CONSULTATION ON ECONOMIC REGULATION OF CAPACITY EXPANSION AT HEATHROW: POLICY UPDATE AND CONSULTATION

CAA CAP 1610 CONSULTATION

Richmond Heathrow Campaign Response - 2 March 2018

Introduction

1. This document is the response of the Richmond Heathrow Campaign to the CAA Consultation on Economic Regulation of Heathrow Expansion as contained in the document: *Consultation on economic regulation of capacity expansion at Heathrow: policy update and consultation, December 2017*- CAP 1610.

2. The Richmond Heathrow Campaign (RHC) represents three amenity groups in the London Borough of Richmond upon Thames: The Richmond Society, The Friends of Richmond Green, and the Kew Society, which together have over 2000 members. The members of our amenity groups are adversely affected by noise from Heathrow Airport's flight paths, poor air quality and road and rail congestion in west London. We acknowledge Heathrow's contribution to the UK economy and seek constructive engagement in pursuit of a better Heathrow. Economic regulation is an important part of this. We are an active participant in the Heathrow Community Noise Forum.

3. Our premise is that it would be preferable to aim for a better Heathrow rather than bigger Heathrow and to capitalise on the world beating advantage of London's five airports, in particular by improving surface accessibility to all five airports, which would be a major benefit to users. London has the world's largest origin and destination market of 160 million passengers annually.

4. Our approach is to continue supporting the case for no new runways in the UK. We believe the evidence produced by the Airports Commission supports this position even though the Commission recommended Heathrow's Northwest runway (NWR) expansion option. Furthermore, evidence in the Revised draft NPS (November 2017), including the DfT's revised demand forecasts 2017, we believe demonstrates there is no case for new runways in the UK. In this regard we differ from the CAA's support for expansion of Heathrow as stated in the Introduction to the consultation. Our reasoning is set out in our response to the DfT on the RHC website at **www.richmondheathrowcampaign.org** .

5. In 2017 we responded to the two CAA's consultations on Heathrow regulation - CAP 1510 and CAP 1541 and we ask please that our previous responses be taken into account when considering our current response.

6. In summary, broadly we support the CAA's approach to developing the regulatory model of Heathrow to manage NWR expansion. It is key to controlling Heathrow's monopoly position. However we do not believe the NWR expansion can be developed while keeping aero charges from increasing in real terms, which would be unacceptable to airlines, passengers and the Government. As yet we have not seen estimates of expansion costs including surface access costs that have been reduced sufficiently to ensure financial viability. It is imperative that this viability issue be addressed by parliament when considering the NPS and that parliament ensures there is no recourse to the Treasury. The consultation raises a number of technical issues regarding

regulation and we have attempted to respond to these. Cost of capital is important and the sharing of return and risk between bondholders and shareholders is addressed. Finally we respond to questions on early construction costs and the extension of the current Q6 regulatory period.

Chapter 1 - Developing the Regulatory Framework

7. It is clear from media and the parliamentary Transport Committee's recent public hearing that the airlines strongly oppose any real increase in Heathrow's aero charges from those of today. The airport is already the world's most expensive airport. The Government and CAA also state they seek no real increase. We sought to demonstrate in our response to CAP 1541, that to achieve financeability and breakeven on the NWR expansion, Heathrow would need to approximately double the charges from today's £22 a passenger to nearly £40 in 2016 money terms. This is based on the Airports Commission's estimate of capital costs of £18.9 bn and our illustrative estimate of surface access costs of £6 bn. These are both in 2016 money terms (the Commission's original estimate was £17.4 bn in 2014 terms and excluding surface access costs).

8. Confusingly, there are different cost estimates in the public domain from Heathrow and other sources, but broadly speaking, we believe the current estimates of capital costs are too high for the expansion to be financially viable. So far Heathrow has said costs can be reduced by £2.5 bn and the Arora Group has proposed that it could develop the airport and save £6.5bn. We doubt even this reduction would be sufficient to achieve financial viability.

9. In the debate on costs, we suggest it is important to recognise that the costs do not just revolve around expansion. Besides the £18.9 bn for the NWR expansion plus, say, £6 bn for surface access there is £14.3 bn for core capital expenditure and £16.3 bn for replacement capital expenditure (2016 money terms), as projected by the Airports Commission. We are not clear that the total £56bn of expenditure is factored into the CAA's consultation but we believe it should be.

10. IAG has around 50% of the current slots at Heathrow and it has said they want the airport owner's (HAL) monopoly broken with competition introduced in the construction and management of Heathrow's terminals; IAG supports the Arora proposal. It seems other airlines may also support the introduction of air-side competition but perhaps are concerned with IAG replacing HAL, given the former's dominant position at the airport as an airline. Seemingly, HAL is strongly opposed to introducing a third party and argues it has successfully developed T5 and redeveloped T2.

11. While we might express some views on the merits or otherwise of introducing 3rd party competition and the regulatory issues flowing from that, we have not seen enough evidence to be able to draw firm conclusions. We would wish to see the alternative designs, costs, legal structure and financing and resulting efficiency, affordability and finaceability. We understand the CAA has commissioned a report on these issues and that the parties are engaged in the Section 16 process of communication and collaboration to consider these and other issues of expansion. From what we have seen of Heathrow's Bond documentation, we believe there would be substantial legal hurdles to the introduction of 3rd party competition due, not least, to changes in existing lenders' security.

12. Implicit in this debate on the need for competition is the presumption by the airlines and others that the CAA's Regulation cannot ensure, as well as a competitive market can, that HAL will expand and manage Heathrow efficiently and at a viable cost. In our response to CAP 1541 we estimated HAL's excess profits were of order of £300 million in 2016. The PwC report - *Estimating*

the Cost of Capital for H7 November 2017 accompanying the current consultation, shows that profits regularly exceed the regulatory profit and return on capital by £100 million or more.

13. However, we support the CAA in seeking to develop a regulatory regime that does control the airport, with or without 3rd party competition, and we recognise the circumstances and difficulties the CAA faces. This will be even more challenging during construction (i.e. H7 period) and especially since we believe it will be very difficult to balance affordability and financeability.

14. We have already expressed our view in response to CAP 1541 that retail needs more transparency and that surface access needs to be better joined- up amongst the many parties involved - perhaps with a separate profit or cost centre. We have also said there should be no recourse to the Treasury on financing expansion, Including surface access.

15. If changes to the licence terms and conditions were a means to improving the regulatory process as raised in Chapter 1 then in principle we would support it. We are not enthusiastic about profiling regulatory depreciation. Depreciation is normally a function of the use of an asset over its life and accordingly is not best used to control aero charges, although of course it is reflected in those charges.

16. In our previous responses to the CAA and particularly in our recent response to the DfT on the Revised draft NPS, we raised significant doubts about the value of International-to-International (I-I) transfer passengers. The research we have produced using CAA data confirms we believe that very few thin routes have I-I transfers and 99% of I-I transfers are on popular daily routes. The NWR expansion results in nine million additional I-I transfer passengers on long-haul routes, representing 92% of the UK's additional long-haul passengers in 2050 compared to the Do - minimum case. These and the seven million additional short-haul I-I transfer passengers are highly inefficient use of the NWR capacity (DfT demand forecasts 2017). This is perhaps a matter of national policy but we still believe the CAA should consider the high expenditure being incurred to satisfy this inefficient use of airport capacity, especially the high costs of baggage handling equipment needed for transfers.

17. We have made the case that we believe the CAA obligation to protect the consumer needs to take into account consumers across all UK airports and not just those at Heathrow. We record here the case we made to the DfT in our response to the Revised draft NPS, which is that Heathrow cannibalises aviation activity from other UK airports and harms their economic viability. The Revised draft NPS estimates that of the 43 million passengers a year served by the NWR, 16 million are additional I-I transfers - leaving 27 million as additional UK terminating passengers. But 17 million of these are sourced from reduced growth at other UK airports resulting in only 10 million net additional UK terminating passengers. There is no UK increase in long-haul business passengers, few additional inbound tourists and an addition of just 7 million UK resident leisure passengers. We do not think the NWR expansion serves UK passengers well and we believe the CAA ought to consider all UK passengers without favour of one group over another based on where they reside in the UK.

18. We have urged the CAA to include environmental costs in its regulation of Heathrow. We have seen the CAA's response on this point - Appendix B paragraphs 5 and 6 where the CAA says *'it is not for the role of the CAA to set environmental targets, but to rely on those other parts of Government with suitable powers and expertise on environmental matters to address these issues. The CAA then takes these requirements into account in setting price controls.'* Our concern is that

the regulatory model does not seemingly include any environmental costs except for noise mitigation and compensation. There are major risks that demand will be curtailed on account of air quality, noise and carbon emissions. These risks may well impact the cost of debt and equity and hence aero charges. We believe the polluter should pay and in the end this should fall to the consumer through higher aero charges to airlines and in turn - ticket prices.

Chapter 2 - Cost of Capital and Debt Indexation.

19. We have studied the PwC report - *Estimating the Cost of Capital for H7* accompanying the consultation and broadly welcome the analysis while reserving judgment on the actual range and point estimates, which in any event the report says are preliminary estimates.

20. We concur with one of the main findings that gilt yields have reduced in the last few years and that this drives down the cost of debt and equity - possibly long term. Fundamentals such as GNP growth and productivity and the share of the UK economy taken by employment and capital determine the long-term trends in gilt yields and hence rates of return. We are not as sure as PwC seemingly is that a reduction in cost of capital should be assumed long-term notwithstanding our support for PwC's use of forward looking evidence in estimating the cost of capital. The duration of the NWR critical payback period is probably 15 years or more from today and it is important to estimate the cost of capital as reliably as possible in this period. We suggest further expert advice be sought on this issue.

21. We suggest that more attention could be given to the underlying asset rate of return and cost of capital. This sets the constraints within which the financial return and cost of capital and the project and financial risks are shared between debt and equity and the Treasury as recipient of tax. The CAA's focus appears to be on the debt and equity financial returns.

22. We suggest that more attention be paid to the financing of expansion by internally generated cashflow net of dividends as this has its own costs that may differ from the cost of debt and externally provided equity.

23. We suggest more attention be paid to the risk protection in the capital cost estimates. At this stage of the NWR project's maturity there are substantial contingencies and optimism bias included in cost estimates and it could amount to double counting if the costs of capital also include the contingent risks provided for in the cost estimates.

24. The point in time when funding will be raised is important. HAL's commitment to proceed will presumably be conditional on sufficient funding being raised and funders will want assurance that all the funding can be raised and that the project can proceed to completion. This points to project commitment and the securing of finance being completed at the same time, at least for all of the project that cannot be independently phased. The costs of capital will presumably decrease as the capital cost contingencies are realised or reduced over time. HAL will incur costs of capital committed but not drawn. In estimating the costs of capital it is not clear that these timings and changes in project risk over the construction period are being taken into account. How to reflect these timing issues in the RAB model with its own timetable needs consideration.

25. As currently proposed, the NWR expansion is not proposed as a separate project with non-recourse financing. So the project risks can be partly born by corporate HAL and its cashflow and balance sheet. It is not clear whether estimates of the construction risk premium are those of a

standalone NWR expansion project or of corporate HAL itself, having absorbed some of the project risk.

26. The CAA regulation reduces risk for bond holders. As a bond issuance prospectus for Heathrow (June 2017) says *'the regulated price-setting mechanism provides significant income predictability and cash flow visibility within each regulatory period as well as protection against longer-term cost and revenue risks.'* The underlying asset risk does not change so this reflects a transfer of risk to the shareholders. It is not clear to what extent the RAB model impacts the sharing of risk and hence respective equity and debt costs of capital.

27. On the assumption that the RAB regulation aims to match the real world with incentives to perform efficiently, we are inclined to support an efficient debt/equity structure rather than a notional one at, say, 60%/ 40% currently used. Similarly, we are inclined towards debt indexation. We realise the practical difficulties of applying indexation to the embedded debt and support the proposal to apply it only to new debt. However, HAL's embedded debt requires refinancing over the medium term and the changing proportions of embedded and new debt will need to be taken into account.

28. There is currently around £12 bn of HAL debt and it is not clear to what extent covenants, etc. allow HAL to progress with the NWR expansion and whether bond holders will seek additional security and/or higher interest or even repayment.

29. We have doubts that some of the existing shareholders will want to take on the construction risk. It is not clear whether dilution would be sufficient or they might seek to exit their HAL investment.

30. The shareholders are treated as seeking the same equity return (i.e. cost capital). The financing required is very large and may be more expensive than envisaged if the marginal return for the last investor means a high return has to be offered to all investors. This applies to both equity and debt providers.

31. We have previously expressed our concern that Heathrow is not subject to thin capitalisation rules introduced last year by the Government whereby tax relief on interest in highly leveraged projects is restricted. As it stands, the Government will contribute a significant amount to the NWR expansion through tax relief on interest thus reducing tax on HAL's profits. The consultation discusses nominal tax and actual tax in the RAB model. We are inclined to support actual tax and a post tax cost of capital and rate of return. We are concerned that consumers should not be supported by Government taxation reliefs more than is appropriate to efficient funding.

Chapter 3 - Financeability and Indexing for Inflation

32. We expressed our view above that based on current estimates of the capital costs we doubt a balance can be struck between no increase in real charges and financeability and we rule out Government support.

33. It is important that before parliament considers the NPS, the financial viability be properly assessed and that were parliament to approve the NPS supporting Heathrow expansion it simultaneously guarantees that the Treasury will not assist the funding of the expansion even as last resort. Not only is this a state aid issue but HAL is a private enterprise and 90% owned by overseas shareholders. At the moment the timetable for the CAA developing a RAB model for H7,

during which period construction is expected to take place, is far into the future at the end of 2020 at the time DCO consent is granted and just prior to start of construction.

34. We broadly agree with the CAAs approach to assessing debt financeability using credit agency financial ratios. We believe the UK sterling market is unlikely to be deep enough to accommodate the sizable funds required and that a significant portion will need to be funded from the overseas debt markets. It is not clear whether the tests of financeability are similar but of course currency exposure will need to be accounted for.

35. We broadly agree with the CAA's approach to assessing equity financeability. But as discussed above we question whether the current shareholders will all wish to support the construction risk given their own investment objectives. It may be necessary to introduce new shareholders prepared to take such risks. Clearly there will be the need for substantial additional equity. It is important that the financial structure be developed so that the shareholders bear all the ultimate risk without recourse to the Treasury.

36. We believe the volume risk is significant, especially if the aero charges have to rise. As we have said above we do not believe the suppressed demand exists and in fact the DfT's aviation forecasts show much of the passenger traffic sourced from Stansted in the early years. It seems unlikley Stansted would allow this to happen. Also, the throughput may be curtailed by air quality restrictions and in the longer term by carbon emission restrictions. Heathrow's competitive advantages, even with additional capacity, may not be as great as sometimes suggested.

37. It is unclear whether growth will be fast or phased. The Revised draft NPS is based on fast growth with Heathrow's runway capacity full within a few years of first flight from the NWR. This impacts the financeability. We suspect Heathrow may propose phased growth. This matter needs to be addressed before parliament considers the NPS.

38. On the subject of indexing of inflation and the CPI and RPI indices we believe the CAA's approach of relying on RPI during the construction period but gradually changing to CPI thereafter is pragamatic.

Financial resilience and ringfencing

39. We believe the CAA's comment that bondholders are primarily interested in their security and not the interests of consumers is pertinent to the situation. The CAA has suggested a number of initiatives for protecting consumers without reducing bond holder security and broadly we support further examination of the options available.

40. As discussed above, we believe residual risks should be channelled to shareholders.

41. We suggest the structure be tested to destruction (perhaps not the right word). But we observe that the corporate structure, of which HAL is a part, may make it difficult if not impossible for orderly administration to be triggered. We have recently seen the unfortunate case of Carillion Group and how the business has failed.

42. We have referred above to some of the volume risks. There are other commercial risks including construction risk, regulatory, financial, other legal risks, tax risks and political risks, which are usefully described in recent bond prospectuses. Surface access remains uncertain and a significant

risk. We believe a comprehensive appraisal of the risks of NWR expansion should be prepared.

Chapter 5 - The regulatory treatment of early construction costs

43. We are still of the view that the expansion of Heathrow will not take place and therefore we are not generally in support of Category A, B or C costs being recovered by Heathrow and included in the aero charge. We understand that Category A costs (i.e. costs incurred prior to a decision by the Government) are for the most part not being allowed by the CAA. Heathrow expects Category B costs incurred in connection with the DCO process to amount to £250-£300 million but we understand the CAA has restricted recovery to an annual £10 million with provisions for recovery above this amount. We would not be adverse to Category C costs eventually being recovered if the project goes ahead. However, some Category C costs could be in relation to compensation to residents in the near vicinity of Heathrow and as RHC we would wish to defer to those residents before commenting on such costs.

Chapter 6 - Interim arrangements to extend the Q6 price control

44. In 2016 the Q6 price control period was extended by one year to the end of 2019. The consultation says Heathrow has plans to apply for development consent around the end of 2019 with the aim of a DCO being granted at the end of 2020 with construction commencing thereafter. We can understand the benefits of matching the Q6 price control period to end of the DCO process and the H7 control to take over as construction commences. A further extension of Q6 for one year is the issue - or is it. We believe the process could be still be further delayed and there could be a further year or two before H7 starts, if at all.

45. We appreciate the CAA and others are concerned at carrying out a full regulatory assessment for an extension of one year. One year extension to end 2019 is already in place and a further extension could be for one or more years. Under the circumstances and given our view that expansion will be delayed and perhaps not take place, we are of the view that the option described in the consultation that adjusts the building blocks for actual and expected performance on pax., opex., single till revenue and WACC should be adopted from the end of 2019. The consequences of less than this may well result in inadequate control of Heathrow through the regulatory process.

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