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August 14th, 2017

The Civil Aviation Authority : Consultation

**CAP1541: "Core Elements of the Regulatory Framework
to Support Capacity Expansion at Heathrow"**

Sirs,

I wish to contribute to the above Consultation.

General Comment:

In March 2017, I responded to the earlier (January 2017) Consultation, CAP1510, the precursor to this Consultation. It turns out that I, along with Richmond Heathrow Campaign, were the only "user" groups, who responded to that Consultation. All other respondents were either "HAL" (Heathrow Airport Ltd), airlines or parties with an interest in Heathrow's development.

Secondly, CAA expresses [ref. CAP 1541, para 10] pleasure that all of their: *"key priorities for developing the regulatory framework for capacity expansion received broad support from stakeholders"*.

I take exception to this claim.

A review of my CAP1510 submission (attached herewith as an Appendix) shows that I argued that the current regulatory framework, i.e. RAB Model, for tariff-setting for HAL and for the Expansion is both artificial and flawed in today's circumstances. Further, since my earlier submission, the validity of the use of the RAB Model for UK public service utilities, particularly in support of major investment projects, have been questioned by a growing number of regulatory experts. There are no references to such reported regulatory failings in either the Exec. Summary or Ch. 1, CAP1541. To ignore such claims out of hand seems somewhat remiss, if not negligent.

Additionally, the lack of "users", i.e. customers, as respondents to the earlier Consultation (CAP1510) shows how out of touch CAA is with those, who represent CAA's prime, statutory responsibility. The airlines and freight handlers have secondary status under the 2012 CAA Act.

In this context, I question furthermore the representative legitimacy and activities of the Consumer Challenge Board ("CCB"), created earlier this year by CAA and HAL, for the Expansion. Through recent contact with them, together with a review of their work to date and future program of activity, I conclude that their "independence" is compromised and much weighted towards supporting HAL and "stakeholders", rather than representing consumer, i.e. "user", views.

Finally, notwithstanding my CAP1510 submission re. conflicts of interest and the compromised status of PwC in the Airports Commission's, CAA's, and the Dept. of Transport's work in support of the Expansion, I am concerned to note [ref CAP1541, para 19] that CAA continues to employ their services for modelling the key issues of affordability and financeability of the Expansion, when transparency and independence of advice have to be above suspicion.

Overall, therefore, there is much for the CAA to do in the coming months to restore the balance and integrity of their regulatory activities with respect to Heathrow's proposed Expansion before proceeding further.

CAP1541: Specific Comments:

1. CAA requests comment with respect to incentives, which should be imposed upon HAL through regulation [ref. para 18 &19 Exec Summary; and Ch. 1].
2. In respect of the proposed Expansion, incentives can be applied during two periods:-
 - Construction phase: to build the new assets to time, cost and specification; and
 - Operations phase: to operate the new assets efficiently and to generate Value for Money for “users”, who will pay for the services delivered by the assets, once built.
3. As HAL is a private venture, it should be for HAL to carry the risks of delivering both of the above objectives, not airlines or “users”.
4. With respect to the Construction phase, the time-tested method of HAL receiving no payment from “users” (or stakeholders), whether as compensation for costs incurred or as a return on capital employed, should be adopted, until the Expansion has been completed and delivering a service. There is no better way for ensuring that performance targets are met in the Construction phase than the developers “putting their shirt on the line”.

The dismal track record of UK infrastructure being built to time and cost in recent years is so poor that the public should demand nothing less than such a condition.

This may prove more expensive in terms of the cost of funding available to support the Expansion, - it will require more equity, - but it is the simplest and strongest incentive available to avoid cost over-runs and delays. For infrastructure projects, the incremental cost of such a payment mechanism outweighs the use of the RAB Model, where payments to the utility/project sponsor are made during construction, thus diluting the incentive to perform. In effect, under the RAB Model, the completion risks are being passed to “users”, who cannot control or mitigate such risks.

5. With respect to Operations, it is assumed that current regulatory incentives imposed on HAL are, - or should be, - sufficient to ensure that a quality service will be delivered.
6. I am equivocal, in principle, with respect to whether the Expansion should be undertaken and funded by a separate SPV, or corporately as by HAL [ref. CAP1541, para 1.16]. However, given that the proposed Expansion is a complex undertaking, with many interfaces with third parties and a construction period spanning many years, it seems likely and preferable that providers of new debt and equity will require the SPV route, as it focuses the SPV owners on the activities being undertaken and avoids any possibility of cross-subsidy.
7. I note HAL’s comments in the context of Procurement. For a project of the magnitude of the Expansion, open international competitive bidding for major, key contracts should be mandatory. Further, I have noted the involvement of HAL shareholders in the construction of both T5 and T2 projects, so independent scrutiny of any Expansion bidding process and the evaluation should be mandatory and public, not least as some taxpayers’ money may well be required to fund access infrastructure (see below).
8. Finally, the need for HAL to present, as part of their Business Case, firm estimates as to the cost of the access infrastructure associated with the Expansion is paramount, with cogent arguments as to the distribution of funding between HAL and Government, given Government’s intentions [ref. para 6.23 & 24] that they will only fund those components which make a positive contribution to infrastructure for public use.

In this context, it is noted that the proposed assessment is based on the ‘Green Book’, whose methodology is based upon economic (“real”) criteria and conflicts with the ‘nominal’ assessments, which private investors would normally undertake. A financially consistent approach is demanded, which seemingly is not to be the case in this instance.

Conclusion:

It is clear from this somewhat voluminous CAP1541 Consultation document that the CAA is very much more balanced towards satisfying HAL (and airline) demands than for customers, or “users”. This unbalanced approach to the regulatory requirements for such a large investment in public service assets is undesirable and is inconsistent with CAA’s statutory responsibilities.

Further, unacceptable conflicts of interest in the process remain and need addressing.

There remains much work to be done for “user” interests to be protected and delivered and for the procedures adopted for implementation attain the highest standards of probity.

cc. Sir V. Cable, MP

APPENDIX:

March 12th, 2017

CAP 1510: Consultation

“Economic Regulations for the Expansion of Heathrow”

I wish to contribute to the above Consultation.

General Comment:

This Consultation covers a key issue for the Expansion of Heathrow. That is, how much will customers, consumers and stakeholders be expected to pay and on what basis? The focus of my comments is the payment for Type ‘C’ costs, i.e. the construction costs, the compensation for the preparatory, Type ‘B’ costs having earlier been conceded by the CAA, with limitations imposed on Heathrow Airport Ltd (“HAL”).

Within CAP1510, the CAA makes many statements with respect to the need for “transparency”, “value for money”, and “financeability”, and supports these with a notice (ref. para 6.5) that a series of briefing sessions for “interested stakeholders” on CAP 1510 will take place between February and May 2017 as part of this Consultation.

On Feb 21st, I made a request to CAA, via the communication channel cited in the Consultation, as to when and where such sessions were to be held. I received no acknowledgement or reply, so on March 8th I chased my request. Sadly, I was informed that, as a member of the public, I was not allowed to attend such sessions.

In the spirit of transparency and integrity of the NPS process and the setting of the key parameters upon which customers are going to have to pay for the LHR Expansion, this response by CAA seems rather out of step with normal UK Consultations for regulated public services. How else can CAA determine public views unless they allow them to speak and participate in the decision-making? I would like to remind CAA that HM Government is a signatory to The Aarhus Convention that demands participation in decision-making by those parties affected by significant developments.

Specific Comments on CAP1510:

1. My comments cover financing and financeability (paras 5.30 – 5.43 of CAP1510). It appears from the text that CAA anticipates that Heathrow Airport Ltd (“HAL”)’s funding proposal will be based on a RAB (“Regulatory Asset Base”) Model. This Model has prevailed since privatization (1986), but “is past its sell-by date” with respect to major capital investments to be undertaken by utilities.

2. The RAB is essentially a theoretical Model, which over time (30 years) has become distorted. For example, it assumes a leverage, or gearing, of 60%, - as has been used by the CAA previously for HAL in Q6, - which is clearly out of line with the ratio of long-term debt to equity in HAL's balance sheet today (viz. > 90% debt). This leads to an over-estimation of the WACC ("Weighted Average Cost of Capital"), and thereby higher allowable tariffs for HAL than should be awarded. The WACC is also based upon a theoretical CAPM ("Capital Asset Pricing Model") assessment, and not on actual market values for the costs of debt and equity.
3. Notwithstanding the above weaknesses, the key flaw is that, under the RAB Model, the construction and completion risk is largely passed over to the customer, and not left with the developer, where it should reside.
4. The underlying principle of privatizing UK public service utilities in the first place was, - and I was around working in the sector at the time, - that private capital should carry the risk of investment and the subsequent delivery of a public service, operating within a regulatory regime, where utilities were licensed to maintain standards of quality, safety and service.
5. This reflects the normal principles of privately financed energy and infrastructure projects, PFI, PPP, etc., where the incumbent private developer receives no payment until the services are actually delivered by the assets so built. The RAB Model demolishes that principle.
6. For minor investments, when the construction period is only 1-2 years, the difference is marginal. But for major investments, such as Heathrow Expansion, - and Thames Water's Super Sewer, - such a use of the RAB Model for funding would not at all be in the customers' interest. It passes the construction and completion risk to customers, when they are not able to control or mitigate such risks.

Such risk imbalance is not in the public interest. Hence, CAA should reject it for the Expansion.

7. The sorry fact today, however, is that HAL's balance sheet is so weak that, for it to be able to fund the Expansion otherwise, it would have to increase significantly, - possibly, double, - its equity capital. To date, I have not perceived any inclination by them to do so.

How has this situation come about?

8. Until 2005, BAA was quoted on the Stock Exchange, with an equity (risk) capital of £5.5bn and long-term debt of £4.3bn., i.e. a capital balance, quite financially and corporately sustainable for a public service utility. Indeed, BAA had just funded corporately the construction of T5 at the time.
9. In 2006, BAA was taken over by the Ferrovial consortium, which over the next 10 years quietly asset-stripped BAA, now called "HAL", to the extent that by the end-2015 BAA/HAL's equity stood at only £1.6bn, whilst its long-term debt is £12.7bn.
10. In simple terms, since 2006:-
 - BAA/HAL's equity has been reduced to one third of its 2006 value; and
 - BAA/HAL's debt has tripled to £12.7bn.
11. In addition,,:
 - BAA/HAL has paid out of over £4bn in dividends to shareholders since 2006; and
 - BAA/HAL has paid minimal corporation tax, if any, over these years. In fact, the aggregate tax 'take' is a tax loss / credit of £818mn, whereas prior to the Ferrovial takeover in 2006 BAA were paying £100-150mn annually to HMRC. Hence, the loss to the Exchequer and the public over the period 2006-15 is notionally £1 – 1.5bn.;

12. An additional outcome of this trend has been that, of the current (2015) HAL long-term debt of £12.7bn., over £10bn has been raised via a Jersey (tax-haven) company, some or most in bearer bond form, an instrument favored by money-launderers. Customers have a right to know and may well ask:-
 - whose money is this?
 - why is it in Jersey in the first place?
 - is this money “clean”? and
 - why should customers’ payments be used to help recycle funds held in tax-havens?
13. A further issue is that the Ferrovial-led consortium, in acquiring BAA in 2006, used approx.. £7bn of debt and sub-debt facilities to buy BAA, then loaded this debt, via a securitization, - which CAA approved, - onto BAA’s balance sheet. In subsequent years, therefore, the regulated BAA revenues from customers were being used to service such debt, e.g. interest payments, repayments, etc..
14. **In effect customers’ payments were helping to fund the takeover of BAA itself by investors. Most BAA customers and stakeholders might view that as a breach of licence. Seemingly, however, CAA took no action at the time.**
15. Finally, following the Ferrovial takeover the corporate structure of BAA changed from one where the shareholders had a direct stake in the licensed BAA plc, whereas post-takeover there are now 10 corporate layers between the shareholders and the licence holder, BAA/HAL. Stakeholders and customers will ask why? Such a structure goes against all intentions of transparency and normal corporate governance. Is this a tax avoidance mechanism?
16. Reading between the lines of the CAP1510 text, I perceive that CAA might already have perceived some of the problems and issues, as outlined above. However, I see no indication that they are prepared or intend to do anything about it,..... or am I wrong?
17. The precedent of the Thames Water “Super Sewer” project may, prima facie, provide HAL with a UK funding precedent. Indeed, the corporate progress of Thames Water over the last 10 years, since it, too, was taken over by an investment group, mirror closely those of BAA/HAL in all respects. However, in that case, ten years on, there is technical evidence to show that the project is not needed today, and that the RAB-type funding package on that occasion may be unsustainable.

The issue of regulated revenues being used to finance unregulated activities (e.g. servicing of acquisition debt) is also being questioned of the Regulator (OFWAT) in that case, as is the impact on HM Government of the contingent liabilities created by Government’s Financial Support Package: the (Eurostat) rules as to the on/off balance sheet impact of such liabilities have recently been updated and remain under continuing review.
18. Clearly, HM Government will not wish to fund the Expansion, and have publicly confirmed that position. This leaves the question as to what to do? Can HAL assemble the funding required?
19. Sadly, the Airport Commission Report was myopic in its Conclusions and took no real account of costs and funding. Cheaper alternatives (“Options”) were, and are still, available, which could be more easily funded as conventional, private sector infrastructure (non-RAB type) investments. The risks for the alternatives would be lower, the timetables shorter, the outcomes more flexible to demographic changes, and they are more environmentally beneficial (viz. noise and air pollution).
20. The Government has not made a final commitment to the Expansion, notwithstanding HAL’s media promotion of the project. So, in the event of a funding impasse, and if Ferrovial and co-HAL shareholders are not prepared to increase their equity capital sufficient to support a conventional project funding, nor is there any acceptable ‘White Knight’ investor to fill the gap, then it would be in the public interest for CAA to demand that the alternatives/Options as

above (para 19) be re-considered as being better Value for Money and environmentally preferable.

21. Such an outcome, would not be “the end of the world”. It would demonstrate common sense, and keep “vanity” in its place. It might also do something to restore CAA’s credibility as operating in the public interest after events at Heathrow over the last 10-12 years have clearly shown up Ferrovial’s sub-standard, corporate and financial stewardship of a major UK infrastructure asset.

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22. **Postscript:**

Conflicts of interests can easily arise in complex transactions, not least major public infrastructure developments. Heathrow Expansion is no exception. However, when such conflicts arise, it is important that they are declared and treated in an open and transparent manner. In some jurisdictions, the failure to publish such conflicts as they arise, - and conflicts of interest are a perception of third parties, not directly involved in any transaction, - can lead to disqualification or licence revocation.

23. In the case of the Heathrow Expansion, PwC***:-

- were auditor to BAA during the Ferrovial takeover in 2006;
- were advisor to BAA during the period when BAA plc was restructured into a 10-layer corporate. [ref. para. 15];
- have been Independent Auditor to the CAA since 2013;
- prepared the CAA’s study for the Cost of Capital (WACC), [dated Feb 2014] for the Q6 Price Review (2014-18);
- prepared for the Airports Commission the Report: “*Cost and Commercial Viability: Funding and Financing*” [Feb 2014];
- prepared for the Airports Commission the Report: “*Cost and Commercial Viability: Financial Modelling Input Costs*” [Nov 2014]; and
- prepared for the Airports Commission the Report: “*Cost and Commercial Viability: Sources of Finance*”, [Jul 2015].

Furthermore,

- the Chairman of the CAA Audit Committee and non-Executive Director was a PwC Partner for 24 years; and
- the Global Head of Consulting and Partner at PwC, during the PwC work for The Airports Commission and until Jun 2016, was appointed, as a non-executive member of the Board of the Department of Transport, Sept. 2016.

Finally,

- the current Chairman of Heathrow Holdings was Minister in charge of the “Infrastructure Department” and National Plan development in HM Treasury, 2013-15, the period during which the Airports Commission and PwC undertook their studies.

Given the above relationships, openness and transparency of the process underpinning the development of the Expansion is paramount, if the final Decision is to be acceptable to the public. This includes independent scrutiny of the outcomes. To date, such targets have yet to be achieved.

[*** = PwC are also:

- auditor to the ultimate owner and controller of Thames Water, the Macquarie Group;
- advisor to OFWAT for the PR14 Price Review (2015-19); and
- Financial Advisor to OFWAT for The Super Sewer.]

Martin Blaiklock

CAREER SUMMARY:

- 1995-2017** Consultant: Infrastructure, Energy & Industrial Project Finance.
- 1991-1995** **European Bank for Reconstruction and Development (EBRD)**
Director Power & Energy Utilities
- 1985-91** **Hongkong & Shanghai Banking Corporation (HSBC), London.**
Director, Midland Montagu Trade Finance
- 1974-85** **Kleinwort Benson Ltd., London.**
Assistant Director: [Resident in Venezuela 1976-82].
- 1962-70** **Shell International Chemical Co., London.**
Manager: organic chemicals (epoxy resins) marketing

SECTOR EXPERIENCE:

- Power: coal; nuclear; hydro; CHP; geothermal, renewable energy.
- Air Transport: airports; ATC; IT systems.
- Road, rail & bridge projects; mass transit; LRTs; ports.
- Water Industry: irrigation; desalination.
- Oil & Gas: pipelines; refineries; facilities.
- Petrochemicals & agro-Industry.
- Industrial: aluminium; steel; cement.

PUBLICATIONS:

“Infrastructure Finance: an Inside View”

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INSTITUTIONAL DEVELOPMENT: Project Finance / PPP Seminars:

Martin Blaiklock regularly presents 1 – 4 day seminars on project finance (infrastructure, power, oil & gas) and PPP. Such seminars have been undertaken directly, or via Course providers.

Over the last 5 years he has given more than 120 such seminars for clients such as:-

- the World Bank / IFC (5 Courses)
- EBRD (3 year program: 26 Courses)
- African Development Bank (3 Courses 2013)

Public and in-house seminars have been held in:-

Turkey	U.K.	Greece	Oman
Romania	France	Kenya (6)	Sri Lanka
Ukraine	Germany	Nigeria (5 in 2011)	India
Egypt	Belgium	Uganda	Bangladesh
Abu Dhabi	Netherlands	Tanzania	Thailand
Dubai	Italy	Ghana	Singapore
Saudi Arabia	Austria	Benin	Indonesia
Tunisia	USA	Venezuela	China
Switzerland	Kazakhstan	Panama	Japan
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