CAA CAP 1964

Economic regulation of Heathrow: working paper on the efficiency of HAL's capital expenditure during Q6

Response to consultation, Stephen Clark MA(Cantab)

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Introduction

This response to CAP 1964 is sent in an individual capacity although I am a member of Teddington Action Group (TAG) and gave evidence in 2018 to the Parliamentary Transport Select Committee on behalf of the no 3rd Runway Coalition. I have been a resident of Teddington for over 30 years.

I am now retired but am a past member of the Royal Institution of Chartered Surveyors and was a senior director of CBRE for 25 years, as well as holding non-executive roles with the Guinness Partnership, including chairman of Guinness Developments Ltd.

In a professional capacity I gave evidence as an expert witness at major planning inquiries, advised on significant infrastructure projects (including HS1) and specialised in provision of strategic advice in structuring private public partnerships, including to the Government of Luxembourg and the European Investment Bank.

Overview

Effective economic regulation of Heathrow's recoverable capital expenditure is essential as the airport dominates the UK aviation market and in practical terms occupies a monopolistic position as the country's main hub airport.

Under its regulatory framework, it operates on a 'cost pushed' model, rather than a market led basis. This potentially gives rise to inefficiencies and distortion in the UK aviation market. Both customers and the national economy could be at risk of high user costs associated with Heathrow as well as an expensive dominant hub airport which does not provide what UK aviation users actually want.

So far as it goes the analysis set out in CAP1964 shows how the CAA is seeking to fulfil its obligations under the current system in scrutinising the management efficiency of sample projects within Heathrow's Q6 programme. The CAA's findings reveal that some major schemes are running substantially over budget. Naturally this raises significant questions regarding what should be recoverable by Heathrow under the RAB model during the currency of the Q6 budget.

Most importantly it illustrates how HAL is failing to adhere to budget on some of its largest projects within the sampled schemes. This has significant implications having regard to Heathrow's ambitions for a third runway (which apparently it still holds). As with the Category B and C costs associated with expansion (please refer to my response to CAP 1918) there are serious overruns in relation to some of the current major projects. This raises questions about whether Heathrow would ever be able to control, manage and finance expansion, in the event the Supreme Court should reverse the Court of Appeal's decision to strike down the ANPS due to the failure of the former Secretary of State to consider an international treaty on climate change (which the UK had signed up to). Given HAL's corporate structure, its extremely high gearing and its track record in managing major projects within budget, there is significant risk that the UK government would need to bail the project out. In addition, airport users could be faced with much higher fees given the nature of the cost pushed funding model, disadvantaging the UK economy and its citizens.

A **key area not addressed** within this CAP 1964 review **is whether the projects** that have been approved in principle for RAB recovery under the existing Q6 programme **represent good value for money at outturn or are actually in the best interests of consumers and the national economy**. It seems Heathrow is able to invest in capital schemes that allow it to improve its asset base through favourable debt funding structures (harnessing RAB) whilst paying very substantial dividends to its international shareholders but comparatively little tax.

Especially given that Heathrow's expansion proposals may not proceed (whether due to environmental constraints, demand issues or financing problems) it is essential that **particular scrutiny should be paid to RAB project appraisal and selection**, as the costs may not be solely applicable to the airport's current operation and in reality, some or all of the cost could be treated as enabling expenditure for expansion (which is supposed to be privately financed).

A broader context

As noted, the CAP 1964 consultation is relatively limited in its scope in that it looks back at **how** approved capital **schemes have been** project **managed, rather than whether they offer overall value in the first place**.

Against this background, it is of concern that the CAA is beginning to consider (as stated in consultation CAP 1966) starting the budgeting process for period H7 as early as January 2021. By this time, it is (i) open to question whether the Supreme Court will have published its decision, (ii) even if it has whether the scheme will still be financeable in the light of the history of cost overruns, the impact of Covid on the aviation sector, Heathrow's highly geared financial structure and changing patterns in the aviation industry, and (iii) how the government will react and in particular whether it will still support the project having regard to a much changed context, including its 'levelling up' and green agendas.

What is needed in future capital programming – what can be learned?

Before a programme for capital projects for H7 can be considered it will be important to undertake a fundamental and objective review of Heathrow's expansion plans - and whether in the latest circumstances they should be abandoned. This is necessary in particular because many of the assumptions and contextual assessments of the Airports Commission are now out of date.

As part of any such review **far greater transparency for decision makers and the general public is required on the relationships between how RAB operates, how finance is secured by HAL under its current and proposed corporate structures, the precise effect RAB has in underpinning the airport's income stream income stream, the extent to which this could cause market distortion and what the tax implications of HAL's corporate financing structure are**. As part of the next consultation documentation the CAA should produce a short, non-technical guide explaining clearly how the present system works.

As part of a comprehensive review leading into H7 a robust foundation needs to be set (much wider than at present) reflecting **how Heathrow would sit within a national integrated and sustainable transport plan**, given the present government's 'levelling up' agenda, recovery after Covid, climate change considerations and constraints, true competition between airports and airlines, changes in the aviation model (with point to point routes utilising newer, smaller and more efficient planes becoming the preferred approach) and what customers will actually want in future.

Finally, in terms of any possible future investment decisions concerning Heathrow, all of the external impacts need to be internalised in cost benefit assessment. In particular Heathrow's environmental and health impacts must fully reflect WHO and other objective, independent health guidance.

Stephen Clark
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