The H7 price control appeal

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In October 2023, the Competition and Markets Authority (CMA) published its Final Determination of the H7 Heathrow Airport Licence Modification Appeals, drawing to a close a process that had lasted over five years.

We set out below our reflections in respect of the H7 appeal decision and some thoughts regarding its potential implications for other regulated sectors.

<u>Context</u>

The H7 process had begun in 2017, at around the same time as the publication of the Airports National Policy Statement (ANPS), which laid the groundwork for the construction of a third runway at Heathrow and which was expected to be the primary focus for H7. Hopes for a third runway were then dashed by the twin blows of a successful legal challenge of the ANPS and the onset of a world-altering pandemic in 2020. This in turn was followed by the significant macroeconomic upheaval of late 2022 and early 2023.

This eventful period led the aviation regulator – the Civil Aviation Authority (CAA) – to delay the finalisation of a new price control by putting in place two 'holding' caps in 2022 and 2023, to allow time to fully reflect the impact of each shock and the extensive barrage of stakeholder feedback.

By the time the CAA published its Final Decision in March 2023, Heathrow claimed losses of around £4.5 billion of revenue due to the pandemic and was facing increases in its borrowing costs. The airlines, too, had swallowed multi-billion losses and were looking to safeguard the recovery of the sector by keeping airport charges low. Seen in that light, a showdown at the CMA was probably inevitable, irrespective of the content of the CAA's H7 decision.

<u>Grounds of appeal and CMA findings</u>

The airlines and Heathrow lodged five grounds of appeal in total.

The first 'joined' ground of appeal ('Ground A') concerned the CAA's reaction to the losses that Heathrow had suffered during the pandemic. Heathrow had consistently requested substantial remuneration in the form of an upward adjustment to its Regulated Asset Base (RAB). The CAA had allowed an upward adjustment that was a fraction of the size of what Heathrow requested, on the grounds that this was all that a notionally efficient airport needed to remain creditworthy. Heathrow argued that it was entitled to much greater compensation, whereas airlines argued that the CAA should not have made any adjustment at all.

The second joined ground of appeal ('Ground B') concerned the cost of capital, and specifically the asset beta and cost of debt. A very large number of individual arguments were advanced by both sets of appellants under this ground, which are not reprised in full here. But it suffices to say that Heathrow viewed the CAA's estimate of the Weighted Average Cost of Capital (WACC) as being too low, and the airlines viewed it as being too high.

The remaining three grounds of appeal – regarding passenger forecasts, a correction term in Heathrow's price control formula, and the CAA's capex incentive mechanism – were largely aviation-specific and are of less relevance to other sectors.

The CMA's Final Determination

The CMA ultimately upheld the CAA's Final Decision in all but three minor areas. Only one of the three errors that the CAA identified concerned the high-profile grounds of appeal pertaining to the RAB adjustment and cost of capital. And in all three cases, the identified errors pertained more to the process that the CAA had followed than the substance of the CAA's original decision, as evidenced by the CMA's decision to remit all three matters back to the CAA for reconsideration.

The CMA's verdict was, therefore, about as close to a clean bill of health as any regulator can reasonably hope for.

There are important lessons to be learned from this outcome, both in terms of the underlying economics of setting price controls and in terms of the broader strategic environment surrounding appeals. For the avoidance of doubt, these lessons carry across most directly to sectors that have an 'Appeal Regime' like H7 (e.g. energy). The CMA's job was, after all, to decide whether an appellant had demonstrated that the CAA had made an error, not to look at all matters afresh. However, some lessons are also relevant to sectors operating under a 'Redetermination Regime' (e.g. water). Here, though, greater caution should be exercised. For example, even where the CMA found in this case that an approach adopted by the CAA is 'not wrong', a different CMA panel might still reasonably adopt a different approach in a future price control redetermination when given a freer hand.

Lessons from Ground B (cost of capital)

Asset risk premium (ARP) relative to the debt risk premium (DRP):

Oxera, on behalf of Heathrow, presented evidence to suggest that the so-called 'asset risk premium' implied by the CAA's Final Decision was below the debt risk premium implied by Heathrow Airport's actual cost of debt, as observed at the end of 2022. Oxera also said that the ARP was below the debt risk premium associated with a hypothetical 100% debt-financed airport operator. It concluded from this evidence that the CAA had set the cost of equity too low. The CMA dismissed this evidence primarily on the grounds that Oxera's approach was subject to certain estimation issues: for example, Oxera's finding was found to be sensitive to the time period under consideration, and how the DRP was measured. It also wasn't altogether clear to the CMA how comparisons of the ARP to DRP were relevant to a cost of equity ground of appeal that focused primarily on the estimation of the asset beta.

The CMA did nonetheless make a point of saying how unsurprising it is that the gap between the cost of equity and the cost of debt is smaller than in previous reviews, noting that this follows directly from the recent increases in interest rates and the standard UK regulatory assumption that the Total Market Return (TMR) is relatively stable over time. The clear message here was that companies cannot have their cake and eat it: if they enjoy the benefit of a long-run approach to the cost of equity when interest rates are low, they should expect a degree of discomfort when interest rates are high.

This sets the stage for some interesting conversations in upcoming price reviews. Several of the authors of the 2018 UKRN report that cemented the 'stable TMR' approach have subsequently said

that they feel uneasy about their advice[1]. And this issue is only going to grow in importance as regulated companies look to attract billions of pounds of new capital to support investments. Should regulators stick with the traditional 'stable TMR' approach? Or is it better to adopt a more nuanced position, in which there is some feed through from interest rates to the TMR? And what does all of this imply for where regulators should set their point estimate of the WACC from within the plausible range? In our view, there is clearly further work to be done in this area.

Inflation:

The other key cost of capital issue concerned the deflator that the CAA applied when converting a known nominal cost of debt into a real terms equivalent. Here, the CMA confirmed that it is 'not wrong' for a regulator to depart from long-term, equilibrium inflation measures where: i) an exceptional inflation shock is expected to take place within the regulatory period; and ii) this is not expected to be offset by an equal and offsetting shock within any defined period. The CMA identified that there was no settled regulatory practice in this area, and that the CAA had flexibility to deal with the circumstances that it was facing in accordance with its statutory duties.

When reading this section of the CMA's report, it is important to remember that the CAA was setting a price control with a start date of 1 January 2022. It was not retrospectively reopening or modifying an existing price control; rather, it was trying to ensure that the future consequences of sudden, faster-than-usual indexation of Heathrow Airport's RAB, together with higher-than-normal levels of uncertainty about future inflation forecasts, were accommodated in appropriate way.

On a plain read, nothing that the CMA says would seem to rule out any of the approaches that are open to a regulator (e.g. the Ofgem/Ofwat approach, the CAA H7 approach, the NI Utility Regulator's approach, or the Australian Energy Regulator approach) when it comes to set the allocation of inflation risk for future controls, even as economic conditions become more benign once again.

Asset beta:

In general, and perhaps not altogether unsurprisingly, the CMA set a high threshold for determining that a regulator's determination of the asset beta is 'wrong', particularly where unusual circumstances prevail and the regulated company is not listed.

More specifically, the CMA indicated that it is 'not wrong' for regulators to apply differing weights to share price data from different historical periods, provided that this is done in a reasoned and systematic manner. The CMA therefore validated the CAA's innovative H7 approach, which involved the CAA's consultant running a form of 'weighted least squares' to calculate Heathrow Airport's new beta. Unlike previous work, which might typically entail taking a single historical benchmark for beta, or perhaps weighting a beta from a distinct period A and a beta from a distinguishable period B, this new approach saw the CAA weight COVID period and non-COVID period data directly within the beta regression equation.

Where a regulated company's risk profile changes, and where it is not altogether obvious which historical period(s) provide the best benchmark(s) for forward-looking betas, the CAA's approach potentially now offers a helpful new framework of analysis around which there can be sensible debate and discussion of the appropriate use of the available empirical data.

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[1] Mason, R. and Wright, S. (2021), "Is Ofgem's allowed return on equity unreasonable? An independent assessment in light of company responses to the PR19 and RIIO-2 determinations", 7th May.

Point estimate for the cost of capital:

The CMA set a similarly high threshold for overturning the CAA's decision regarding the appropriate point estimate to choose from the estimated range for the cost of capital. This mirrored the CMA's finding in its 2021 RIIO-T2/GD2[2] appeal decision.

The takeaway here appears to be, once again, that, unless the regulator has demonstrably failed to take account of relevant considerations, it is unlikely that the CMA will consider a regulator's judgement to be 'wrong', given the inherent imprecision in all cost of capital calculations and the inevitable role for reasoned regulatory judgement.

The notional company:

The CMA also allowed the CAA a degree of latitude when defining a notional financial structure in a sector in which only one company operates. It considered that the CAA's definition – that of a hypothetical alternative airport operator with the same assets but hypothetical, notionally efficient debt liabilities – was a reasonable one. It also considered that no obviously superior alternative exists, including HAL's actual financial structure.

Significant weight was nonetheless placed on the fact that the notional cost of debt was close to HAL's actual cost of Class A debt in determining that the former was 'not wrong'. This suggests that although regulators are at liberty to base the cost of debt allowance on a notional benchmark such as a debt index, it is still necessary for a regulator to undertake a balance sheet check, with any divergences – at a minimum – being adequately explained.

Lessons from Ground A (RAB adjustment)

Status of the RAB:

Heathrow Airport's appeal on the CAA's RAB adjustment argued, among other things, that there was a general principle in regulation that a company would always have an opportunity to collect a return of its RAB. In Heathrow's eyes, the drop in passenger numbers during COVID denied it that opportunity (because there wasn't sufficient revenue to cover operating costs plus a return on the RAB, let alone the depreciation of the RAB).

The CMA's determination has, however, firmly debunked the notion that the return of the RAB cannot be placed at risk, regardless of whether non-recovery of the RAB is due to factors within or outside of companies' control. The rules going forward are therefore very clear: a regulated company's ability to return investors' capital depends on the company's out-turn performance against its successive price controls. Any protection against non-recovery of the RAB is generally at the discretion of the regulator.

Risk allocation:

The CMA's decision also confirmed that unless risks have been specifically allocated to consumers through an explicit risk sharing mechanism, risks are allocated by default to companies – although regulators will need to have due regard to their statutory duties when considering how to react to the crystallisation of a particular risk.

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[2] RIIO stands for 'Revenue = Incentives + Innovation + Outputs'. RIIO-T2 refers to the price control framework that currently applies to the electricity and gas transmission networks. RIIO-GD2 refers to the price control framework that currently applies to the gas distribution networks.

Broader strategic observations

Stepping back, the H7 appeals appeared to demonstrate an increased reluctance on the part of the CMA to overturn the reasoned judgement of an expert regulator compared with previous appeals. In particular, the CMA was clear that it was not enough for an appellant to demonstrate a flaw in the regulator's approach: they had to demonstrate that the regulator dismissed a clearly superior alternative.

This distinction was, evidently, not fully understood at the outset by stakeholders, who seemingly underestimated the extent of the evidentiary burden needed to demonstrate that their approach was manifestly superior.

The stance of the CMA is perhaps understandable. It has exhibited no particular wish to become a de facto regulator, particularly given that it has a heavy caseload of other work in the form of merger controls, competition enforcement and digital markets, to name a few of its major priorities.

An interesting question is whether the spate of regulatory appeals in recent years (seven in RIIO-T2/GD2 alone) may have caused the CMA to take a deliberately more conservative approach this time around. It is noteworthy in this regard that a different CMA panel was similarly reluctant to substitute its own decision in place of Ofgem's decision at the end of a recent RIIO-ED2[3] appeal, even when it identified a clear error in Ofgem's decision and when the parties could not agree how that error should be remedied. If this was a deliberate CMA policy to stand off, it could be seen as discouraging future appeals, except where the regulator genuinely has gone off the rails.

What this means for companies operating in Appeal Regimes is at present unclear. But one interpretation could be that the chances of obtaining a better outcome from a CMA appeal are now a little lower than they might have been in the past.

The next big regulatory case that the CMA could have to deal with is Ofwat's PR24. Any appeals arising out of Ofwat's decision will, of course, be full redeterminations, creating a very different set of dynamics.

[3] RIIO-ED2 refers to the price control framework that currently applies to the electricity distribution networks.