HEATHROWWEST

Your Choice For A New Terminal

HEATHROW WEST'S RESPONSE TO CAP 1812

WORKING PAPER SUMMARISING AFFORDABILITY AND FINANCEABILITY MODELLING FOR CAPACITY EXPANSION AT HEATHROW AIRPORT

1. Introduction

1.1. Heathrow West Limited (HWL) is pleased to provide a response to the CAA's consultation paper, CAP 1812, "Working paper summarising affordability and financeability modelling for capacity expansion at Heathrow airport".

1.2. HWL is progressing a DCO application for components of the Airports National Policy Statement (ANPS), which includes the additional terminal capacity required to support a third runway. HWL's proposals are known as Heathrow West and provide the opportunity to introduce competition into Heathrow Airport and to realise benefits for consumers.

2. Executive Summary

2.1. We believe that HAL's masterplan and the infrastructure covered by the CAA's modelling in CAP 1812 is considerably broader than the provisions of the ANPS. This is in terms of scope, capacity, phasing and timescale. This means that the true cost of HAL's implementation of the ANPS is being hidden within HAL's longer term and broader ambitions and aspirations.

2.2. This prevents the true cost of implementing the ANPS to be clearly identified. For example, the CAP 1812 modelling appears to relate to HAL's masterplan and at a cost of c. £32.5bn. However, HAL's positioning has been around a forecast cost for the new runway, excluding any terminal capacity of c. £14bn.

2.3. This means that different issues and infrastructure assumptions and timings are being mixed and that the costs of implementing the ANPS are not clearly visible within the CAA's consultation material. Clear focus and transparency on ANPS costs and benefits is necessary to enable a true comparison to be made with alternative parties and delivery mechanisms for implementation of the ANPS. We request the CAA to clearly identify and provide transparency on the true costs of the ANPS to enable this comparison to be made.

2.4. In CAP 1812, the CAA asserts that there are credible scenarios against which the expansion programme put forward by HAL is affordable and financeable. We strongly challenge this conclusion by the CAA. The consultation demonstrates that it is extremely unlikely, if not impossible, that HAL will be able to meet the affordability challenge set by the Government.

2.5. Our view is that HAL's costs are continuing to increase and are increasing very significantly. HAL has recently requested that it be allowed to spend £3bn before it has even obtained planning permission. Whether or not it achieves planning permission, it is also requesting that £3bn be put onto passenger charges. This shows a project where the costs are out of control and regulation is unable to exercise proper control and scrutiny.

2.6. There is an alternative to costs being allowed to balloon in this way. That is by the promotion of competition rather than regulation. Heathrow West provides the opportunity to build, own and operate the new terminal, providing the potential for lower airport charges and crucially lower airline fares, while allowing passengers and airlines choice. Introducing competition into Heathrow will complete the competition dynamic started with the break-up of the airport monopoly in the UK.

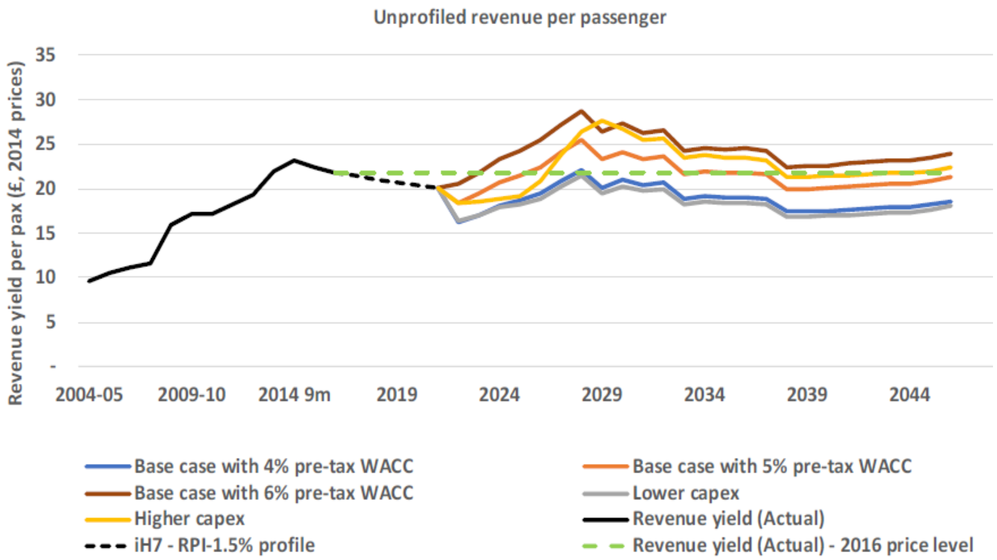
2.7. Affordability and financeability are at the heart of expansion, being in the interests of consumers, airlines and the UK economy. As a result, it is incumbent on the CAA to take a rigorous approach to its assessment of these elements in HAL's expansion plans and we urge the CAA to address our concerns set out in this response.

3. "A range of credible scenarios"

3.1. We have reviewed the CAA's analysis contained in CAP 1812. Our high level summary of the consultation is somewhat different to that of the CAA. In CAP 1812, the CAA concludes that *"there are credible scenarios in which expansion of Heathrow is both affordable and financeable."*

Figure 1 is re-produced below.

Figure 1: illustrative price paths



Source CAA analysis

3.2. The CAA's conclusion (which it concedes is "high level and illustrative") relies in part on the fact that there is a "lower capex" or lower WACC scenario that allows the affordability challenge to be met. We would tend to dismiss both of these scenarios as being plausible. Three factors bring us to this view.

3.3. First, we can now see that HAL's pre-construction costs are already higher than had been forecast. CAP 1819[1] sets out in detail how HAL's Category B and Category C costs have increased significantly and over a relatively short period of time. Indeed, CAP 1819 shows that HAL's estimate of Category C costs increased by over £1bn between October 2018 and early 2019.

[1] Heathrow West will be submitting a separate response to CAP 1819

3.4. Second, it is not clear how much capital expenditure is required after the opening of the runway. There appears to be a significant amount of capex in the Central Terminal Area and north of Terminal 5 that was not envisaged by the Airports Commission. This would seem to put an upwards pressure on the capital expenditure that should be associated with the project.

3.5. Third, the cost of capital assumed by the CAA to reach one of the "plausible" scenarios is 4% pre-tax real. While we understand that this lower figure is only used for illustrative purposes, we would be very surprised if this level of cost of capital was acceptable to HAL given the risks that are associated with a project of the complexity of Heathrow's expansion. Any assumption of a higher cost of capital leads to scenarios that show that the affordability challenge set by the DfT seems unlikely to be met by HAL.

3.6. We would therefore conclude that there is only a very limited chance that the affordability challenge will be met by HAL.

4. The case for competition

4.1. In view of the evidence and likelihood that HAL will be unable to meet the affordability challenge, it is critical for the CAA to actively consider Heathrow West's proposals for a competitively constructed and operated terminal and to include this option in an open and level process.

4.2. At a high level, Heathrow West's proposals will make it more likely that the affordability challenge can be met:

4.3. First, we expect the terminal construction and operation to be more efficient than any HAL counter-factual. We will be able to demonstrate this by a comparison of like-for-like capital expenditure projects at the airport.

4.4. Second, the competitive pressure put on HAL by Heathrow West's proposals should lead to a downward movement in HAL's cost of delivery in the rest of the airport. We would expect that the ability to compare and contrast the delivery of capital expenditure should be welcomed by the CAA. We observe with interest the desire of Ofgem to have competitive tendering for infrastructure that to date has been provided by the incumbent regulated monopoly. Thames Tideway is another example of infrastructure that has been traditionally provided by the incumbent regulated monopoly, now being provided by an alternative provider.

4.5. Third, competition in the provision of infrastructure at Heathrow will lead to a reduction in air fares, which will be to the benefit of passengers. The Airports Commission, the Government, the regulator and HAL itself all believe that extra runway capacity will lead to lower fares. We agree. However, we believe that the competitive dynamic introduced by competing terminal operators seeking to attract passengers and airlines will lead to lower fares still.

4.6. The Airports Commission was clear that the possibility of low fare airlines into Heathrow would be to the benefit of passengers. We consider that the willingness of low fare airlines to come into Heathrow will be greater with an independent terminal operator. We see no reason why the introduction of low fare airlines will undermine the status of Heathrow as a hub, but at the end of the day, it will be for passengers to choose how they want to use the new facilities.

4.7. Finally, there have been a number of reports into the benefits of terminal competition, including Walbrook Economics, the Adam Smith Institute and Frontier Economics. We include a summary of the relevant conclusions in the attached Appendix.

5. Accuracy of data

5.1. CAP 1812 highlights at paragraph 1.7 that the estimates generated by the CAA's model are caveated by the high level nature of the capital expenditure forecasts provided by HAL. We consider that this is a serious issue to be addressed by the CAA and that the CAA must seek from HAL complete and substantiated forecasts so that the CAA can undertake a thorough assessment. The recently issued consultation on Category B and Category C costs gives no confidence that HAL has any control of the costs of the project.

6. Financeability

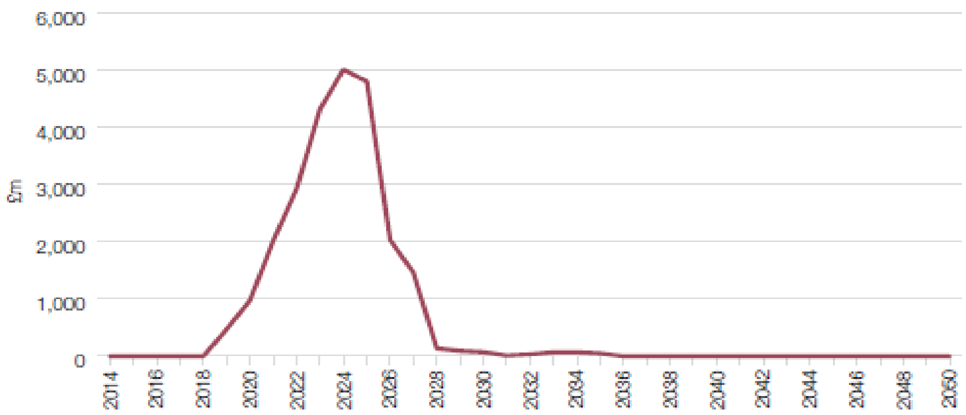
6.1. We note that the financeability analysis is based on a notional gearing level of 60%. In a business as usual scenario, the use of notional as opposed to actual gearing is a standard approach by a regulator. However, the scale of the project being proposed by Heathrow – capital expenditure of over £32bn against the existing RAB of c. £15bn, appears to put a high degree of financial risk on HAL. Clearly, any acceptance of the proposal by Heathrow West to construct the new terminal and associated infrastructure would reduce the financial risk of the project to HAL. In addition, diversification of risk across two companies would reduce the overall risk of the project.

6.2. Financeabilty and affordability are of course intrinsically linked. That is, if the airport charges arising from the development mean that airlines are not willing to pay, the forecast revenue would not be forthcoming to pay the equity and debt costs that will be necessary to support the project. The level of airport charges will also be an important consideration for any new entrants.

7. Project phasing

7.1. The diagrams below show the different capital expenditure profile that is now being suggested by HAL. The first diagram shows the profile given to the Airports Commission and upon which the decision to select the Northwest runway was made. This shows the majority of expenditure was to be completed by 2026 in line with runway opening at that time. This expenditure included a new terminal. At the time, the Airports Commission estimated that expansion would cost £17.6bn (at 2014 prices).

Figure 4.2: Scheme Capex requirement under the AoN-CC demand scenario (£m) 2014 prices

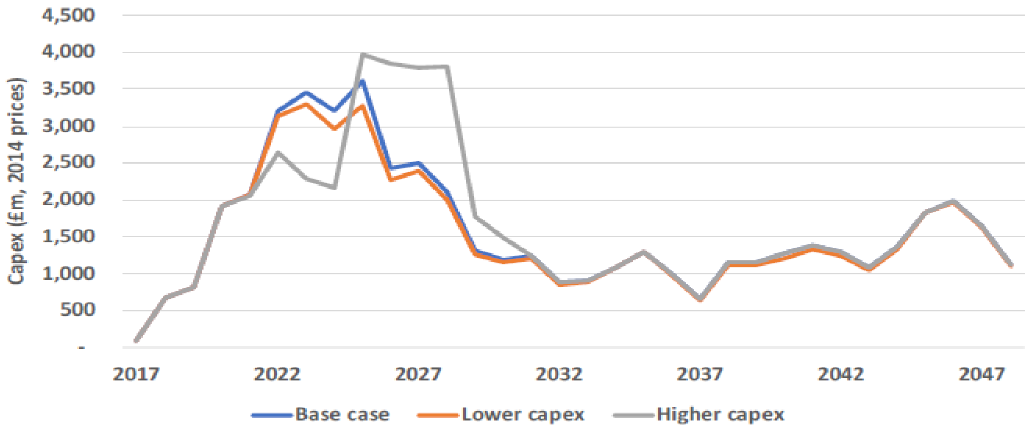


Source: Airports Commission analysis

7.2. The diagram below shows the profile as contained in CAP 1812. This shows that the cost of expansion is now £32.5bn (at 2014 prices). The capital expenditure is both higher than given to the Airports Commission and involves significant expenditure after 2026. Indeed, there is much expenditure after 2030. This seems to challenge the requirement of the National Policy Statement that the runway and terminal facilities are delivered by 2030.

7.3. We understand – and the CAA has confirmed - that the £14bn being used by HAL "to runway opening" no longer includes a terminal. This therefore represents a very different project to that suggested to the Airports Commission.

Figure 5: Capex profiles



Source: CAA analysis

7.4. We have scrutinised the financial model that has been published by the CAA. We note that the model has not been updated for this particular consultation. However, it is difficult to unpick the single capex line that is contained in the model. In particular, we are trying to reconcile the Airports Commission's £17.6bn vs HAL's later £14bn vs CAP1812's £32.5bn (all at 2014 prices). It appears on the face of it that the expansion project in HAL's masterplan is now significantly different and more expensive that had been assumed by the Airports Commission and involves major infrastructure being developed later than had been assumed by the Airports Commission.

7.5. We would expect that the CAA is able to demonstrate how the line by line capital expenditure profile given to the Airports Commission has developed since the Airports Commission's conclusions. Our suspicion is that the combination of expansion capital expenditure and business as usual capital expenditure is intended to hide the increase in expansion costs. While HAL is claiming that expansion costs have reduced, we believe that expansion costs have in fact increased significantly.

8. Cost of capital

8.1. We note that the CAA is considering giving longer term guidance on the cost of capital (i.e. beyond 5 years). Given the scale of the project, this seems a sensible consideration by the CAA. The CAA would have to ensure that any longer term guidance was binding on its successors.

8.2. In general, we have concerns that the cost of capital that is being suggested appears too low for a project of this complexity. In particular, the mark-up for the construction risk of the runway appears very low. We would be surprised if HAL was prepared to proceed with the project at the cost of capital proposed by the CAA. Again, allowing the terminal and associated infrastructure to be constructed by an alternative provider to HAL would allow the CAA to consider alternative financing frameworks which would assist when considering an appropriate cost of capital for HAL.

8.3. We also have concerns that the CAA has not got to the bottom of where the debt is sitting in the Heathrow financial structure all the debt is sitting. The current financial structure has a degree of subordinated debt sitting above the regulated entity. The CAA will need to ensure itself that the financial structure being proposed by HAL will not lead to undue financial stress on HAL. There must be some concern that if HAL is allowed to proceed with the entire project, and there is a degree of financial stress caused by external events, that there might not be any alternative to taxpayers and / or passengers being asked to bail HAL out. We note that the insolvency provisions seen in other regulated sectors do not apply to HAL.

13th August 2019

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Appendix 1

Previous analysis supporting the case for terminal competition at Heathrow

The case for competition has been developed and articulated in recent independent reports by Walbrook Economics and the Adam Smith Institute. These reports build on earlier work by Frontier Economics for Easyjet in 2008.

The Walbrook Report says:

> "If airline monopoly stiffed competition, raised prices and reduced choice, is it not odd that airports have not moved with the times? Why must entire airports be owned by one operator? Would competing service levels between terminals not offer a better service and would not more competition offer a more effective use of valuable and scarce landing slots? Ultimately would competition not increase employment and choice in what can only be a win-win scenario?"

> "there is a degree of competition between Heathrow, Gatwick and Stansted, but the truth is that competition is really an illusion as each airport maintains an effective local monopoly."

> "By opening different terminals up to competition from different operators, this will quickly drive improved efficiency, increased choice and drive down prices."

The Adam Smith Institute says the following:

> "Currently, regulation is used to address issues of market power. However, competition is widely understood to deliver better outcomes in the economy. Many of the benefits of competition cannot be determined in advance. For example, when European aviation was deregulated and the number of airlines was allowed to be expanded, the specific model of Ryanair or Easyjet was not envisaged in advance, nor was an A380 first class suite. These were developed by innovative businesses who sought to identity a gap in the market. The existence of competition between airport terminals would

> diminish, if not alleviate, the need for other airport regulations and price controls. It would encourage investment in terminal capacity consistent with market demand, ensure terminal facilities are provided in an efficient manner, lower regulatory costs in the longer run, and reduce the need for price controls. The regulator, instead of setting price caps for per passenger charges, could focus on regulating the monopoly provision of runway usage, ensuring equal access no matter which terminal an airline uses."

Frontier, on behalf of Easyjet in 2008, had the following view:

> "Involving players other than the existing airport operator, in the provision of terminal facilities could be expected to result in a more efficient delivery of required additional terminal capacity. Ultimately, the market would determine the appropriate scale, design and timing of terminal capacity, reflecting the needs of passengers. Competitive pressures would also be expected to improve the service provided at existing terminals, as airlines have the opportunity to shop around for the best 'deal' amongst different terminal operators.
>
> Direct contracting between terminal providers and the airlines could also allow both parties to tailor the services being offered and the price for those services to the needs of the particular airline in question, reducing the "one size fits all" problem identified in the existing regulatory regime.
>
> Also, by allowing third-party developers to contract directly with airlines or groups of airlines to provide terminal facilities it may be possible to remove the issues of the design and cost of these facilities from the CAA's regulatory problem, thus greatly simplifying the price-setting task that it faces."

This report from Frontier is particularly important. The concept of terminal competition was considered by the Competition Commission in 2009, and they concluded that the law should be changed to give the CAA the option to introduce terminal competition. Heathrow West's proposals complete the competition journey started with the break-up of the airport monopoly in the South East.