HEATHROWWEST

Your Choice For A New Terminal

Introduction

Heathrow West is pleased to provide an initial response to CAP1825, "Economic regulation of Heathrow Airport Limited from January 2020; notice of proposed licence condition".

Executive Summary

Heathrow West welcomes the proposals by the CAA to introduce a licence condition on HAL promoting economy and efficiency. We firmly believe that the continued increase in HAL's costs of expansion – as noted recently by International Airlines Group and Heathrow Hub – show that this condition is desperately needed and will need to be triggered immediately it comes into force.

Heathrow West's plans for a new independently owned terminal at Heathrow continue to develop. We are proceeding to a statutory consultation in early 2020, with the aim of making a Development Consent Order towards the end of 2020. We are confident that our plans will represent a cost-efficient, timely and flexible development that will be welcomed by airlines and will be to the benefit of passengers. Competition, rather than regulation, should govern the next stage of Heathrow's development.

Heathrow West welcomes the CAA's enhanced engagement with respect to Heathrow West's proposals. We look forward to CAA consulting on issues associated with Heathrow West later in 2019.

Interim price control arrangements for HAL

The CAA is proposing to extend the current price control by 2 years. It is proposed that the commercial deal negotiated between HAL and airlines should be the basis of this extension.

Heathrow West notes the comments made by the airlines over the process by which the deal was reached, and that it in part reflected their view that the CAA's April 2018 proposals were weak. There are 3 lessons to be drawn from this "commercial deal":

- We note the views of some airlines that they had no choice other than to accept the deal. This is of course classic monopoly behaviour.

-
- We note the comment that HAL was not prepared to negotiate with the airlines over the deal. This again is a classic sign of monopoly behaviour.
- The view was that the CAA's proposals to extend the price control were so weak that the commercial deal was preferable. These views about the difficulties of regulating HAL echo our concerns that the regulatory framework is failing at Heathrow. Expansion costs are rising (although the CAA believes they are falling) and early DCO costs are now over £3bn before a spade goes anywhere near the ground.

As the CAA is aware, Heathrow West's concerns echo much of what the airlines have said. HAL refuses properly to engage with Heathrow West, withholding information that is important to enable Heathrow West to deliver expansion in an efficient manner. HAL's refusal to discuss how an independently owned terminal might integrate with the rest of the airport again risks expansion being delivered in a less efficient way than otherwise would be possible.

Against the backdrop of HAL's behaviours, we urge the CAA fully to support the concept of competing terminals at Heathrow. Subject to whatever form of regulation is developed with respect to Heathrow West, it is our hope that we will be able to strike commercial deals with airlines (incumbents and new entrants) to support the development and operation of the terminal.

We believe that it is important to seek alternative delivery models since the traditional method of regulation at Heathrow is no longer fit for purpose. The consultation on allowing over £3bn of Category B and Category C costs shows that the traditional regulatory framework is just not capable of controlling the expenditure related to expansion. Instead, we urge the CAA to explore commercial arrangements and competition to augment, or even replace, the traditional regulatory framework.

We note the CAA's comments that there is much work for HAL to undertake to develop a more commercial relationship with airlines. It does not appear to us that HAL is engaging successfully with airlines on expansion. We cite in this regard the comments of IAG recently.

> *In a submission* to the Civil Aviation Authority (CAA) today, IAG says it has absolutely no confidence in Heathrow's ability to deliver cost-effective expansion.*

> *Initial construction and planning costs, originally forecast at £915 million, have jumped by more than 250 per cent in two years. And Heathrow continues to cover up the true cost of expansion.*
>
> *The airport says expansion will cost £14 billion. Initially that covered both the runway and additional terminal and aircraft stand capacity. However, its latest masterplan says that now only builds the runway. The total cost is £32 billion.*
>
> *Willie Walsh added: "Heathrow told the CAA that pre-planning permission costs were £915 million. They've now been ramped up to £3.3 billion. The airport is treating customers with contempt and the CAA like puppets".* [1]

These comments are not a sign that HAL and its airlines are moving towards a more commercial relationship with its airlines. In contrast, we can report that Heathrow West's initial discussions with airlines have revealed a positive view from airlines as to the possibility of choice at Heathrow.

Finally, we note the CAA's comments about the pressure on HAL's timetable for expansion. We can now see that HAL's programme to deliver the airports capacity envisaged by the Airports Commission has already been significantly delayed. Terminal capacity does not begin to be delivered by 2030, with terminal capacity being delivered in increments, in various places of the airfield, and not finally delivered until 2050. In contrast, Heathrow West are planning that full terminal capacity will be delivered by 2032 which would deliver much needed resilience and competition benefits between terminals, with overall demand increasing in line with HAL's predictions. This will limit the construction impact of expansion to a much shorter period than HAL. It will also deliver the benefits of competition as soon as possible. Heathrow West also provides flexibility to bring in more capacity earlier, if the demand profile changes.

Promoting economy and efficiency

[1] "Heathrow's £3.3 billion expansion heist", IAG, 21 August 2019, https://www.iairgroup.com/~/media/Files/I/IAG/press-releases/english/2019/IAG09.pdf

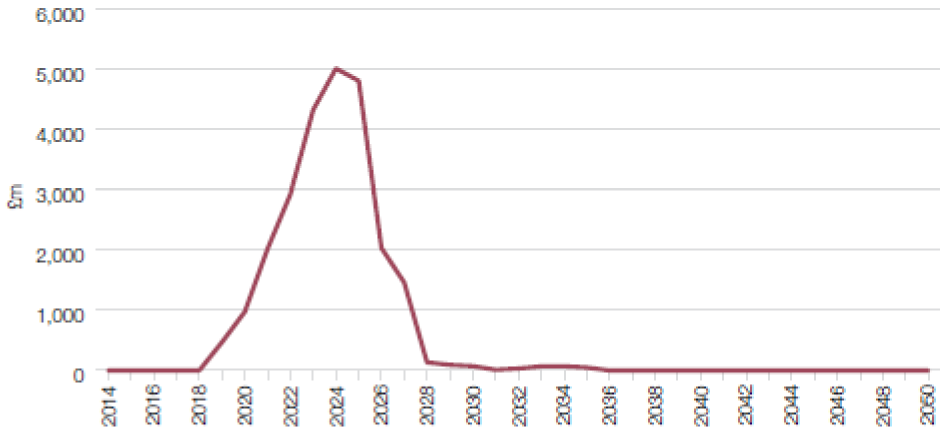
The CAA is proposing that an efficiency licence condition be introduced to HAL's licence. This is intended to give the CAA more flexibility in responding to any systemic failings in HAL's conduct. It is also intended to allow stakeholders to raise concerns in "real time".

In our response to earlier consultations, Heathrow West welcomed this proposal by the CAA. We also asked the CAA to ensure that the introduction of the condition did not slip beyond the end of 2019.

We also believe that circumstances have evolved to mean that the CAA should seek to impose this licence condition as soon as possible. First, HAL's Category B and Category costs have increased significantly, apparently as a surprise to the CAA and the airlines. We do not believe that an increase in Category C costs of around £1bn in a little over six months represents a *prima facie* demonstration that HAL will be able to demonstrate that this represents an economic and efficient approach by HAL.

Second, and a matter that continues to be subject to correspondence between Heathrow West and the CAA, is the overall costs of expansion. The CAA continues to say that the costs of expansion have fallen. Indeed, HAL is now claiming the costs of expansion to 2026 are "only" £14bn (in 2014 prices), representing a reduction in costs of around £2.5bn compared to the Airports Commission costs of £17.6bn (also in 2014 prices), a view reported by the CAA in its submissions to the DfT. However, this is clearly not the case. The figures used by the Airports Commission showed the runway and terminal were mostly delivered by 2026 as the diagram below shows.

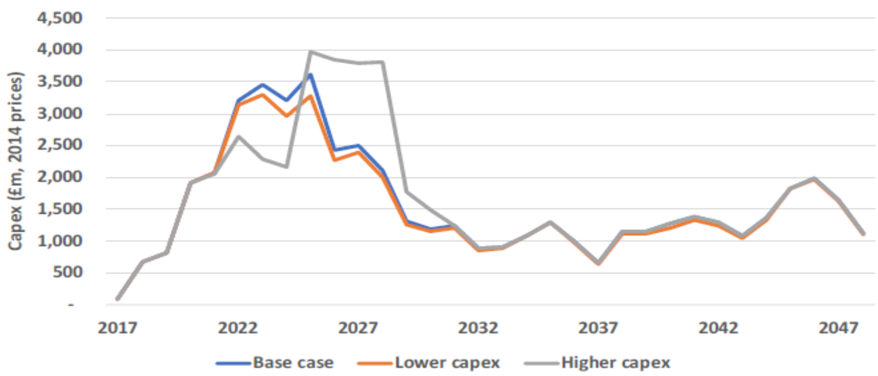
Figure 4.2: Scheme Capex requirement under the AoN-CC demand scenario (£m) 2014 prices



Source: Airports Commission analysis

HAL's expenditure to 2026 now excludes all terminal expenditure, which only starts to be delivered in 2030, and then not fully until 2050. The current profile of expenditure, including, but not limited to expansion expenditure is given below. Thus, the claim by HAL that costs have fallen is plainly untrue. We believe this to be another *prima facie* example of inefficiency on the part of HAL.

Figure 5: Capex profiles



Source: CAA analysis

We note that it is not possible to compare the differing capital expenditure profiles. The CAA's H7 model also does not allow a like-for-like comparison between the Airports Commission proposals and the project now being advanced by HAL. This gives little comfort that the CAA is able to come to a view as to whether the project is economic and efficient.

Third, the CAA knows that Heathrow West has been seeking information from HAL that would avoid Heathrow West having to duplicate costs already incurred by HAL. Thus, overall costs of expansion are higher than they need to be due to HAL's approach to data availability.

Each of these examples shows that the approach of HAL represents clear examples of inefficiency by HAL. We therefore conclude that the licence condition is required, and should be brought into force immediately. We note however that the CAA is proposing implementation from 1 January 2020. This raises concerns that HAL will continue to operate in an inefficient way between now and the start of 2020. Certainly, it raises the prospect that the licence condition will need to be triggered early in 2020.

We are happy for this response to be published.