an error in approach.

3.3.4 The CAA's approach is also a fundamental change in the financial structure of airport and air traffic control regulation. To date, inflationary risk has been allocated to equity and financial flows linked to long-term estimates of inflation. As a consequence, cash flows are stable and related to long term inflation assumptions, whereas outturn differences in inflation are reflected in movements of the RAB. This provides a regime that provides stable cashflows from year to year and period to period, which supports financial ratios, credit rating and investment. However, the CAA's proposed move to using short term inflation forecasts means that the regulatory regime changes from:

- one that provides a real return on RAB to one that provides a real return on equity and a nominal return on debt, thereby fundamentally changing the risk allocation of inflation;

- one in which cash flows are not impacted by variation is short-run inflation forecasts to one where the underlying cash flows become very volatile.

3.3.5 Updating the inflation estimate used by the CAA to the most recent by the OBR would result in a very low or even negative underlying WACC for 2023. In addition, the reduction of 11.1% between 2023 and 2025 results in the WACC increasing by 3.3% between these two years. The outcome of this would be huge volatility in the underlying cashflows for the different years. Indeed, were inflation forecast to be at the level of 2023 for the whole of NR23, the CAA approach would result in a negative or extremely low real WACC over the period. This would result in turn in insufficient cash flows to finance the business, and clearly shows that the CAA approach is not appropriate.

3.3.6 On this basis, the approach taken by in the NR23 Initial Proposals is inconsistent with the financing of regulated companies and therefore an error in approach.

3.4 The approach to estimating asset beta is inconsistent with current market data

3.4.1 The CAA has taken a similar approach to assessing the asset beta for NERL as they used for Heathrow in H7. We set out a range of issues that demonstrate why the CAA approach is in error in our response to the H7 Final Proposals. The errors made by the CAA that are set out in that response are also largely present in the CAA approach for NERL. In particular, the CAA has made a large number of adjustments to observed market data. These adjustments are not supported by financial theory or empirical evidence and are based on unsupported assumptions.

3.4.2 This approach is contrary to good practice. In the PR19 Appeal Determination, the CMA stated:

"We recognise that beta may change over time … we consider the most robust approach to be to use the available beta evidence that we have from historic

[2] CAA (2014), Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences, CAP 1140.

movements in stock prices, rather than to make speculative adjustments to reflect how beta may change in the future."[3]

3.4.3 The CAA should base its estimates of the market data directly rather than make the speculative adjustments included in the Initial Proposals.

[3] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report, March 2021, Para 9.477