

Arora Group's response to 'CAP1541: Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow'

Introduction

This response to CAP 1541 is submitted by the Arora Group and in collaboration with the Bechtel Group. We are pleased for the opportunity to present our views on how the Heathrow expansion programme should be delivered, owned and operated.

We believe that expansion at Heathrow provides a great opportunity to open up the airport to competition to the significant benefit of users. We believe this should start with the delivery of the Heathrow expansion programme and extend to subsequent ownership and operation of the expanded airport.

The Arora Group is a major private property, development and hotels group. It is based at Heathrow and its business is predominantly airport-focused. It is also the major landowner within the Government's preferred North West Runway (NWR) scheme. Bechtel is an international Group, experienced in the inception and delivery of major airport infrastructure projects.

For convenience, we have structured our response by following the chapter headings set out in the CAA's CAP 1541 document.

Background

The Arora Group submitted a response to the Government's NPS consultation on Heathrow expansion on 25th May 2017. The submission was prepared in conjunction with an industry leading design team led by Bechtel, who provide extensive experience and expertise in airport design and delivery on a world-wide basis.

The key points made in the NPS were as follows:

- Our support for expansion at Heathrow and for the Government's NWR scheme.
- Our team's credentials as potential developers of the Heathrow expansion programme.
- Opportunities were identified for potential design improvements to the Government's NWR scheme, particularly the length and position of the new runway, the more efficient design of the western campus and the option of retaining Terminal 3 within the Eastern Campus.
- How our design and delivery approach can reduce estimated cost and project risk considerably. Our NPS submission included a cost estimate for the existing NWR scheme of £12.4 bn and potential to reduce this to £10.9 bn if the full design opportunities were to be adopted. These estimates are significantly below known existing cost estimates.
- That our approach is highly customer focused and our proposals have been prepared in conjunction with Heathrow airlines.
- That our proposals address the key issue of Heathrow expansion affordability for airlines and users.
- That our options show there is no worsening of the environmental impacts of the NWR scheme and that there are likely to be benefits, particularly a significantly reduced land take, less community disturbance and the opportunity to reduce the impact of bridging the M25 motorway.
- That Heathrow expansion is a great opportunity to introduce competition into the airport, both in terms of efficient delivery and how this can lead to competition in subsequent ownership and operational responsibility at an airport level.

Our proposals and opportunities were subsequently publicised in July 2017. They received widespread media coverage and interest. We have since

continued with a widespread stakeholder engagement programme, including the DfT. We are also progressing next stage design activities.

Chapter 1 – The January 2017 Consultation: Stakeholders’ Responses

We note the CAA’s summary of the January 2017 consultation and agree with the CAA’s view that increased airport capacity in the South East is much needed and is in consumers’ interests.

We also agree with the CAA’s key priorities that Heathrow expansion should be aligned to consumer requirements and be delivered in a cost effective manner, which makes the scheme affordable and financeable.

We are particularly pleased that Heathrow airlines supported the suggestion that it should be possible to develop alternative delivery mechanisms, with certain assets designed, developed and delivered competitively, with financing outside the RAB/Single Till. This appears to align with the CAA’s conclusion that “the RAB approach does not preclude commercially negotiated alternative delivery arrangements”.

However, we believe the CAA should view this in a wider context as to how this could align with a more strategic objective of introducing competition to Heathrow at an owner and operational level. We consider this approach is in line with the CAA’s obligations, which focus on the interests of users of airport operational services (AOS), including capacity expansion and to promote competition.

Chapter 2 – Regulatory Framework

In this Chapter, the CAA seeks views on the current regulatory framework and how alternative delivery arrangements could be incorporated to benefit consumers.

Heathrow is currently owned and operated by a single private entity, Heathrow Airport Limited (HAL). HAL's activities are licenced by the CAA. The current licence commenced on 1st April 2014. Licensing derives from the CAA's Market Power Test (MPT) which was most recently applied in January 2014. This determined that Heathrow has market power for both full service carriers and associated feeder traffic.

The licence acts as a check on HAL, both in terms of its existing operational role and any role it may have in the delivery of Heathrow expansion. However, we feel strongly that these regulatory controls are not a perfect substitute for the benefits which would be provided to airport users by true competition. This is reflected consistently in our feedback from airlines through our engagement process.

Themes we have heard from airlines relate to both expansion delivery as well as day to day activities and headlines include the following:

- Airlines have no choice, but to receive services from HAL as the single owner and operator at Heathrow. They would prefer choice to be introduced.
- Regulation acts as a check on HAL's dominant position, but true competition would be much more effective.
- Aviation charges at the airport are too expensive, to the detriment of passengers and airlines. Heathrow is the most expensive commercial airport in the world per passenger.
- HAL is inefficient in implementing its capital expenditure and the RAB approach "rewards" excess spend.
- Airlines have limited confidence that HAL will be able to deliver an efficient and effective Heathrow expansion project.
- The RAB is an inappropriate mechanism to fund a project of the scale and complexity of expansion. Nor is it well suited to deal with risk and reward, which is the essential characteristic in a development activity.
- There is inadequate transparency on the RAB.

- HAL's operating costs are too high.
- The current WACC is too high and doesn't reflect the underlying risks.
- There is an absence of partnership between HAL and airlines in addressing the interests of passengers.

All airport costs ultimately feed into user charges and so it is critical that these are controlled and made as efficient as possible.

Heathrow expansion will be of a scale and complexity not experienced at the airport previously. As such, we are pleased that CAP 1541 recognises the advantages that could be realised by opening up the Heathrow expansion programme to delivery by a third party. This would be based on the principle of design, development and funding outside of the RAB / Single Till. We do not agree that HAL should be assumed as the sole delivery agent.

We also believe that this should be structured in a manner that leads to the introduction of competition in subsequent airport ownership and operation. From our feedback, this approach has the support of airlines and would give Heathrow expansion the best chance of success and deliver long term benefits to consumers.

We provide comments on the introduction of competition at both levels as follows:

Alternative Delivery Mechanisms

Heathrow expansion will be one of the UK's most significant infrastructure projects. Its scale and complexity means it should not be undertaken on a business as usual basis. It will require the very best market-led approach by a team who have the experience and capability to deliver it. Only this approach will ensure its success and the protection of user and consumer interests.

The CAA refers to alternative delivery mechanisms. There would be a variety of structures which could be adopted, but very simply it is the principle of introducing a third party developer supported by a highly capable team, using private finance outside of the existing RAB.

We consider that the Heathrow expansion project is perfectly suited to this approach and that competition is the means to secure the necessary change in

behaviour. Financing outside of the RAB will enable a more robust link between risk and reward, meaning decisions are made on a commercial basis, rather than through a regulatory framework where the RAB approach serves to support HAL's returns. Our approach would adopt the following principles:

- A development led approach integrating the full spectrum of activities from design through to delivery and to subsequent operation.
- Benchmarking to establish best practice and with related transparency.
- Establishing a highly customer focused approach, with a robust link between a third party developer and customer airlines. This would establish scope, cost, reward and performance.
- A holistic business case linking development and cost to subsequent ownership and operation.
- Raising of private finance outside of the RAB at competitive rates and separating users from development and cost risk.
- Using the world's best team with international experience and expertise in delivering infrastructure projects of this magnitude.
- Achieving the best and most efficient design, based on international airport experience and learning and a relentless focus on customer operational requirements. This is in evidence from the design options set out in our NPS submission. This approach is already addressing the cost and affordability issue and has the confidence and the support of airlines.
- Use of the best delivery suppliers with first-hand experience in major infrastructure projects around the world.
- A strategic, planned and collaborative approach to procurement, involving close integration of the entire supply chain and client structure.
- Phasing in procurement and construction to maximise benefits in operations and early commissioning and use of facilities.
- The early development of design that is focused on delivery, so that principles of DfMA (Design for Manufacture and Assembly) can be adopted widely.
- A planned approach to off- site logistics and fabrication.
- A single and flexible delivery organisation structure with single lines of communication and decision making for expediency.
- Proactive risk and opportunity management with early warning signs and regular control and assessment.
- A project culture and environment that is unified and encourages innovation and progressive thinking.

- The introduction of asset management and commissioning principles at the earliest opportunity to avoid on stream delays.
- The opportunity to integrate airlines into the project at the earliest stage.

In CAP1541, the CAA discusses safeguards which may be required on HAL to address cost risk for Heathrow expansion and to protect the interests of users. This should include the option of adding an additional licence condition for airport development to take place in a maintained and efficient manner and should take into consideration the opportunity for a third party(ies) to develop and / or offer a commercially sound alternative to that of HAL.

Given the scale and complexity of Heathrow expansion, our contention is that the substantial level of project cost and risk, is best situated outside of the RAB and within the remit of a development-led team who are able to secure non-RAB finance and identify, manage and cope with risk effectively. Therefore we do not consider that the apportionment of cost risk between HAL and users within the RAB is the right solution to the issue.

This would have the advantage of separating users from the substantial cost exposure. We are concerned that seeking to place risk of this magnitude to parties who are unable or unwilling to absorb it, will create delays. The best solution is to bring capability into the risk issue and to integrate this with a private finance structure outside of the RAB.

Competition in Ownership and Operations

We feel strongly that third party expertise should not be restricted to delivery, but should be structured in such a manner as to naturally lead to the introduction of competition into the airport as a whole at an ownership and operational level. Only this approach will enable the efficient delivery of the Heathrow expansion project and the introduction of competition and real choice for users once it is completed.

We would therefore strongly encourage the CAA to consider this broader objective, which we believe will best serve the interests of users and has their general support. We don't believe that there is a single way of structuring this separation, but believe the overall objective should be to introduce choice for users by way of competing owners in the provision of capacity and services at the airport. This would have the following effect:

- Owners competing with each other for airline and passenger business.
- Competition applying competitive pressure on user charges.
- Stronger potential for leasing and bi-lateral agreements with airlines.
- Service standards and facilities more closely aligned to user requirements.
- More sharing of risks and upsides.
- More partnership between operators and customers.
- Stronger potential for a joint approach to enhancing passenger experience.
- Greater accountability.
- More joined up investment decisions.
- Potential for lighter-touch regulation.

We believe this can be most easily achieved by the facilitation of competing owners and operators for terminal capacity, either at a terminal or campus level. As we have said previously, Heathrow expansion would be an ideal platform to create this separation through third party delivery. As an example, the Western campus would be an obvious ownership separation point from the existing Eastern and Southern campuses, each having broadly equivalent capacity.

We realise that if separation is to occur, the point of separation would need to be carefully defined, so as not to create duplication and inefficiency. It should also ideally align with the Heathrow expansion development responsibilities. We also feel that certain common airport infrastructure should be operated at an airport level. An obvious example is the actual three runways at Heathrow.

We do not plan to identify all of the options as to how this separation could be structured in this response to CAP 1541, but would encourage the CAA to consider the underlying principle as a means of introducing much needed competition at the airport. This would have the related advantage of potentially reducing the degree of regulation. We would welcome the opportunity to set out and discuss our thoughts on these options with the CAA in due course.

Partnership and Collaboration

We are conscious that a third party's involvement in delivering Heathrow expansion and the introduction of subsequent ownership and operation will require significant integration, collaboration and partnership with HAL.

We have a good record of working with HAL and we would encourage the CAA to actively promote and facilitate this for Heathrow expansion. Close integration would provide the best result for users, albeit we recognise that some structures may result in us competing directly with HAL.

Chapter 3 – Incentives

In this chapter, the CAA seeks views on the manner in which HAL should be incentivised to operate and invest efficiently.

We believe this issue only arises as a consequence of HAL being in a single supplier situation and regulation having to incentivise what is normally provided by market conditions based on competition. The very nature of the CAA having to create incentives for efficiency is in itself endorsement for the merits of third party involvement.

In a competitive environment, there would be inherent incentive and requirement for a developer and subsequent owner and operator to address the issues set out in this chapter by the CAA. We believe that entrusting Heathrow expansion to a third party developer who is able to construct a holistic business case from inception through to subsequent ownership and operation would best address the interests of users.

Chapter 4- Costs: Incentives and Efficiency Assessment

In this Chapter, the CAA seeks views on the regulatory treatment of costs and the development of incentives for efficiency.

For Heathrow expansion to occur and to be successful, it must be designed and delivered efficiently in line with best market principles and in line with user requirements. Only this approach will enable the project to be delivered at a competitive cost and to be affordable and fundable.

Our NPS submission makes the fundamental link between design, delivery, cost and affordability. The key points are on cost are summarised as follows:

- For comparison, we assumed a HAL baseline cost of £17.6bn (Airports Commission, Jacobs report, June 2015). There are indications of a range of cost between £15.6bn (May 2014) and £20.6bn (House of Commons, April 2017).
- All of the known HAL estimates are in the form of a high level elemental summary, and we are not aware of any detail and transparency.
- This assumed HAL cost baseline is believed to exclude c. £4.8bn of surface access costs, including a proportion of the M25/M4 costs. We have assumed that these elements are proposed to be funded by the Government or are currently unknown.
- We believe that the above costs are unnecessarily high and make the NWR scheme potentially unaffordable for users (see our comments in Chapter 5 ahead).
- Our NPS submission set out the opportunity for various design improvements to align expansion with user requirements, to reduce cost and to make the scheme affordable. These options have the support of airlines.
- Our NPS included a detailed cost estimate prepared by Doig and Smith, Chartered Quantity Surveyors. For direct comparison, their cost estimates are summarised as follows:

Option	Estimated Cost
HAL NWR Scheme	£17.6bn
Option A – Runway as HAL NWR, but more efficient Western Campus	£12.4 bn
Option B – As option A, but retain T3 and avoid T2D and E	£10.9 bn

We would repeat our views expressed in Chapter 2 as to how an alternative delivery mechanism and a third party development approach is the best means of ensuring cost control for the protection of user interests.

Chapter 5 – Affordability and Financeability

In this Chapter, the CAA seeks views on issues relating to affordability and financeability of Heathrow expansion.

We consider these issues to be inextricably linked; an affordable scheme is inherently financeable. In contrast, a scheme which is unaffordable for its customers is unlikely to be viable and would be difficult to finance.

Heathrow expansion is critical to retail and business users in terms of providing much needed airport capacity. As such, this connect needs to be addressed as a key enabler for the scheme to proceed.

In Chapter 4, we have summarised the considerable variance between the HAL estimated cost and those prepared on behalf of the Arora Group in line with industry best practice. These cost savings arise from our different approach to development.

We believe that the link between affordability and financeability would be best enabled by a third party progressing Heathrow expansion, using private non-RAB funding and being able to make the necessary commercial connects between the project and customers.

If so, we consider that there would be strong potential investor demand for financing of Heathrow expansion from both a debt and equity perspective. We also believe that comparable major UK infrastructure projects e.g. Thames Tideway indicates that this funding could be at a substantially lower cost of capital than the existing regulatory rate of 5.6%.

Chapter 6 – Surface Access

In this Chapter, the CAA sets out its current surface access policy and seeks views on whether this should be updated, in the context of Heathrow expansion.

We share the CAA's view that the development of new airport capacity at Heathrow will generate an increase in passenger numbers and that high quality, efficient and reliable road and rail access will be a critical enabler, both for consent and subsequent operation of an expanded Heathrow. As such, expansion and new transport infrastructure are symbiotic and the latter should be encouraged.

Our response to the Government's NPS confirmed our support for the surface access principles set out by the Government for the NWR scheme. An expanded Heathrow will require improvements to both road and rail connectivity, but the primary focus should be on the rail element to enable our commitment to achieving the Government's requirement for a 55% public transport mode share by 2040. We expect this to be a binding commitment on the airport arising from the NPS. We are conscious that this might create an inherent conflict with HAL who currently control the majority of on airport car parking revenues.

We are supportive of both the Western Rail and Heathrow Southern Rail (HSR) proposals and Crossrail connectivity and would seek to enable and encourage these as key enablers for Heathrow expansion

In CAP 1541, the CAA is seeking views on the principles for funding of new surface access infrastructure associated with Heathrow expansion. It is difficult for us to be prescriptive at this stage, but our strategy for surface access funding would be to encourage private funding of new rail infrastructure to the airport and following a user pays principle.

Chapter 7 – Timetable and the extension of the price control

This Chapter relates to the CAA's views on the Q6 period and the requirement to align the current regulatory framework with the expansion design and consent process.

The current Q6 period continues until the end of 2019. We note the CAA's intention to extend Q6 by at least a further 12 months, until the end of 2020 or beyond. This reflects the CAA's recognition that Heathrow expansion carries a great deal of uncertainty and it would be difficult to set the H7 framework until this becomes clearer.

We regard the period of Q6 and the related price control as business as usual issues, reflecting the current regulatory framework. As such, we have no particular views on the period which should apply, or the related price control. However, we are conscious that considerable design, consent and related activities for expansion will be required during the period to the end of 2020.

Our response to CAP1541, set out in this submission, encourages the CAA to facilitate and enable the introduction of competition at the airport, both in terms of development responsibility and also subsequent ownership and operation. If the CAA adopts this approach, it will necessitate some structural change to current responsibilities. As things stand, these reside solely with HAL and so we would encourage the CAA to address this issue as early as possible.

This will enable all of the parties to focus on their specific end-game responsibilities and to avoid duplication and overlap. This will ensure that the expansion activities which will run alongside the H7 timetable set out in the CAA's Figure 2 are carried out by the appropriate parties and as efficiently and cost effectively as possible.

Conclusions

We are strong supporters of Heathrow expansion and are pleased to play our part in helping to make the programme a success. We are grateful to the many airlines who have provided their support and for their valued input to our proposals

We are pleased that the CAA has provided us with the opportunity to provide our views on how Heathrow expansion can be delivered in line with best industry principles and subsequently owned and operated in a manner which best serves the interests of users.

We believe that Heathrow expansion provides a great opportunity to introduce the benefits of real competition to the development, ownership and operation of the full airport. We would welcome the opportunity to discuss our proposals in more detail with the CAA in due course.