

**ECONOMIC REGULATION OF THE NEW RUNWAY AND CAPACITY EXPANSION AT  
HEATHROW AIRPORT: CONSULTATION ON CAA PRIORITIES AND TIMETABLE**

**CAP 1510**

**CONSULTATION - February/March 2017**

**Richmond Heathrow Campaign Response**

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: *Economic Regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable (CAP 1510), January 2017*.

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.

Over recent years we have undertaken extensive research on Heathrow and submitted a large number of papers to the Airports Commission and others - all of which can be found at [www.richmondheathrowcampaign.org](http://www.richmondheathrowcampaign.org) and [www.rhcfacts.org](http://www.rhcfacts.org).

Unfortunately, we learned of the consultation late in the day and would have liked to have devoted more time to our response. We are treating this consultation as an opportunity to focus on the principles of economic regulation of the expansion and we aim therefore to give more time to the details in response to a subsequent consultation, which we understand the CAA will be conducting in June 2017 with the aim of a final report in November 2017.

Our understanding on the subject is as follows:

1. Heathrow has passed the Market Power Tests of Strategic Market Dominance and therefore requires regulation by the CAA under licence according to the Civil Aviation Act 2012.
2. The Primary Focus of the regulation is to protect the interests of the current and future users of Heathrow (passengers and freight owners) from exploitation of the market dominance but only so far as protection is not otherwise provided by competition and other laws. This involves the volume of service and price, its availability and continuity, quality of service, and delivery costs and efficiency.
3. The restrictions and commitments on Heathrow's charges to airlines are the key mechanism for intervention by the regulator.

4. The charges allowed historically have been set over five year regimes with the next one (H7) currently scheduled to commence in January 2020. The aim is to provide a regime (integrated at least in part with H7) for the expansion of Heathrow.
5. The expansion of Heathrow by way of a third runway and associated facilities is such a major development that the current regulations for business as usual need to be re-modelled.
6. The regulation model seeks to allocate between stakeholders the relevant costs and benefits of expansion and the associated risks in a fair and equitable manner that is transparent and robust over the short and longer term.
7. Where possible the CAA would like to see the markets achieving the desired outcomes (e.g. the airlines and Heathrow working out solutions that avoid Heathrow's market dominance) so that intervention focuses on the exceptions and remaining market distortions. The CAA's intervention can be through restrictions (e.g. on charges) but also in the form of incentives and penalties.

Point 6 above is Pandora's box because it raises issues of who are the stakeholders, what costs and benefits are relevant and what are the risks and what is equitable sharing. We comment on these in the following response – first as General Comments and then in regard to Specific Priorities in the Consultation.

## **GENERAL COMMENTS**

### **1. The shadow cost of not expanding Heathrow**

The CAA consultation adopts the premise that there is an economic shadow cost of not expanding Heathrow. This is relevant when considering the incremental economic benefit to users from expanding Heathrow. We do not agree with this premise. In section 2 below we highlight some negative impacts on users resulting from Heathrow expansion, as evidenced by the Airports Commission. In section 3 below we outline the false truth on international-to-international transfer passengers and Hub status of Heathrow. Were transfer numbers to be reduced (for example, by removing the Air Passenger Duty exemption) then this could free up 30% of Heathrow's capacity. Heathrow is not efficiently full. There are around 74 million passengers a year currently using Heathrow compared to runway capacity of 95 million. Furthermore, Heathrow claims to be able to raise traffic throughput by 25,000 flights a year without impact on resilience. Heathrow is a high frequency airport with many popular routes but often less than full use. Three quarter empty planes to and from New York are examples of misuse of existing capacity. These and other issues challenge the CAA's premise on the shadow cost of not expanding Heathrow and hence the benefit to users of expansion and the background to economic regulation.

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. But this is not the place to expand on our preference.

## 2. Users

### a. UK verses Heathrow Users

The Airports Commission demonstrated that in its final preferred scenario (carbon capped) that expansion of Heathrow would have a negative impact on the UK aviation market as a whole:

- Expansion reduces overall UK aviation growth and diverts growth from the rest of the UK at the expense of regional balance.
- Fifty percent of the new runway would be used by international-to-international transfers that add little economic benefit to the UK.
- Expansion has a negative impact on the two main sources of economic benefit: it reduces growth across the UK of inbound tourism and of long-haul business passengers that bring trade to the UK.
- It results in no material change to the number of destinations from the UK or domestic destinations and hence no improvement in connectivity.
- Air travel would be concentrated with limited competition at a single airport, Heathrow - the most expensive major airport in the world.
- The economic return on investment using Government criteria is bordering on poor.
- Expansion may not be deliverable without substantial State aid, ultimately to support international-to-international transfers and leisure passengers from the UK, which provide little benefit to the UK economy.

These outcomes, projected for the most part by the Airports Commission, are forecasts and not fact. But they are realistic, which under carbon constraint, result in Heathrow's market dominance across not just the southeast but the whole UK. We have examined the matter in greater depth in our responses to the Airports Commission at [www.richmondheathrowcampaign.org](http://www.richmondheathrowcampaign.org) but also in our fact sheet on the expansion economics at [www.rhcfacts.org](http://www.rhcfacts.org).

Our understanding is that the historic and indeed current regulation model focusses only on Heathrow users and the airport charges to those users, notwithstanding that Heathrow's market dominance can impact the whole of the UK.

**We urge the CAA to consider all UK Users and not just those using Heathrow when designing appropriate regulation for expansion.**

### b. International-to-International Transfer Passengers

The best kept secret is that Heathrow has little value as a hub airport. The Commission says international-to-international transfers provide little economic value to the UK. They do not leave the airport. Moreover, unlike passengers terminating in the UK they are exempt from Air Passenger Duty. The idea that Heathrow is a hub airport that needs transfers to make routes viable is fiction. Evidence from the CAA and DfT demonstrates that in 2011, for example, only 2% of transfers were on Heathrow's thin long-haul routes and only 7 out of 44 thin long haul routes had any international-to-international transfers. For the most part, the transfers are on popular routes. These transfers contribute to a substantial environmental cost in terms of noise pollution, use up capacity at the expense of UK passengers and compete with UK business passengers. The Airports Commission estimated that in its preferred scenario (carbon capped) that around 50% of the 3<sup>rd</sup> runway capacity at Heathrow would be used for international-to-international transfers.

**We urge the CAA to consider discounting the value of international-to-international transfers as Users of Heathrow's capacity in its regulatory model.**

### **3. Regulatory Model costs and benefits**

There is a big difference between the economic model and financial model for Heathrow expansion. We are not suggesting the regulatory model should mirror an economic model, such as Webtag, but we believe Heathrow's corporate financial model is too narrow as a basis. We realise the regulatory model adjusts the corporate model, for example using a regulatory asset base (RAB) and notional debt rather than actual debt.

We are especially concerned with two particular weaknesses – the treatment of surface access costs and environmental costs. There are widely varying views on surface access costs (£1.5bn to £20bn) and who should pay for them and we believe Heathrow will not end up paying its fair share. The result is likely to be investment that is not sufficient to avoid road congestion and hence excess air pollution and inconvenience to the public but also overcrowding on public transport. Furthermore, we believe it likely that Heathrow will not contribute a fair share of even the inadequate investment.

The environmental cost of avoiding damaging air pollution and noise seemingly is not adequately addressed by the regulatory model. While the consultation mentions environmental cost there is virtually no explanation. We understand that Heathrow's expenditure on mitigation and compensation is included in the model, other things being equal, but this substantially under-estimates the real cost to the community. Furthermore, the cost of carbon, either capped or traded is not adequately dealt with by the model.

The risk is that the community, tax payer and others will end up paying for surface access and environmental costs and moreover have no way of controlling these costs.

**We urge the CAA to consider further how best to incorporate surface access costs and environmental costs in the regulatory model.**

### **4. Uncertainty and Risk**

As far as we can see there is some way to go in developing a regulatory model that is fit and able to deal with the gamut of risks arising from Heathrow expansion. Controllable risks need to be allocated to those that can best control them and they should be given responsibility and also accountability – this applies to both costs and benefits. At the moment it is not clear how political risk, construction risk, demand risk, operating risk and financial risk, etc. will be allocated. Normally one would expect the shareholders of a private company to bear the brunt of the downside risks. But following the acquisition of BAA in 2006, the shareholders have stripped the company of equity by paying themselves substantial dividends and replacing equity with debt. These are not actions one would expect of shareholders responsibly preparing for a major investment and the associated risks. Some risks are uncontrollable and the model needs to determine who will bear these risks. Much more needs to be done to make sure that the tax payer does not end up paying for the downside risks.

**We urge the CAA to place greater emphasis on the shareholder bearing the risks in the regulatory model and non-recourse to the Treasury than currently appears to be the case.**

## 5. Heathrow's expansion viability and timetable

Heathrow expansion may not be financially deliverable without substantial State aid. The Airports Commission's base case financial model for Heathrow forecasts capital costs of £80 billion (money of the day) (£48 billion £ real 2014), excluding a potential underestimate of up to £15 billion of surface access costs. The £80 billion comprises £25 billion for the Northwest runway expansion scheme, £22 billion for core capital expenditure and £33 billion for replacement capital expenditure, all through to 2050. Heathrow needs to find £28 billion to finance a third runway and ongoing cash outflows and potentially £20 billion for surface access. Peak debt will need to rise from £11 billion in 2014 to £34 billion in 2028, which with re-financing needs will be a huge challenge for debt markets. The shareholders (90% owned overseas) are forecast to raise their capital from £3 billion to £8 billion, which is hardly cushion enough to absorb the substantial construction, operational and financial risks. The passenger and tax payer are left to absorb most of the risk but the former will be heavily burdened with high aeronautical charges leaving the risk to be borne by the UK tax payer.

According to the Airports Commission, Heathrow's aeronautical charges will rise from £22.53 per passenger in 2014 to an estimated £31.20 with expansion (£ real 2014). This compares with around £9 at Gatwick, £12 at Schipol, £8 at Dublin and Manchester and £11 at New York JFK, for example. The high cost of Heathrow is partly due to facilities for I-to-I transfers, which in (2b) above we submit are of questionable value to the UK. How it is possible to get from these estimates (BA has even estimated a £40 charge) to no increase on average in real terms targeted by the Secretary of State is a mystery. We understand the airlines are strongly opposed to pre-loading the charge, which might smooth out the peak charges.

It is essential the business and financial plans of Heathrow are published and scrutinized before a decision is made by the Government to support expansion of Heathrow. It is also essential that the regulatory model and its impact be published and scrutinized in the context of Heathrow's plans and again before a decision it made by the Government. Not to do so would expose the Treasury to a major risk of having to pick up the tab, for unaccountable environmental costs as well as allowing Heathrow to benefit from excess profits due to its market dominance.

We are concerned with the timetable set out in the Consultation in Chapter 6. The decision making process on expansion appears to be well ahead of finalizing a regulatory model and to us this is wholly unacceptable. The CAA's timetable is for the licence to be granted in January 2020 compared to a Government decision possibly by the end of 2017.

**We urge the CAA to publish and consult on a definitive regulatory model and its impact well ahead of a Government decision on Heathrow expansion and indeed before scrutiny by Parliamentary Select Committee and before a vote by Parliament which we expect to be in the autumn this year, 2017.**

### COMMENTS SPECIFIC TO THE 4 PRIORITIES IN THE CONSULTATION

***Priority issue 1: HAL must develop a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders on the potential options, costs and value for money.***

**RHC Response**

We agree with this principle. We believe the other stakeholders should include the local community and UK regions that may well experience economic disadvantage due to Heathrow market dominance. We believe protection for international-to-international transfers should be discounted or non-existent.

***Priority issue 2: HAL must develop robust cost estimates and we need to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way.***

**RHC Response**

We agree with this principle. It is essential appropriate contingencies are built into the estimates and that the budgets seek to resolve the many current issues on surface access and environmental impact.

***Priority issue 3: HAL must develop proposals for efficient financing and we need to develop the regulatory framework in a way consistent with efficient financing, affordability and financeability.***

**RHC Response**

We agree with the principle. But the project should not in any way be financed by the tax payer or local community and should be non-recourse in this respect. Excess profits from market dominance must be disallowed.

***Priority issue 4: HAL must develop coordinated proposals for existing operations (i.e. for the H7 price control) alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable.***

**RHC Response**

We agree with the principle. However, we believe shortage of financial capacity and the excess risks from high debt leverage of Heathrow's existing balance sheet should not be assumed as part of the expansion and if necessary should be made good by the existing shareholders before expansion. We also believe the substantial burden of ongoing core and replacement capital expenditure (see 5 above) should be recognised by the regulatory model. It is important the model is sufficiently long term to recognise ongoing risks and we believe that a 5 year regime is inadequate in this respect.

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