T. Martin Blaiklock

Consultant

Energy & Infrastructure Project Finance

182 Broom Road,
Teddington,
Middlesex TW11 9PQ, UK

Tel: (44)-208-255-3851

E-mail: tmblaiklock@me.com

June 29th, 2018

The Civil Aviation Authority : Consultation

"Economic Regulation of Capacity Expansion at Heathrow"

CAP1658: "Policy update and consultation"
CAP1674: "Working paper on the cost of capital and incentives"

Sirs,

I wish to contribute to the above Consultations.

1. I have studied the above two Consultation documents, and have submitted responses to earlier CAA Consultations on this same topic.

   Nothing in CAP's 1658 & 1674 has changed my views as expressed in earlier Consultations.

   The evidence supporting the LHR Expansion is still lacking, or remains undisclosed, so an informed response is impossible. Both CAP1658 & 1674 are "long on words, but short on figures".

2. The Airports Commission's work and subsequent CAA commentaries suggest, - albeit they do not explicitly state, - that the underlying methodology for assessing the financial viability of the LHR Expansion and all other options was HM Government's "Green Book" [ref. p4, PwC Modelling Report to Airports Commission, Nov 2014) and the DfT's derivative, WebTag.

   The Green Book is essentially a methodology for assessing the Value for Money and benefits, or not, of a Government-funded project. The analysis requires data inputs and produces outputs in 'real', as opposed to 'nominal', terms, i.e. excluding inflation. As a result, such analysis distorts outputs on taxation and costs of finance,………. and can lead to erroneous decision-making and the underestimating of future costs, if used for budgeting purposes.

   However, Heathrow Airports Limited, like Gatwick, et al., operate as private enterprises, i.e. live in a 'nominal world'. Hence, any analysis on their investment plans should be undertaken in 'nominal' terms.

3. A second flaw in the Airports Commission work was the application of Optimism Bias ("OB"), - a unique-to-the-UK multiple, - to cost estimates, as derived under the Green Book. The OB multiple assumption, as used for the option analysis by the Commission, was 20%. This assumption was the same for all LHR options and LGW, notwithstanding significant differences in the implementation/cost risks between all options. Hence, the outcome was an artificial bias towards the LHR Expansion.

   The above flaws remain unaddressed today. Indeed, no project cash-flows have been published for the Expansion, notwithstanding that 5 years have passed since this Expansion concept was first mooted.

4. There is much discussion and analysis within CAP's 1658 & 1674 as to LHR's WACC, and in particular the cost of debt. Worryingly, CAA seem to be much dependent on the advice of PwC against other consultants, whilst PwC, I perceive, have some undisclosed conflicts of interest in this scenario. After all, they were advisor to the Airports Commission, auditor/advisor to the CAA, and are well-embedded in the DfT.

5. Notwithstanding the outcomes of the analysis, it seems too early to determine the long-term WACC for the Expansion ('C' costs,) whereas the WACC for any 'B' costs, if allowable, - something about which I have earlier expressed reservations, - should use short-term cost of debt comparators.

6. What is surprising, however, is that there is little mention of:-

   (a) **<u>the cost of, and return on, equity</u>** in this discussion. The analysis seems dependent on ratings' agency measures, i.e. an assessment of creditworthiness. Recent events in the UK water industry have shown, nevertheless, that investors have been able to 'game' the RAB determinations, to much public outcry. The CAA seem oblivious to this issue.

   (b) **<u>gearing, or leverage</u>**: i.e. the proportion of debt to equity in the funding structure for the Expansion. The current assumed ratio of 65% (65% debt versus 35% equity) allows a higher rate of WACC than the funding needs, leading to windfall investor profits. It is in this area where the RAB Model , - "RAB", being a notional value based on 1980'/90's original data, updated annually, - does not necessarily reflect reality. Given the significant values attached to the Expansion investment, is it not time for the CAA regulation of such investment fits with today's values, not some virtual figures?

7. Finally, I am concerned as to the time, effort and cost CAA are spending with respect to structuring and finalizing a financing scheme for LHR Expansion. Under the UK's private airports regime, it is up to LHR to develop its plans first, - which it has not to date, - and then for CAA to respond. As it stands, the public have good reason to consider that the CAA is 'bending over backwards' to satisfy the needs of LHR / HAL and its investors, and placing customers, - airlines and the public, - at a lower priority.

<u>Postscript.</u>

Does it not show a strong manifestation of support for UK plc, when the controlling/managing shareholder in LHR announces the departure of its international HQ from the UK within 24hr of Parliament's approval for the Expansion? So much for Ferrovial's loyalty to the UK. Does such a move receive the support of the CAA and benefit the taxpayer?