



# HEATHROWWEST

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## HEATHROW WEST LIMITED'S RESPONSE TO CAP 1819 – August 2019

### ECONOMIC REGULATION OF CAPACITY EXPANSION AT HEATHROW AIRPORT: CONSULTATION ON EARLY COSTS AND REGULATORY TIMETABLE

#### 1. Introduction

- 1.1 Heathrow West Limited (Heathrow West) is pleased to provide a response to the CAA's consultation paper, CAP 1819 "*Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable*" (CAP 1819).
- 1.2 Heathrow West is progressing a DCO application for components of the Airports National Policy Statement (ANPS), which includes the additional terminal capacity required to support a third runway. Heathrow West's proposals provide the opportunity to introduce competition at Heathrow Airport and to realise benefits for consumers.

#### 2. Executive Summary

- 2.1 CAP 1819 reveals that Heathrow Airport Limited (HAL)'s estimated costs for Category B and early Category C costs are substantial and have increased significantly. Our key points are as follows:
  - The escalation in HAL's forecast costs is deeply alarming and provides evidence that HAL will be unable to implement airport expansion efficiently and effectively. CAP 1819 indicates that HAL's Category B and C costs have increased significantly in a short period of time. In addition, CAP 1812 indicates an increase in expansion costs from the originally forecasted c.£14bn to HAL's latest forecast of £32.5bn (2014 prices). If this has occurred at such an early stage, it gives zero confidence that HAL is capable of full implementation of the project in a cost effective and affordable manner and even within £32.5bn.
  - Further, It is evident that the current regulatory framework has been unsuccessful in ensuring HAL's financial discipline in managing its costs efficiently. The CAA needs to recognise these alarming early warning signs and take positive action immediately to address this situation. Leaving it any longer will almost certainly make interventions too late to be effective. We strongly urge the CAA to openly



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embrace, incorporate and facilitate alternative parties and delivery mechanisms into expansion.

- While we welcome some of the proposals that the CAA is making with regards to the regulatory framework to increase scrutiny of HAL's costs, we fundamentally believe that mere tinkering and "more of the same" is unlikely to be any more successful in ensuring effective control. If so, this has major implications for consumer interests and for the viability of expansion.
- The primary action required of the CAA is to proactively incorporate and facilitate alternative parties and delivery mechanisms into expansion. Whilst we believe the CAA has made some positive progress in incorporating the benefits which can be offered by Heathrow West, it is still short of the level and open basis required. Competition and alternative proposals need to be promoted and integrated by the CAA more proactively and more quickly. If not, there will be no alternative and this will put expansion and its timetable at risk. We consider that competition has the potential to bring about real benefits for passengers and consumers, including by acting as a disciplining force on HAL's overall expansion costs.
- In view of the scale and serious impact, we urge the CAA to (1) put an immediate stop on any Category C expenditure, (2) undertake a full review of HAL's Category B costs to establish whether these can be justified and where savings can be made and (3) prescribe that HAL's costs are only allowable (in total or part) in the event of a successful DCO consent.

### **3. Why Competition is necessary**

3.1 Competition can provide an alternative. It will provide the opportunity for appropriate components of expansion to be implemented and operated more efficiently and effectively. It would also provide a new airport benchmark by which to monitor and control HAL's performance. Competition is not a novel issue, it has been incorporated into many other airports worldwide.

3.2 To date, there has been no competition within Heathrow Airport for the provision of infrastructure or the delivery of expansion. Heathrow West's proposals for the delivery



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of an independent and privately financed new terminal and associated infrastructure would provide the opportunity to bring about the benefits of competition. The comments on competition made in this submission are made in that context.

- 3.3 The break-up of the South East airports monopoly has been demonstrably successful in improving the passenger experience across all the London airports. However, the Competition Commission (the predecessor to the Competition and Markets Authority) was explicit that the scope for competition could extend not just between airports, but also within airports. The Competition Commission considered that competition for a new terminal at Heathrow is an obvious way for such competition to be delivered. In pursuit of this policy objective, the Civil Aviation Act 2012 (CAA 2012) is definitive that there can be more than one operator within an airport and cites the separate operation of a terminal as one scenario in which that might be delivered.
- 3.4 Given the unprecedented and, apparently, unforecasted increase in HAL's costs, we urge the CAA to properly consider the case for competition within Heathrow airport. Only by introducing competition to HAL can there be any chance of downward pressure on the overall costs of expansion, including incentivising HAL to rein in its costs (rather than its current approach which seems to be merely seeking the CAA's permission to increase its costs, by almost 100% for Category B costs and more than four times for early Category C costs).
- 3.5 By way of illustration, HAL's estimated costs prior to obtaining the DCO are equivalent to c. 20% of the entire existing RAB. This, for a planning application. The magnitude and level of increase should not merely be approved by the CAA without serious scrutiny and concern.

## 4. Category B costs

### *Overview*

- 4.1 Cap 1819 highlights the increase in HAL's Category B costs from £265m to £500m. There is relatively little detail as to what this increase covers. However, we notice that £80m is associated with the delay from the 2017 General Election and the knock- on



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impact, we assume, on the overall project. We do not understand how the general election can have an impact and certainly not of this scale. The fact that such a huge increase in costs is covered only in a footnote supports our view as to the casual nature of cost control at HAL. The delay in the election affects all companies in the UK. We would be surprised if commercial companies were content for costs to increase in such a way.

- 4.2 The CAA does not need to search too far for benchmarks to show that the overall level of HAL's Category B expenditure is unjustifiable, excessive and wasteful. Heathrow West is making its own DCO application. Although not identical in scope, the level of budgeted cost is substantially less than HAL's and an unplanned doubling of forecast beyond budget at an early stage would not be possible under Heathrow West's strict financial controls.
- 4.3 In general, we believe that an increase of this magnitude is very clear evidence that HAL has at best, poor and at worst, no control over its ongoing level of costs. We also suspect that the CAA will be unable to identify and clearly see the reasons for this cost increase. It is difficult not to reach a conclusion that the current regulatory framework, which allows HAL to assume remuneration on its costs, is a significant factor in the current profligacy. In contrast, Heathrow West's costs are privately funded and not supported by regulatory provisions. This drives much greater discipline and justification. We ask the CAA to show what benchmarks it is using to judge whether HAL's Category B costs are reasonable / efficient and what is the appropriate level of expenditure which can be justifiably remunerated by consumers.
- 4.4 The CAA concludes that there is only limited evidence of the efficiency of HAL's Category B costs and that it is appropriate to carry out a review of its policy. However, we believe this must go way beyond merely tinkering with the present policy, to ensure it is effective in keeping HAL's costs under control and a more fundamental change in approach is required.
- 4.5 Our comments on the specific issues identified by the CAA are set out below.

*Strengthening existing governance arrangements*



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- 4.6 We agree that if the CAA is seeking greater control of HAL's costs, greater governance should be introduced. However, we ask why this is being suggested at such a relatively late stage. The CAA has suggested that HAL should provide a quarterly update on Category B costs with the CAA and the airlines. Given that these costs are to be recovered from passengers, Heathrow West believes that these revised cost estimates should be made public. It cannot be the case that costs can double without any sight or scrutiny from all stakeholders.
- 4.7 The CAA is seeking to extend the recovery cap to allow recovery of the increased costs. The CAA is expecting that costs above the recovery cap should not be assumed to be recoverable. However, by proposing an increase in the recovery cap to accommodate the doubling of costs, creates no incentive on HAL to control any further increase in costs. The CAA should conclude that any further cost increase is at the risk of HAL's shareholders. This might then create an incentive to improve HAL's management skills in terms of cost estimation, targets and control.
- 4.8 The CAA has proposed that there be increased cost scrutiny. We agree with this as a necessary further step to enable control of HAL's costs. We urge the CAA to commission an independent review of HAL's costs. Any inefficient costs should be disallowed.

### *Strengthening regulatory incentives*

- 4.9 The CAA is proposing that the cost of capital applied to the original estimate of Category B costs should be set at the Q6 cost of capital of 5.35% on the basis of regulatory stability. For these early costs, this seems a sensible approach, thereby creating a degree of regulatory stability. For the higher level of Category B costs above the original estimate, the CAA is proposing to use its current estimate of the cost of capital, being a somewhat lower figure, yet to be finalised. We agree with this differential approach.
- 4.10 We note however that since the cost of capital is meant to be a reasonable estimate of HAL's cost of capital, HAL will in no way be penalised for its complete failure to estimate and control these costs. Indeed, the fact that HAL has over-recovered during Q6 to date, in part due to financing costs being below the Q6 cost of capital, the CAA's



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approach could be seen as rewarding HAL for its failure to estimate and control Category B costs. It will continue to earn income on its overspend, being the difference between the CAA's Q6 cost of capital and its actual current cost of financing.

- 4.11 The CAA is proposing that HAL be allowed to recover “only” 100% of its costs for sums incurred above £265m, rather than the 105% allowed for costs up to £265m. It is clear that the CAA's initial incentive mechanism has failed. We do not see that this tweak will make any substantial difference. However, introducing a “reasonable” or “best endeavours” test might have some effect or alternatively the CAA stipulating that all costs incurred have to be justified before becoming allowable.

### 5. Early Category C costs

#### *Overview*

- 5.1 HAL's forecast and requested increase in Category C costs is equally astounding and worrying. That costs can increase by over £1bn from late 2018 to early 2019 shows that HAL appears to be meandering and to have lost control over its expenditure. To expect passengers to pay around £3bn even if the DCO fails, creates no incentive on HAL to control its costs.
- 5.2 Figure 5 shows that HAL's estimates of early Category C costs has risen from £672m (2014 prices) in 2017, to £1.6bn in October 2018 to £2.8bn (nominal prices) in early 2019. We simply do not understand how such an increase in estimated costs can be justified by HAL's Board or Executive Management.
- 5.3 The justification for such a large increase in early costs appears to be the retention of a 2026 runway opening date. We make two points on this. Firstly, this date hasn't changed, it has always been the target date by the CAA, DfT and Airports Commission. So what has changed? Secondly, there is no detailed evidence or detail on whether this date is achievable as a means to justify any expenditure, let alone such a large increase ahead of DCO consent. This evidence needs to be provided to the CAA and published and subject to scrutiny prior to any Category C costs being allowed.



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5.4 We would like to remind the CAA of the comments we made on HAL's proposed early expenditure in our response to CAP 1658 in July 2018.

- Firstly, we said that HAL should take an element of risk sharing.
- Secondly, we said that we were alarmed by the high level of proposed expenditure and without any justification.
- Thirdly, that confidentiality must not be used as a HAL smokescreen to avoid justification.
- Fourthly, that a commercial developer (Heathrow West) would adopt a different approach focused on justification, risks and benefits.
- Fifthly, that the CAA should incorporate alternative parties on a level and open basis to reduce the risk of leverage by HAL and to enable choice and comparison.

These points are highly relevant to the current circumstances set out in CAP 1819. However, these safeguards don't appear to have been embraced and adopted by the CAA.

5.5 In addition, we made separate points in our response to CAP 1610, in March 2018, which are also of relevance here. Firstly, that the very nature of underwriting of HAL's early costs places potential competitors at a disadvantage. It therefore follows that the CAA should take this into account if it is committed to operate an open and level process for expansion. In fact, we believe it would be uncompetitive if the Category C costs are allowed. Secondly, that the CAA should have zero tolerance of inefficient spend and duplication. The point here is that Heathrow West has consistently sought engagement and collaboration with HAL, including the avoidance of duplicate activities. This has been refused by HAL. We ask the CAA to clearly identify what element of HAL's Category B costs fall within this category, to publish it and to ensure that it is disallowed, as a minimum.

*Assessing whether spending is in the interests of consumers*



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- 5.6 Heathrow West agrees that early provision of capacity at Heathrow Airport should be in the interests of consumers. Relieving the runway capacity constraint should lead to lower fares and more choice for airlines and passengers. However, while such capacity should be delivered as early as possible, it must be affordable. The level of increase indicates that HAL is already struggling to deliver an affordable project. The fact that the CAA is even considering asking HAL to cease all work demonstrates that HAL's management of this project is leading to a real possibility that the interests of consumers are already compromised.
- 5.7 Neither HAL, nor the CAA, seems to have any way of understanding the proposed costs and timetable. We look forward to seeing the options that have been requested by the CAA from HAL. We note that two of the options requested by CAA result in a delay in the programme for the delivery of runway capacity.

### *The regulation of early Category C costs*

- 5.8 Our comments on the points raised by the CAA are as follows.
- **The allocation of risks.** The CAA is proposing that Category C costs, as well as the increased Category B costs, be recovered from airlines and passengers via HAL's RAB. We agree that efficiently incurred costs should be recovered from the RAB. However, it is not yet demonstrated that the vast increase in Category C costs have been efficiently incurred. Until HAL, and by turn, the CAA can demonstrate that an increase in forecast costs of around £1 billion in a little over 6 months is an accurate demonstration of efficient costs, there should be no regulatory support to add the increased Category C costs to HAL's RAB.
  - **Governance arrangements and regulatory allowances for early Category C costs.** The CAA is considering augmenting the existing governance arrangements over the increased Category C costs. Given that the existing governance arrangements have not prevented the £1 billion of increased costs, we have severe doubts as to whether any revised governance arrangements can control HAL's costs.



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- **Incentive mechanism for cost efficiency.** The CAA comments that it is difficult to establish appropriate and reliable benchmarks against which to assess the increase in Category C costs. If this is the CAA's concern, the CAA should fully support Heathrow West's attempts to introduce such a comparator.
- **Recognising Category C costs through the licence.** The CAA is considering a licence change that would cover the programme for early Category C costs and formalise existing governance procedures. Heathrow West supports such a licence condition. The CAA is concerned that the introduction of a licence condition provides an opportunity for an appeal to the CMA and therefore delay in any new governance and clarity over the treatment of Category C costs. Since the ability to appeal to the CMA is a right established under the CAA 2012, any uncertainty caused by such an appeal is part of the overall regulatory framework. It is possible that such uncertainty would give HAL pause to consider its rate of expenditure. This would seem to be a positive outcome of any such reference.

## 6. Conclusions

- 6.1 We can think of no other example where a regulated company could double its costs of obtaining planning permission, ask for (and obtain) regulatory approval to recover such costs, and also assume that such costs would be picked up by airlines and passengers, should planning permission not be obtained. This appears to Heathrow West to be a fundamental failure in the management of the project by HAL.
- 6.2 Such failure puts the CAA in an impossible position: either it accepts such an increase in costs, or alternatively it seeks a new regulatory paradigm. Competition should be encouraged as the most plausible way to ensure downward pressure on HAL's overall costs for expansion. The CAA should complete the competitive journey started with the break-up of the BAA airports monopoly. Competition within Heathrow airport is the necessary and sufficient regulatory intervention to ensure that runway expansion is delivered in a way that is to the benefit of airlines and passengers. Heathrow West's proposals for an independent and privately financed terminal will help to ensure that expansion is timely and affordable.