HEATHROWWEST

Your Choice For A New Terminal

HEATHROW WEST LIMITED'S RESPONSE TO CAP 1876

Economic regulation of Heathrow Airport Ltd: further consultation on regulatory framework and financial issues, January 2020

Introduction

The Court of Appeal has ruled that the designation of the Airports National Policy Statement (ANPS) was unlawful unless and until the Secretary of State has undertaken a review of the ANPS. This response is written on the assumption that the Secretary of State will seek to address the error identified by the Court and / or that an appeal to the Supreme Court is successful. Heathrow West Ltd has applied for leave to appeal to the Supreme Court.

In this regard, we would welcome a policy statement from the CAA that it continues to support the Government's policy towards the expansion of Heathrow.

This particular consultation document is about the financeability of Heathrow's expansion assuming that all expansion is delivered by Heathrow Airport Ltd (HAL). We believe that the CAA should conclude that the element of expansion to be delivered by Heathrow West is "plausible, credible and deliverable". In that light, we request that the CAA begin to consider the affordability and financeability issues relevant to a Heathrow expansion which includes the Heathrow West proposals.

Executive summary

The HAL Initial Business Plan (IBP) published recently shows what we have all known. HAL's expansion proposals are simply not affordable. Airport charges are forecast to rise to well over £30, around 50% higher than today.

In contrast, Heathrow West is proposing an expansion which is expected to be many billions of pounds lower cost than the plans contained in the IBP. It is our expectation the alternative plan that is being developed by Heathrow West should enable expansion to proceed, in a way that meets the affordability challenge set by the CAA and the Government. Indeed, in some scenarios, we envisage overall airport charges being lower than today's charges.

Allowing expansion to proceed with only HAL will ensure that airport charges <u>are not</u> affordable. Allowing expansion to proceed with HAL and HW should ensure airport charges <u>are</u> affordable.

Incentives for capital efficiency

The CAA is proposing enhanced incentives for capital efficiency. This is to reflect the large and novel nature of the capital expenditure being proposed by HAL. Given the way in which Category B and early Category C costs have changed (always upwards), it seems that HAL's control of its costs is weak. In this regard, we are not sure that more regulatory incentives will address this fundamental problem whereby HAL is rewarded for the capital expenditure it has incurred. The CAA has hardly ever reviewed capital expenditure that has been incurred and disallowed it. We have no confidence that the regulatory process is going to be amended to put HAL under more scrutiny with respect to its capital expenditure proposals.

The CAA will not be surprised to hear that Heathrow West believes that competition is the best way to ensure the overall costs of expansion are lower than HAL's proposals. Our proposed expenditure is many billions of pounds lower than that contained in the various CAA and HAL documents that discuss capital expenditure. The HAL Initial Business Plan (IBP) shows that the costs of HAL expansion are not affordable, with charges rising to levels well over £30 / passenger. The most expensive airport in the World is proposing increases in airport charges of around 50%. In contrast, the Heathrow West scheme will deliver capacity earlier than HAL at a lower cost with airport charges lower than proposed by HAL. We believe we will be able to demonstrate that expansion via Heathrow West will allow airport expansion to be affordable as has been defined by the CAA.

Allowed return

The CAA has made proposals on:

- Equity financing: with a business as usual cost of equity and an expansion cost of equity;
- Cost of new debt, and
- Allowances for corporation tax.

Equity financing

We have not undertaken detailed analysis on the appropriate mark up to the cost of equity that might be set by the CAA. On first glance, the mark up of 0.25% to 1% looks relatively small when considering the overall risk of the expansion, whether or not HAL carries out all of the project or it is split between HAL and Heathrow West.

In general, the CAA mentions the work carried out for it by PWC. We do not see how the CAA has taken this work forward and look forward to forthcoming CAA documents on the cost of capital.

Debt financing

In Q6, the CAA made an estimate of HAL's debt costs. It would appear that HAL has been able to raise debt for less than forecast by the CAA. The CAA is therefore considering debt indexation and/or some form of pass through of debt costs (while trying to preserve incentives to minimise the cost of raising debt).

Whoever is successful in winning permission to expand Heathrow, the amount of debt to be raised is likely to be significant. The CAA's proposals to ensure that benefits flow to passengers, while retaining incentives to keep the cost of debt as low as possible, seem broadly sensible.

Tax

The CAA is considering making the cost of capital a “vanilla” calculation with a separate allowance calculated for corporation tax. This would be in line with the approach of the other economic regulators. This seems to be a sensible approach.

The regulatory framework and financeability

The CAA discusses the need for expansion to be financeable and affordable (described as “airline aspirations for no real increase in charges”). However, the CAA then goes on, at paragraph 3.16, to say that this is a “relatively narrow” view of what constitutes affordability. This seems to imply that the CAA might be walking away from one of the key premises of expansion, namely that it should be affordable.

It is clear from the HAL IBP that HAL is indeed abandoning any pretence that its expansion will be affordable, particularly in the “Service” business plan, where charges increase to well over £30 / passenger. Thus in response to the request from its largest customer, International Airlines Group, that prices remain flat, HAL’s response is to propose an increase in charges of around 50%. A clearer demonstration of monopolistic behaviour, and therefore the need to introduce competition, is difficult to imagine.

In contrast, Heathrow West is proposing an expansion which is expected to be many billions of pounds lower cost than the plans contained in the IBP. It is our expectation the alternative plan that is being developed by Heathrow West should enable expansion to proceed, in a way that meets the affordability challenge set by the CAA and the Government. Indeed, in some scenarios, we envisage overall airport charges being lower than today’s charges. Allowing expansion to proceed with only HAL will ensure that airport charges are not affordable. Allowing expansion to proceed with HAL and HW should ensure airport charges are affordable.

The CAA discusses the possibility of making a longer term commitment to parts of the regulatory framework and in particular whether the cost of equity should be set for longer than 5 years. We note that HAL, in its IBP, is suggesting a 15 year regulatory settlement in this regard and the CAA is suggesting 10 to 15 years.

In principle, Heathrow West supports this approach. The level of investment is so significant, over a long period of time, that such a regulatory innovation should be considered. We note however that the degree of regulatory certainty needed for Heathrow West is likely to be somewhat lower than HAL may request and need. The cost of our proposed expansion is significantly lower than HAL’s current plans. Our construction plans envisage somewhat under 10 years of construction (assuming that HAL is able to deliver the runway on time and on budget). This can be contrasted to the 30 years of construction that is envisaged in the HAL statutory consultation.

The CAA will need to give careful thought as to how to deliver such regulatory stability. It is well known that a regulator cannot fetter its discretion, although since the passing of the Civil Aviation Act 2012, the CAA has more flexibility as to how to set price controls. It is also the case that the CAA sought to provide 10 years of regulatory stability to support the development of Terminal 5, and then failed to deliver this stability in the second 5 year quinquennial period. We also note that Ofgem's experiment with an 8 year price control has reverted to a more traditional 5 year period. Nevertheless, we support the CAA's thinking in this area.

The CAA discusses the need for investment grade credit ratings as being necessary to support expansion. We agree with this approach, although we are not yet determined as to what particular credit rating would be appropriate for Heathrow West.

The CAA raises a number of further issues about which we have not formed a view at this stage.

We are content for this submission to be published.

Heathrow West Ltd 5th March 12020