Economic Regulation of Heathrow Airport Limited: Working paper on Financial Resilience and Ring Fencing

Civil Aviation Authority Consultation CAP 1832

Response from Richmond Heathrow Campaign
11 October 2019

SUMMARY KEY POINTS

For ease of reference, set out below are the main concerns in the response from Richmond Heathrow Campaign (RHC) to the consultation by the Civil Aviation Authority (CAA). These concerns have gained additional traction from the recent recommendation from the Committee on Climate Change that projected growth in air traffic to 2050 should be cut by 50% in order to meet the UK's net-zero carbon targets. Also, the recently announced Environment Bill renews pressure on the non-compliance of air quality standards by Heathrow - resulting in potential restrictions on growth.

We are concerned that the CAA's emerging revised regulation of Heathrow and its expansion falls short of dealing with major financial issues and we are not confident these shortfalls will be remedied.

1. The current balance sheet has little equity capital and while the equity may be sufficient for the existing low risk cash generating 2-runway Heathrow, in our opinion the balance sheet is very under-capitalised for an opening position for a substantial high risk expansion and its financing. The shareholders have taken a stream of dividends over the years leaving little equity in the group.

2. The corporate structure is complex and while the regulatory control is applied to Heathrow (SP) Ltd this excludes Heathrow Finance plc, its parent and which provides some finance, and also several other companies up to the ultimate parent FGP Topco Ltd. The main asset, Heathrow airport, is near the bottom of the corporate hierarchy, seemingly complicating Heathrow's financing and its security as well as the CAA's regulation.

3. We have concerns that going forward the substantial expenditure risks are not being adequately addressed. Reference is made in public to a project costing £14bn in 2014 prices but actually Heathrow's capital expenditure including expansion is likely to be over £55bn (2016 to 2050) based on figures produced by the Airports Commission and Government. Also, the expansion project is complex and the expenditure and timetable potentially are high risk.

4. Government Policy is to restrict the price of Heathrow's services (the aero charge to airlines) to no more than today's level in real terms. Heathrow is already the most expensive large airport in the world on a per passenger basis and will be more so after the proposed expansion, especially if growth in demand does not materialise. Expansion is likely to harm Heathrow's terms of trade.

5. We doubt the willingness of the current shareholders (90% based overseas) to take on the project risk of expansion, which is quite different from the investment in the existing relatively low risk airport. As mentioned above the shareholders have taken most of the equity generated from the business over the years instead of re-investing it for the future. Perhaps they realise the expansion seems likely to dilute the rate of return from their existing investment.

6. We believe the debt markets will require a major injection of equity to absorb the project and financial risks. We doubt there will be sufficient internally generated and external funds available for the expansion. Even if Heathrow raises the finance and commits to the development, we believe significant financial risks will remain live for an extended period during construction and build-up of use.

We believe a Government review of the decision to support Heathrow expansion leading to withdrawal of support is increasingly likely and that in any event there is insufficient financial resilience to enable the 3rd runway proposal to go ahead. This presents an immediate financial risk on account of the substantial unrecoverable expenditure being incurred prior to planning approval.

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Attachment: Report to the CAA in response to its consultation on Financial Resilience and Ring Fencing CAP 1832, August 2019

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INTRODUCTION

1. This is a written response of the Richmond Heathrow Campaign (RHC) to the CAA's consultation titled *'Economic Regulation of Heathrow Airport Limited: Working paper on Financial Resilience and Ring Fencing, CAP 1832, August 2019'.*

2. This working paper focusses on options the CAA is considering to provide further assurance that Heathrow Airport Limited (HAL) operates in a financially resilient manner and that risks to consumers arising from financial distress are appropriately mitigated while not cutting across the financing arrangements that HAL already has in place to support its regulated business.

3. 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. We are an active participant in the Heathrow Community Noise Forum

4. 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. Our approach is to continue supporting the case for no new runways in the UK and we believe this is well supported by the evidence produced by the Airports Commission and the DfT in relation to the Airports National Policy Statement.

5. Over recent years we have undertaken extensive research on Heathrow and submitted a large number of papers to the Airports Commission, the DfT, CAA and others - all of which can be found at www.richmondheathrowcampaign.org

6. RHC has responded to eight CAA consultations on economic regulation - CAPs 1510, 1541 in 2017, CAPs 1610 and 1658 in 2018 and CAPs 1722, 1769, 1782, 1812 in 2019. The responses and other material are on the RHC website.

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RICHMOND HEATHROW CAMPAIGN RESPONSE TO CAP 1832

BACKGROUND

1. RHC's historic responses to the CAA CAPs 1541, 1610 and 1722 are particularly relevant to our response here and can be viewed on RHC's website.

2. We use the term HAL to include Heathrow Airport Limited and its linked companies including its ultimate parent, FGP Topco Limited. Heathrow Airport Limited is the direct owner of Heathrow airport and there are a number of companies between it and FGP Topco Ltd but essentially the group corporate structure has the airport as its main asset along with associated financing. We understand that Heathrow (SP) Limited and its subsidiaries, including Heathrow Airport Limited, is the Group regulated by the CAA. This means that Heathrow Finance plc, which raises subordinated debt, and is the direct owner of Heathrow (SP) Ltd is outside the regulated base, as is FGP Topco Ltd.

3. The current shareholders of FGP Topco Ltd are Ferrovial (Spain) 25.00%, Qatar Holding Aviation 20.00%, Caisse de depot et placement Quebec 12.62%, GIC (Singapore) 11.20%, QS Airports UK LP 11.18% CIC (China) 10.00%, and Universities Superannuation Scheme 10.00%.

4. The current CAP 1832 considers provisions for (a) ensuring HAL has sufficient financial resources and (b) mitigation of the impact of financial distress and providing information to the CAA. The licence provisions are listed as follows with the CAA conclusions in italics and those of RHC in bold:

   a. **Ensuring HAL has sufficient financial resources:**

      i. Gearing cap. *CAA: Not appropriate;* **RHC does not agree. Cap is essential**

      ii. Restricting Disposal of Assets. *CAA: Not appropriate*; **RHC agree**s

      iii. Obligation to hold investment grade rating. *CAA: the potential for a regulatory obligation to maintain an investment grade credit rating is worthy of further exploration;* **RHC agrees**

      iv. Sufficiency of resources. *CAA: Clarification in the licence of resources to include (i) cash, financial facilities and access to liquidity as well as other financial resources, and (ii) operational and physical assets*, *and making clear that these assets must be maintained to enable HAL not just barely to provide airport operation services at Heathrow, but to do so in accordance with the licence.* **RHC agree**s

   b. **Mitigation the impact of financial distress and providing information to the CAA:**

      i. Compliance certification. *CAA: Various evidence enhancements*. **RHC: agree**s

      ii. Targeted curtailment of HAL's ability to make dividend payment. *CAA: Any rules in HAL's licence curtailing its ability to make dividend or other restricted payments should apply only in circumstances where a problem is manifesting itself in specified ways.* **RHC agrees but seeks stricter rules than the CAA suggests.**

      iii. Ultimate Controller undertakings. *CAA: the "ultimate controller" to be defined as the "top" holding company of HAL's group and not shareholders.* **RHC agrees but**

we are concerned at the absence of shareholder responsibility for the risks of expansion.

iv. Monitoring and information. *CAA: enhanced information to the CAA about the financing platform.* **RHC: agree**s

5. In our view the proposed changes to HAL's licence (summarised above) are far too limited to deal with the risks of expansion. They focus on timely detailed provision of information but of itself this does not prevent financial distress or deal with the distress should it occur.

6. The consultation does not examine the project and financial risks that potentially challenge financial resilience and lead to financial distress. Accordingly, we examine the risks and raise questions as to how they might be absorbed (in some cases inappropriately) by the several stakeholders and whether residual risks remain leading to financial distress. This goes further than the consultation's coverage and questions.

7. HAL's debt leveraged financial structure amplifies the project risks. Our response starts with a brief examination of HAL's current financial performance and balance sheet. While the financial performance is reasonably healthy the balance sheet, while adequate for the current operations, is in our view in a weak position to start a major expansion.

8. Looking forward we provide a brief summary of what we perceive as the project risks - no doubt there others - foreseen and unforeseen.

9. In previous responses to the CAA's consultations, RHC has expressed major reservations as to the affordability and financeability of Heathrow's expansion. Under the lean financial circumstances that arise with expansion, we believe the two are not compatible and one will probably have to give way, which on the grounds that the Government and the Airports National Policy Statement (APNS) limit aero charges per passenger, it seems likely to be the financeability. We believe the project risks are high and that there is a significant probability that expansion will not be financially viable. But should the financing hurdle be surmounted in the next couple of years with HAL's commitment to the development and to its finance, we believe there will continue to be a substantial risk of financial distress extending into the future. The second part of our response therefore focusses on the dispersion of risk between stakeholders and the extent to which there is residual risk and insufficient financial resilience to mitigate the risk.

HAL'S CURRENT FINANCIAL HEALTH

10. Annex A provides the profit and loss statement for Heathrow (SP) Limited. These are the regulatory accounts for the year ended 31 December 2018, which differ slightly from the statutory accounts which are shown in Annex B.

11. In 2018 the aero revenue was £1.75bn and the non-aero revenue was £1.20bn totalling £2.95bn. Operating costs were £1.13bn and depreciation was £0.80bn - resulting in a regulatory profit (excluding interest) of £1.02bn on an average regulated Asset Base (RAB) of £16bn i.e. 6.37% internal rate of return.

12. The senior plus junior debt totalled £13.12bn at 31 December 2018 in Heathrow (SP) Limited on which £0.47bn of interest was charged at an average rate of 3.9%.

13. Annex B shows the 2018 consolidated statutory accounts for Heathrow(SP) Ltd and FGP Topco Ltd (the most senior company). They differ only slightly in most respects except FGP

Topco includes an intangible investment of £2.9bn. The long term debt in FGP Topco is £14bn and this is the best representation of 3rd party debt for the Group. This is very high compared to non-tangible non-current assets of £14.7bn. The shareholder equity is only £0.97bn and in Heathrow (SP) it is a negative £2.64bn.

14. Annex B shows the profit after depreciation, interest and tax was just £0.38bn in consolidated FGP Topco in 2018.

15. Our conclusion from this brief analysis is that the business has adequate profit before financing and an adequate return on assets as a going concern two-runway airport. The very high leverage with debt means that the rate of return to shareholders is very high. They actually have negative equity invested in the tangible assets and even taking account of the intangible assets the shareholder investment is very small. The operating cashflow of £1.8 bn is sufficient to support the debt and shareholder return.

16. However, as a base from which to launch a major expansion and financing we believe this starting position is weak, especially in balance sheet terms. The business would be unable to absorb anything other than a very small degree of expansion risk. We suggest this needs to be born in mind when assessing the risks going forward with expansion.

PROJECT RISK

17. We examine below the main components of project risk - capital expenditure and revenue. While we believe the existing 2-runway airport has an adequate positive cashflow, the expansion project risks are high, both from revenue and cost perspectives. There may be some opportunity to phase expansion of facilities so as to better hedge revenue uncertainty but the project requires substantial fixed upfront expenditure on the M25, land purchase, etc. before revenue is generated from the expansion.

18. Some of the project risk may be reasonably dispersed to other stakeholders but at a price. For example, suppliers and contractors might be required to enter into fixed price contracts. If Arora for example were to build one of the terminals then it would presumably take on the project costs and risks for the terminal. The equity base would be different from that of HAL and would enlarge the overall capital base but there might be additional project risks in integrating the development into the wider scheme.

19. Clearly, the successful management of project risk requires an appropriate management structure and experienced staff. Those with responsibility need to be well informed. The plans and budgets need to be robust and with appropriate levels of contingency. A feasible but challenging timetable is essential. The risk strategy needs to be well developed and implemented. There needs to be flexibility and awareness of what is essential and what is less essential to the airport's future. The project needs to be stress tested and sensitivity analysis undertaken. Essential provisions not within HAL's control need to be identified and contingency plans drawn up. IAG and other airlines have expressed serious doubts about HAL's ability to manage the expansion successfully. On the other hand, the CAA's proposals outlined in this consultation go some way to providing the information needed to manage the risks.

<u>**Capital Expenditure (capex)**</u>

20. HAL's recent proposed Master Plan consultation contained very little financial information and we await publication of Heathrow's Interim Business Plan later this year. Unfortunately, the only detailed published financial information dates back to the Airports Commission's

assessment in 2015, which was used largely unchanged by the DfT in support of the APNS in 2018. The best we can do is to compile a chart of capex as shown in Figure 1. The Airports Commission estimated the scheme capex in 2014 prices as £17.6bn; the remaining expenditure in the chart is core and replacement expenditure and is in addition to the scheme expenditure.

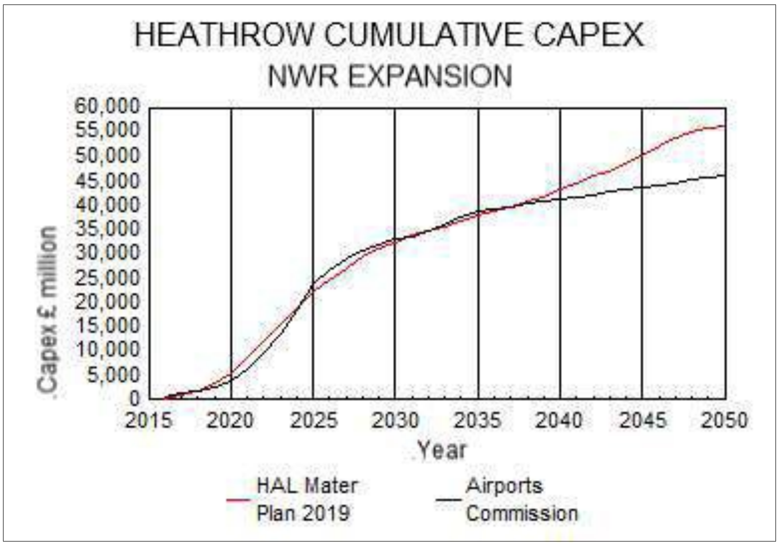

Figure 1 Cumulative Capex 2014 prices

21. In our response to CAP 1541 in September 2017 we provided a detailed cashflow model. It used Airports Commission's estimates of capex updated from 2014 to 2016 prices (see following table).

Heathrow Capital Expenditure	Source: Airports Commission update to 2016 prices.	
£ bn 2016 to 2050	2016 prices	mod prices
NWR Expansion scheme capex	18.9	24.6
Core capex	14.3	21.7
Replacement capex	16.3	31.1
Surface Access	6.0	7.5
Total	55.5	84.9

22. We understand from Heathrow's proposed Master Plan that almost all terminal capacity will be built after first flight from the NWR in Q4 2026. It is difficult to reconcile this with the Airports Commission's capex profile that showed almost all the facilities being completed by first flight; as Figure 1 shows, the Commission's capex phasing is almost identical to that of the proposed Master Plan, until later years.

23. On previous occasions RHC has responded to the CAA on Heathrow's capex for expansion. RHC believes surface access costs are substantially under-estimated. Ultimately the consumer should pay, either directly or via HAL. The surface access expenditure needs to be included in the scheme's budget if the costs cannot be passed on to the consumer directly at the point of service. To the extent surface access is provided by others, then the financial base and risk absorption capacity is expanded. But HAL lose some control and the integration of airport and

surface access may be at risk. It is essential that using multiple providers does not lead to less than adequate surface access provision, higher costs and subsidy by the tax payer.

24. We believe the complexity and sheer size of the capex pose substantial project risk and that a significant proportion of the expenditure will have to be incurred up front and will be a sunk cost by the time the project reaches peak financial risk, say around the time of first flight. But this point does depend on the phasing of capex, and as highlighted above, the picture is confusing.

25. The issue of phasing is important to financial resilience because phasing of capex to match revenue should increase financial resilience, other things being equal. If HAL went into administration then clearly it would be essential to keep the 2-runway airport operational. The decision would be whether or not to continue the expansion and if so how to finance it. There is the question of how to separate the accounting for assets and operations of a two runway airport from those arising from expansion. It will be important to define the scope of the expansion and hence the development project as distinct from existing operations. A similar question arises on the financing, as to whether the expansion should be non-recourse to HAL's corporate cashflow and balance sheet. If HAL needs to be rescued from financial distress, then the rescue should first of all be of the two-runway airport. **We do not believe CAP1832 adequately considers the important issue of how to separate the assets and operations of the two runway airport from the expansion and keep the airport operating in the event of administration.**

__Revenue__

26. Figure 2 charts Heathrow's passenger growth from details in HAL's proposed Master Plan consultation. HAL estimates a much slower passenger growth rate than predicted by the DfT in its support of the APNS in June 2018 but a faster rate than predicted by the Airports Commission in 2015. It is unclear how the sizable difference in passenger growth rates reconciles with the absence of difference in capex shown in Figure 1.

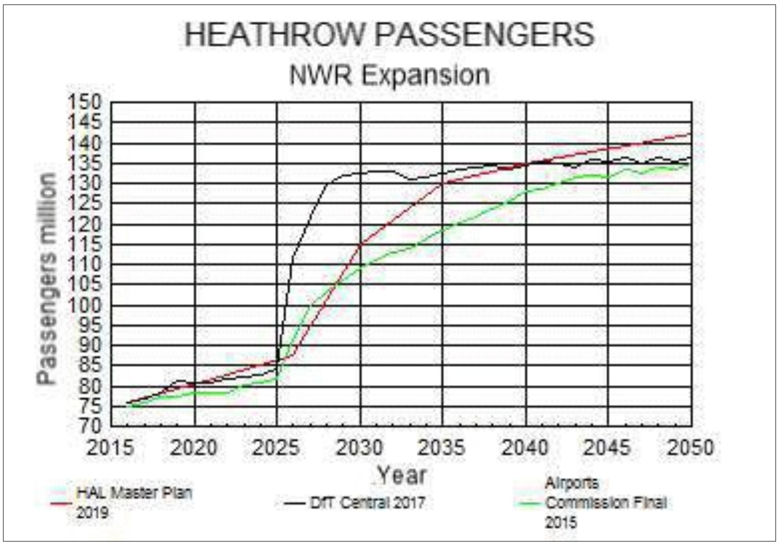

Figure 2

27. HAL's revenue is mainly in the form of aero charges to the airlines and non-aero revenue such as services and goods sold to passengers at the airport. Both of these increase with demand.

The Government and the Airports National Policy Statement (APNS) limit aero charges per passenger, so an increase in demand also lifts the constraint by spreading the total aero-charge across more passengers. The aero charge feeds through each airline's profit and loss account into ticket prices, which in turn affects demand. So we need to examine aviation demand to understand financial resilience.

a. Aviation demand is uncertain due to world and UK economic headwinds, and demand could be weak in a couple of year's time when HAL seeks to commit to the expansion project and its financing.

b. The need to respond to the climate change emergency and the fact that Heathrow is the largest single producer of carbon in the UK adds uncertainty and increasingly so as the ceiling for emissions is reduced. Advice this year to Government by the Committee on Climate Change (CCC) on UK net zero carbon and aviation and shipping make clear the need to restrict aviation growth and not rely on international offsets or other mitigation. The CCC's Core options are aligned to the 2008 planning assumption, i.e. aviation 37.5 MTCO2e by 2050. The CCC says that these aviation emissions could be achieved through a combination of fuel efficiency improvement of around 0.9% per year, limited use of biofuels (i.e. 5% in 2050), and by limiting growth in UK passenger demand to 60% above the 2005 level of 230 million passengers per annum (mppa), i.e. 368 mppa in 2050. According to the CCC even 368 mppa may need to be further reduced for the UK to achieve net zero carbon by 2050 and conceivably to a level no higher than in 2016 (267 mppa). The Airports Commission's carbon traded case and the APNS assumed UK demand of 435mppa in 2050. The Government is now under pressure to include the CCC recommendations in its Aviation Strategy. The dilemma for the aviation industry is where is growth to be cut. Surely, Heathrow expansion is the main candidate but expansion would probably become financially unviable.

c. The forecasts by the Airports Commission and DfT assume other UK airports will take the brunt of demand constraint but it is unrealistic and other airports are unlikely to let this happen.

d. Competition from the expansion of Gatwick with a second runway and other London and regional airports could defer and constrain growth of Heathrow's demand. Out of the 43 mppa growth from a 3rd runway at Heathrow, 17 mppa are assumed in Government forecasts to be cannibalised from growth at other airports. We believe HAL is at significant risk in assuming this demand.

e. RHC believes that HAL's emphasis on international-to-international (I-I) transfers and Heathrow's hub status is vastly over rated. I-I transfers provide little if any benefit to the UK economy and result in excessive carbon emissions. Worse still, the emissions are allocated to the UK carbon footprint in a constrained carbon world. Point-to-point air travel with long-range mid-sized aircraft is increasingly likely instead of by I-I transfer. It is increasingly unsustainable for the Government to continue exempting I-I transfers from Air Passenger Duty. Out of the 43 mppa growth from a 3rd runway at Heathrow, 16 mppa are assumed in Government forecasts to be I-I transfers. We believe HAL is at significant risk in assuming this demand.

f. We know that the CAA believes there is a substantial scarcity rent at Heathrow and that with 3rd runway capacity ticket prices will fall and thereby cause demand to increase. The DfT's estimates in support of the APNS were for there to be passenger benefits of £67.6bn and airline losses of £55bn (60 year NPV 2014 prices) - the idea being that the airlines can sustain these losses. RHC takes an opposite view and does not believe ticket prices will fall. For a start, the airlines do not have long-term excess profits to absorb a reduction in prices when they have the burden of the highest airport costs in the world. Furthermore, consumers will need to bear additional surface access costs and carbon costs. We believe HAL is at significant risk in assuming airline ticket prices will reduce with expansion and demand will therefore increase.

g. Inadequate surface access could prevent an increase in Heathrow's catchment area and demand could suffer. Also, poor road and public transport access could deter people from using Heathrow.

28. We referred above to carbon emissions and their restriction on demand growth but also noise and air pollution will probably restrict growth as determined by HAL's proposed set of environmental envelopes and capacity restrictions. An Environment Bill announced in the Queen's Speech to parliament will enshrine environmental principles in law including those introduced to improve air quality. The Times newspaper and others urge ministers to adopt into law the WHO's limit of 10 ug/m3 for PM2.5 fine particulates against the current EU/UK level of 25 ug/m3. This would be very difficult to satisfy with Heathrow expansion.

29. As we have said above, the APNS requires Heathrow's aero charges not to materially increase in real terms as a result of expansion. So while the consumer is seemingly protected from increased aero charges, HAL's finaceability and financial resilience are potentially at risk as a result.

DISPERSION OF RISK AMONG STAKEHOLDERS

Equity

30. The proposed thin capitalisation of corporate HAL will result in insufficient capital to provide resilience (assuming around 80% debt). We are surprised that CAP 1832 seeks to limit the exposure of the shareholders. RHC takes the opposite approach and recommends that the design of financial resilience has as its prime objective the mechanisms for transferring project and financial risk to the shareholder. To stop the risk at the senior company and board of HAL's corporate structure, as is suggested by CAP 1832, is inappropriate in our view.

31. Examination of HAL's shareholders suggests that there may be considerable resistence to the shareholders taking on HAL's need for equity and HAL's financial risks.

   a. 90% of HAL's shareholders are overseas based organisations and there are indications that some may be less willing than in the past to invest in the UK for reasons of Brexit or otherwise.

   b. Absorption of financial risk depends on the weakest of the shareholders and the marginal price to attract shareholder support. At least two have potential financial difficulties.

   c. HAL's existing shareholders have invested in a stable cash generating business but expansion presents a whole new set of project risks and financial demands for additional equity and dividend restraint or famine. Investment risk and security will be quite different to the past. It is not clear HAL has the shareholders it needs for expansion either in terms of investment return and risk objectives or capacity.

   d. Investors may become weary of investing in high carbon emitting companies. Some institutions we believe have already expressed reservations about investing in Heathrow's expansion for environmental reasons.

32. CAP 1832 says very little about capitalisation of HAL and the shareholder structure and support. We believe this needs to be remedied urgently. Moreover, unlike the CAA, we believe a debt cap and substantial equity is needed. The proposed high debt/equity ratio will inevitably divide the project risk in favour of the debt holders resulting in amplified financial risk to the shareholders. Clearly, the ideal debt ratio depends on the available supply and demand of debt and equity for HAL, taking account of the risk aversion of each of the potential providers and the relative costs. We believe that during the higher risk construction phase, equity needs will be substantial.

33. We realise non-recourse project finance is potentially expensive but non-recourse finance and separation of the two-runway airport assets from the expansion assets might enable the continuation of the two-runway operations more easily in the event of HAL's administration. But funders of expansion will be looking for the cash generation from the two-runway operations to secure their funding. To the extent HAL is under-capitalised, risks have to be transferrable beyond HAL to its shareholders.

34. One recourse to the shareholder is through managing the dividend and re-investing cash generated from the existing two-runway airport. Another method could be through the issue of partly paid shares requiring equity to be invested if a call is made by HAL on those shares. The shares could be of a different class to the Ordinary capital and purchased by investors prepared to take on more risk but for a higher return. A more novel approach could be the establishment of an escrow account (say £2bn), which would be available in specified circumstances and during the four or five years of elevated risk. Another approach could be for one or more shareholders to provide limited guarantees or undertakings for a fee.

35. At the end of the day, all shareholders should be prepared to lose their entire investment - that is the nature of equity for which the shareholders potentially receive a high rate of return. The best way to ensure this does not happen is to invest sufficient equity.

<u>Debt</u>

36. Bond holders will exact a high price in terms of yield and security for the high risks created by Heathrow's expansion, thus leaving other stakeholders to bear the risks of failure. CAP 1832 seeks to ensure the debt financing platform remains unchanged by any CAA intervention aimed at providing financial resilience. However, presumably the financing platform will have to change significantly from today because of the introduction of considerable project risk from the expansion.

37. Debt should be structured so that different levels of risk are matched to the debt markets' appetite for a variety of risks, e.g. junior and senior debt. This is an essential feature of efficient finance.

38. Lenders may become weary of investing in high carbon emitting companies (see similar comments on equity).

39. HAL's financial risks will vary over the course of the construction and then subsequent operation and we recommend the debt instruments recognise the changing nature of the risks and so vary the interest and security to reflect this.

40. Lenders look for security in terms of charges over specific or global assets or over cashflow or by way of guarantees from third parties. At all times lenders need to be able to see how they will be repaid. In the event of default it impossible to see how selling Heathrow's assets or realising asset charges achieves much. The assets are for the most part only of value in

supporting an airport and in the event of financial difficulties, continuing the two-runway operations surely would be essential financially. There does need to be a pathway to ensure that should there be financial difficulties the lenders become entitled as necessary and appropriate to all future equity returns from both a two-runway airport and its expansion.

41. We suggest that the financial structure should allow HAL to let lenders withdraw and new lenders join in an orderly manner under circumstances where the lenders objectives cannot be met due to changed circumstances. Priority, ranking and security would need to be maintained for individual lenders. We would not support the Treasury becoming a lender or shareholder even on commercial terms and even for the reason of national interest.

42. Were the Treasury to provide support in the moment of financial distress, we strongly argue this should only be for the two-runway airport and not the expansion.

Consumer

43. We appreciate the working paper is about protecting the consumer from failure of Heathrow. The Government prohibits material increase in Heathrow's aero charges in real terms as a result of expansion. It is not clear from CAP 1832 how the Government/regulator would ensure no increase in aero charges and in turn ticket prices in the face of Heathrow's financial difficulties. This needs to be remedied.

44. Consumers might suffer from poor service in the event of Heathrow running into financial difficulties. For example, there may be insufficient terminal capacity built or poor quality of facilities provided. It is not clear from CAP 1832 to what extent service provision might be reduced in the face of financial difficulties and this needs to be remedied. As we say above, the remedy is making sure there is sufficient equity to avoid the risk of an increase in ticket prices and loss of service.

Airlines

45. We have discussed the claimed scarcity rent or price premium caused by capacity constraints, although we disagree with this concept under the circumstances. The airlines are the immediate customers of Heathrow and arguably they might be expected to share some of the risk, especially the demand risk. They will have the benefit of a price cap on the aero charge and at the moment they bear relatively little cost for climate change. We believe the consumer should bear most of the cost of climate change but, as with the tobacco industry, the aviation industry should also bear some of the responsibility; that would mean a share of the carbon cost being born by the airlines and HAL. CAP 1832 is short on exploring the airlines sharing some of the risks.

Other Airports

46. Heathrow is potentially a monopoly in spite of the CCA's regulation. On previous occasions we have demonstrated the excess profits made by Heathrow from a two-runway airport. One particular issue is the impact of Heathrow's expansion on other airports, which we have mentioned above and examined in previous responses to the CAA. Heathrow cannibalises growth from other airports. This may assist Heathrow but for the UK as a whole it increases the risk other airports will not survive or will be inefficient because of the loss of economies of scale. This places passengers at other airports at risk. The north-south balance is at risk. While this may not immediately be relevant to HAL's financial resilience, as we have said, moves by the Government or the airports themselves to address the imbalance would probably reduce HAL's financial resilience.

Treasury/Government

47. Heathrow is owned and managed by a private company, and notwithstanding the airport's strategic importance to the country, we are quite clear that the Government (i.e. tax payer) should not provide financial resilience by bearing the project and financial risks. We have said many times before that mechanisms must be put in place to prevent the tax payer being the provider of last resort. We are disappointed that CAP 1832 does not discuss the issue.

48. One obvious escape-hatch for HAL is to pass the costs and risks of surface access to the tax payer and other users of road and public transport. RHC estimates the cost to the UK of road congestion, public transport over-crowding, and pollution in respect of inadequate Heathrow access as £25bn (60 year NPV 2014 prices). We believe HAL is already benefiting from a surface access subsidy by the tax payer. The issue has been raised by TfL, RHC and others for many years and seemingly there continues to be an unacceptable gaping hole in the financing and risk absorption of Heathrow's surface access needed for expansion.

49. It is especially important that the Government does not provide financial support for HAL and its expansion in the form of guarantees, undertakings or uncommercial loans and finance.

50. It is important that the Government is not explicitly or implicitly the lender of last resort on the grounds that Heathrow is of national interest to the UK economy or for any other reason.

51. HAL already benefits unreasonably in our view from tax relief on all debt interest. Airports have inexplicably been given exemption from thin capitalisation rules relating to tax relief on interest. The unreasonableness would be magnified if the Government also provided financial support for a high debt/equity ratio.

52. We are concerned that the Airports Commission did not rule out Government support. The Final Report (para 11.25) said *"the government may wish to consider additional sources of liquidity should raising finance become more challenging. Current options that could be considered would be the European Investment Bank, or something similar to the current UK Guarantee Scheme (UKGS) which is scheduled to close in December 2016. Both sources would require active engagement by both government and the entity looking to raise finance."*

53. We are concerned that the Government may already be at substantial financial risk from claims should it have to withdraw its support for Heathrow expansion for what ever reason.

Local Communities

54. Another obvious escape-hatch for risk absorption is the avoidance by HAL of its environmental responsibilities for noise and air pollution leaving communities to bear the costs and risks. We have major reservations against the use of environmental envelopes to determine growth and environmental capacity. The polluter should pay and in our view it is unfair and inequitable to expect communities around Heathrow to bear the cost of incentivising the aviation industry to mitigate noise and air pollution. We have little doubt that should HAL's financial resilience be tested then the losers will be the environment and communities around Heathrow. CAP 1832 does not recognise this important environment issue; more generally we are concerned that the CAA is not fundamentally tuned to the environmental issues of Heathrow's expansion. That is not meant as a criticism of the CAA per se, because we think the statutory structure of environment management between the several Government agencies is not fit for purpose.

RESILIENCE AND RESIDUAL RISK

55. **RHC believes there will remain substantial residual risk and insufficient financial resilience in the absence of sufficient equity**. We realise HAL is a private company and arguably should be left to its own devices to expand Heathrow but we have highlighted here the significant project and financial risks and stressed the need for contingency planning now to deal with lack of financial resilience and potential financial distress.

56. Annex A shows Heathrow's current operating cashflow as £1.8bn pa before interest payments. A back-of-the-envelop calculation in real terms and pre-tax might assume that with expansion an annual average increase of the operating cashflow of 25% between 2027 and 2035 as passenger numbers increase and then 50% to 2050. (9yrs at £2.25 + 15yrs at £2.7)bn which equals £61bn plus say £14bn from 2016 to 2026. Total free cash from 2016 to 2050 could amount to £75bn. But interest of £0.55bn pa on current debt of £14bn amounts to £17.5bn over 32 years leaving £57bn to fund the expansion, which barely meets the £55.5bn required and with nothing left for a shareholder return. Shareholders might expect between £10bn and £20bn over 32 years. Even were there to be a positive return for HAL as a whole, we believe from our analysis that the positive return from a 2-runway Heathrow will be significantly diluted by the incremental expansion. Why shareholders would want to do this and at considerable project risk is a mystery. The economics look very poor. This was the conclusion we reached with a detailed corporate cashflow model presented in our response to CAP 1541 in 2017.

57. We do not believe modest changes to the licence, as suggested by the CAA in this consultation, go anywhere near far enough in dealing with the issues we raise here and the wide ranging consequences of HAL entering administration. We stress the need for much greater shareholder responsibility and willingness to provide a safety net than seems to be the case.

58. We have assumed it is the CAA, as economic regulator of Heathrow, that has the responsibility to ensure financial resilience. We appreciate that the CAA is constrained by the need for HAL independently to manage its financial platform with lenders and shareholders and that CAA intervention could unintentionally undermine this platform. We acknowledge the CAA's concern that at times of financial distress the lenders and shareholders' financial platform is designed to protect their several financial interests and not necessarily the ongoing operation of the airport. It is not clear what financial controls might be introduced by the DCO and we recommend this requires urgent consideration.

59. Finally, the expansion may prove financially successful. But the subject of the consultation is financial resilience and we have therefore focussed on a pessimistic outcome. Until we see HAL's Interim Business Plan later this year it is difficult to assess the outcome otherwise.

END

Please note a few minor corrections have been made (e.g. para numbering) to the original version of this report.

Annex A Heathrow's regulatory Accounts 2018

Annex B Heathrow's statutory accounts 2018

ANNEX A

File: Regulation

26-Oct-19

Heathrow Regulatory Accounts Year ended 31 December 2018

	Revenue £ million	%
Airport Charges:		
Departing passenger charges	1,193	40.4%
Landing charges	477	16.2%
Aircraft parking charges	65	2.2%
Non-passenger flights	10	0.3%
Total Aero Revenue	1,745	59.1%
Retail:		
Retail	401	13.6%
Catering	61	2.1%
Other retail revenue	124	4.2%
Retail income before parking	586	19.9%
Car parking	126	4.3%
Retail expenditure	-14	-0.5%
Net retail income	698	23.6%
Property	118	4.0%
Baggage check-in	140	4.7%
Other regulated charges	103	3.5%
Rail	137	4.6%
Other	11	0.4%
Total Non-Aero Revenue	1,207	40.9%
Total Revenue	2,952	100.0%

	Operating Costs £ million
Staff:	
Security	154
Other operational	91
Non operational	124
Pension	63
	432
Maintenance & Equipment	183
Rent	15
Rates	126
Utilities	90
Other	284
Total Operational	1,130
Depreciation	802
Total expenditure	1,932

	£ million
Regulatory operating profit	1,020
Regulatory EBITDA	1,822

	RAB £ million
Opening RAB 1/1/18	15,786
Additions in year capex	793
Assumed ordinary depreciation	-802
Indexation at 31/12/18	425
Closing RAB 31/12/18 (x)	16,202
Average RAB	15,994
Return on average RAB	6.4%

Heathrow Passengers:	**'000**
UK	4,795
Europe	33,326
North America	18,100
Asia Pacific	11,532
Middle East	7,660
Africa	3,338
Latin America	1,351
	80,102
Airport charges per passenger	£21.66
Net retail income per passenger	£8.71

Statutory Accounting Statement Heathrow (SP)	£ million
Revenue	2,970
EBITDA	1,837
Adjusted Cash Flow (y)	1,787

Senior debt (a)	11,765
Junior debt (b)	1,353
Cash & cash equivalents (c)	-711
Consolidated net debt (d)	12,407

Senior Regulatory Asset Ratio (a+c)/x	68.2%
Junior Regulatory Asset Ratio (d/x)	76.6%

Interest & charges:	£ million
Senior debt (e)	375
Junior debt (f)	100
Yield:	
Senior debt	3.2%
Junior debt	7.4%

Senior Debt Interest Cover (y/e)	4.8
Junior Debt Interest Cover (y/(e+f)	3.8

Prepared by P Willan 6/10/19. Source: Regulatory A/cs 2018 and Heathrow Investor report June 2019

ANNEX B

File: Regulation
11-Oct-19

Heathrow Statutory Accounts Year ended 31 December 2018

	Heathrow (SP) Ltd Consolidated A/C £million	£million	FGP Topco Ltd Consolidated A/C £million	£million
Non-current Assets:				
Property, Plant & Equip	11,405		11,609	
Investment properties	2,472		2,472	
Intangible Assets	173		2,936	
Other	591		621	
		14,641		17,638
Current Assets:				
Inventories	13		13	
Trade debtors	302		299	
Cash & deposits	711		772	
		1,026		1,084
Current Liabilities:				
Trade Creditors	-433		-411	
Borrowings	-496		-742	
Other	-91		-95	
		-1,020		-1,248
Net Current Liabilities		6		-164
Non-current Liabilities:				
Borrowings	-14,813		-14,060	
Derivatives	-1,523		-1,523	
Deferred Income Tax	-907		-876	
Other	-40		-42	
		-17,283		-16,501
Net Assets		-2,636		973
Shareholder Equity		-2,636		973
Revenue		2,970		2,970
Operating costs		-1,133		-1,130
Other costs		117		117
Operating profit		1,954		1,957
Depreciation		-743		-752
Financing		-789		-751
Profit before tax		422		454
Tax charge		-89		-73
Profit after Tax		333		381