

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

## CAA CAP 1782 CONSULTATION

### Richmond Heathrow Campaign Response - 24 May 2019

#### INTRODUCTION

1. This document is the response of the Richmond Heathrow Campaign (RHC) to the CAA Consultation on Economic Regulation of Heathrow Expansion as contained in the document: *Economic Regulation of Capacity Expansion at Heathrow: Policy Update and Consultation March 2019 CAP 1782*. The consultation focusses on H7 development period (2022-2026) and in particular *ex ante* methods for incentivising efficient cost management.
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.
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's Final Report 2015 and by the government in the Airports National Policy Statement June 2018 (ANPS) supports this position, even though Heathrow's Northwest runway (NWR) expansion option was recommended in both cases. Our reasoning is set out in our responses to the DfT on the RHC website at [www.richmondheathrowcampaign.org](http://www.richmondheathrowcampaign.org).
5. As explained in our previous responses to the CAA consultations on economic regulation, we do not believe there is a scarcity rent so are not in agreement with the CAA on the benefits of additional capacity as stated in the current consultation.
6. RHC has responded to six CAA consultations on economic regulation- CAPs 1510, 1541 in 2017, CAPs 1610 and 1658 in 2018 and CAPs 1722 and 1769 in 2019. The responses and other material are on the RHC website.

## RHC RESPONSE

### Chapter 1 Approach to Financeability

#### **RHC Comment on CAA's Overall (holistic) approach to financeability**

7. Broadly, we support the financeability framework set out diagrammatically in Figure 1 of CAP 1782.
8. We think it would be helpful to put our response into the context of Heathrow's projected financial performance with a 3<sup>rd</sup> runway. Unfortunately, we have not had access to updates on Heathrow's financial forecasts for several years. This CAP 1782 says in para 3 page 6 '*Heathrow's forecasts of capital expenditure are broadly consistent with its 2017 Westerly Option estimates*'. But the accompanying CEPA report, March 2019, says '*details of capacity expansion at Heathrow remain highly uncertain*'.
9. All we can do here is refer back to our response to CAP 1541 in September 2017 (on RHC's website) where we assessed in some detail Heathrow's financial viability with a 3<sup>rd</sup> runway. The source of the figures for the cash flows was primarily from the PWC reports to the Airports Commission in 2014. We know that Heathrow did reduce the forecast capex by £2.5bn in late 2017, ahead of the ANPS 2018, and apart from this adjustment we believe the figures discussed below are broadly those estimated by Heathrow at the time of the ANPS 2018.
10. We await with interest Heathrow's imminent publication of its Master Plan with updated estimates.
11. Our response to CAP 1541 in 2017 showed that Heathrow expansion may not be financially deliverable without substantial State support. 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 before including substantial surface access costs. Excluding 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.
12. We find that if there is to be no increase in the aero charge compared to the Do-minimum option, then Heathrow's shareholders are likely to experience a drop in value of at least £12bn (based on incremental NPV), which approximates most of the debt and equity of Heathrow and clearly is untenable. To breakeven on the expansion requires the aero charge to be increased by 38% from first flight in 2026 compared to the Do-minimum aero

charge. The airline group - IAG has estimated similar charges. We believe a charge of £37.67 per passenger (real 2016 prices) would be unacceptable to airlines and passengers.

13. The ANPS rules out an increase in aeronautical charges in real terms so the passengers are protected. This leaves the tax payer through guarantees, financing of surface access and tax relief on debt interest to absorb much of the risk. We have argued previously, that Heathrow and the aviation sector already do not pay sufficient tax in comparison with other sectors of the economy. This was compounded last year when the Government exempted airports from thin capitalisation rules restricting interest tax relief on highly geared balance sheets. In addition, Heathrow's local communities will be at risk of being exposed to the costs of insufficient noise and air pollution mitigation and society as a whole to insufficient mitigation of climate change. **We urge the CAA to avoid satisfying the affordability and finaceability requirements by any or all of the means described here.**
14. If the regulation model cannot satisfy affordability and financability then higher traffic volumes could improve the situation by not only improving the revenues but also spreading the costs over a larger number of passengers. We believe Heathrow's runway capacity could be substantially higher than 740,000 flights per annum and that Heathrow will seek to use this to remain financially viable, provided there is the demand. The problem is that there will be consequential adverse environmental impacts, the mitigation costs of which will not be adequately included in the economic regulation or the DCO decision. **We urge the CAA to take the environmental costs into account.**
15. In the circumstances we describe above, where expansion is not financially deliverable without adverse impacts, **we urge the CAA to direct the risks to the shareholder, as in other commercial organisations.** CAP 1782 seems to suggest Heathrow needs to be protected and if that means the shareholder then we strongly disagree.
16. The CAA proposes using a holistic approach and one in which all capex is taken into account. As Table 1 below illustrates, NWR capex represents only part of the total capex and the model as presented does not address how best to deal with the substantial core and replacement capex.
17. Table 1 on the next page contains RHC's 2017 capex estimates based on PWC estimates to the Airports Commission 2014 plus RHC estimates of Heathrow's share of surface access costs.

£ million	H6+	iH7		H7 Period						
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
								1 <sup>st</sup> flight		
NWR 3.5% esc	474	980	2029	2935	4332	5022	4817	2039	1465	135
Core capex 3.5% esc	113	277	586	775	1004	1640	2023	2036	2043	1847
Asset replacement 3.5% esc	345	362	375	388	412	430	450	523	588	631
Surface access	0	1000	1500	1500	1500	1000	1000	0	0	0
<b>Total Capex</b>	<b>932</b>	<b>2619</b>	<b>4490</b>	<b>5598</b>	<b>7248</b>	<b>8092</b>	<b>8290</b>	<b>4598</b>	<b>4096</b>	<b>2613</b>

18. The H7 control period would need to be 6 or 7 years instead of 5 years duration if most of the remaining NWR capex is to be covered, which we believe it should.
19. Insufficient attention is being paid to the environmental costs. The ANPS established policies for noise, air quality, carbon and surface access. The policies require that capacity be released only in so far as the criteria for the four environmental issues are satisfied. CAP 1782 suggests that the DCO process will result in only minor changes to Heathrow's Master Plan, but we believe the changes could be substantial when the environmental caps are considered by the planning inspectorate during the DCO process. Conversely, the risk to society and more specifically to local communities is that the restrictions (e.g. noise envelopes) will be weak and ineffective and that the changes to the Master Plan will indeed be minor.
20. While the CAA has reported on surface access in previous consultations, it is not clear how the Approach to Financeability (Chapter 1) and Incentives for Capital Expenditure Efficiency (Chapter 2) and Heathrow's licence (Chapter 3) could be applied to surface access.
21. We suggest CAP 1782 might have expanded on the use of contingencies and optimism bias included in the capex budgets. The Annex here shows the Heathrow estimated capex prepared by Jacobs (it matches Table 1 except for small rounding differences). The optimism bias is 13% and the contingency 14.5% of total capex. The release of the contingency and optimism bias is a crucial part of managing the capex.
22. CAP 1782 does recognise that the suppliers could absorb part of the development risk, for example with fixed price contracts. But the allocation of risk in this manner probably results in higher priced supply. It will be important to establish the allocation of risk to suppliers in time for deciding the allocation of residual development risk to Heathrow.
23. CAP 1782 suggests that timing of the capex is secondary and in consequence demotes the use of annual targets and control. We suggest the opposite in that the success of large complex capex projects depends very much on the critical path. Cost increases often result

from projects taking longer and slippage on timings often indicates underlying cost increases are on the way.

**RHC Comment on what assumptions the CAA should make on capital structures and gearing**

24. Broadly we believe it would be preferable to use Heathrow's proposed financial structure, whatever that might be, rather than a notional say 60% debt level. As we have said previously we believe there should be a cap on the level of gearing. High levels of gearing indicate Heathrow is making sufficient excess profits to support the debt or the Government is providing support, for example, by way of guarantees - neither of which is appropriate in our view, especially because of the tax relief on the debt interest. Furthermore, the proposed structure would be more consistent with credit ratings and credit ratios used in the financeability framework.
25. The penalties and rewards associated with a regulatory *ex ante* incentive scheme might give greater volatility to the financial risk but if the incentives result in more efficient expenditure then overall the financial risk should reduce. It would appear that an *ex ante* scheme would provide greater certainty compared to an *ex post* scheme where adjustments are left until after the expenditure has been incurred. This should be welcomed by the lenders and so reduce the costs of debt.

**RHC Comment on the CAA's approach to stress testing and credit ratings and metrics**

26. Broadly, we support the CAP 1782 approach to stress testing and credit ratings and metrics.

**RHC Comment on what approach the CAA should take to financeability adjustments**

27. Broadly, we support the CAP 1782 approach to financeability adjustments.

**Chapter 2 Incentives for Capital Expenditure Efficiency**

**RHC Comment on the models described in CEPA's report, including any possible improvements or refinements that we should consider**

28. We commend the CEPA analysis of both the regulatory model and governance model as applied to ex ante cost efficiencies. We would welcome the models being applied to the costs that we identified in Table 1 and the Annex or better still the costs to be published shortly in Heathrow's Master Plan. On balance we would prefer to include detail costings rather than rely on an overall programme cost. We generally support the *ex ante* approach.

**RHC Comment on CAA's initial view that the regulatory model would provide better incentives on HAL to control the overall costs of its capital programme**

29. There is a question of how quickly does capex and capex over- and under-runs feed through into aero charges. We have discussed the topic in previous responses and are in support of what we believe is the airlines' position that there should be no pre-loading of costs. In other words, costs used to provide expansion should be matched with the revenue generated by the expansion. In short, today's passengers should not have to pay for tomorrow's

additional passengers. The RAB model, whereby depreciation spreads cost recovery over time, does by and large achieve this matching. However, arguably the incentives and penalties of *ex ante* regulation means that the impact on HAL of the incentives is deferred likewise and perhaps should be designed to have a more immediate impact on Heathrow.

**RHC Comment on specific issues that we should consider during the next stage of our work on capital expenditure efficiency incentives.**

30. The substantial capex in the iH7 control period (see Table 1), recently consulted on (CAP 1769), is not adequately addressed by the proposals for iH7 regulation. The total capex in 2020 and 2021 could be around £7bn according to Table 1.

**Chapter 3 Promoting Economy and Efficiency**

31. This chapter focusses on adding to Heathrow's economic licence. We commented on this question in our response to CAP 1722 in January 2019 and have no further comment here.

**Chapter 4 Alternative Delivery Arrangements**

32. This chapter focusses on the Arora's proposal for building a terminal and other works at Heathrow in connection with the airport's expansion. We commented on this question in our response to CAP 1722 in January 2019 and have no further comment here.

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Annex attached

**TABLE 2**

**Heathrow Capex Source Jacobs 2014 real prices £ million including mitigated optimism bias**

	Total	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035
Terminal Buildings	3482																						
Plant	729						17	34	69	98	143	159	141	41	27								
Tunnels and Bridges	0																						
Transit Systems	1232						6	13	25	112	241	334	320	109	72								
Runways	180						9	18	36	36	36	27	18										
Taxiways and Aprons	642						20	41	82	82	82	73	87	105	70								
Equipment	1143									59	147	233	287	250	167								
Land	2880						144	288	576	576	576	432	288										
Airfield Ancillary	758						34	68	136	140	146	117	87	18	12								
Car Parks	577									14	36	58	83	86	84	60	40	30	4	13	26	26	17
Thrid Party Land Use	91						5	9	18	18	18	14	9										
Environment	669						33	67	134	134	134	100	67										
Community	400						20	40	80	80	80	60	40										
Optimum Bias	2302						52	104	208	291	415	464	430	176	122	11	7	5	1	3	5	5	3
Risk	2558						58	116	231	323	461	516	478	196	136	12	8	6	1	3	5	5	3
<b>TOTAL</b>	<b>17643</b>						<b>398</b>	<b>798</b>	<b>1595</b>	<b>2229</b>	<b>3180</b>	<b>3559</b>	<b>3297</b>	<b>1351</b>	<b>937</b>	<b>83</b>	<b>55</b>	<b>41</b>	<b>6</b>	<b>19</b>	<b>36</b>	<b>36</b>	<b>23</b>
Nominal +3.5%pa		1	1.035	1.07	1.11	1.15	1.19	1.23	1.27	1.32	1.36	1.41	1.46	1.51	1.56	1.62	1.68	1.73	1.79	1.86	1.92	1.99	2.06
Nominal +3.5%pa	<b>24.625</b>						<b>473</b>	<b>981</b>	<b>2029</b>	<b>2935</b>	<b>4334</b>	<b>6020</b>	<b>8814</b>	<b>12041</b>	<b>16465</b>	<b>134</b>	<b>92</b>	<b>71</b>	<b>11</b>	<b>35</b>	<b>69</b>	<b>72</b>	<b>47</b>