

Economic Regulation of the New Runway & Capacity Expansion at Heathrow Airport: consultation on CAA Priorities & Timetable

1. This submission is made by International Airlines Group plc (IAG) in response to the CAA's consultation of January 2017 on its priorities and timetable for economic regulation of capacity expansion at Heathrow Airport (CAP1510). It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling and Aer Lingus plus IAG Cargo.
2. In broad terms, we agree with the CAA's for key priorities; however, as always, as these develop into policies and the regulatory framework, it must incentivise Heathrow Airport Limited (HAL) (and its shareholders) to deliver the objectives of protecting consumer interests, efficiency and affordability. This requires that prices remain flat in real terms, over the short and long term.
3. We look forward to working with the CAA (and other stakeholders) towards these goals, but in the meantime, this response will briefly set out IAG's submission on the key principles relating to its four main priorities. We hope this response will inform the CAA's thinking, particularly in shaping the future regulatory framework.

Priority issue 1: HAL must develop a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders on the potential options, costs and value for money

4. At the date of this response, HAL's plans for capacity expansion remain essentially unchanged from those envisaged in the Airports Commission: Final Report published in July 2015. It is not at all clear that HAL has seriously considered any significant variation to these plans, which are demonstrably not in the best interests of consumers. In our view, the costs associated with HAL's planned development are vague, unjustified and prohibitive.
5. We have consequently developed and shared a number of more efficient and more effective alternatives with HAL – and will continue to work towards a best-value outcome at Heathrow Airport.
6. Rather than an after-thought (at best delivering marginal benefits), technology is a key enabler for the design of airfields, terminals and associated infrastructure – and critically, how these interact to deliver best-value to consumers. In our view technology and innovation should be entirely integral to development at Heathrow. We have seen little evidence that HAL has adopted this principle.
7. There have been a number of recent major airport developments, similar in scale and scope to those envisaged at Heathrow Airport, which provide useful benchmarks, in terms of: terminal efficiency (area/passenger); cost (unit cost/incremental capacity); and financial efficiency (phasing and sources of finance). As things stand, HAL's proposals fall well short of these industry benchmarks.
8. In our view, regulatory policy should force HAL (or any other developer) to measure up to these industry benchmarks. In our estimation, these benchmarks could be achieved and/or surpassed, and should be required in conjunction with the Government and CAA requirement that airport charges should not increase in real terms, over the short or long term. In our bilateral discussions with HAL, this

requirement has not featured as a key consideration for HAL, which appears confident that whatever investment it makes will be remunerated.

Priority issue 2: HAL must develop cost estimates and [the CAA needs] to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way

9. We are concerned by HAL's lack of meaningful engagement regarding its proposed costs of development and potential financing mechanisms, which in our view, are key issues to be resolved.
10. We will continue to engage with HAL, in order to close the considerable gap which currently exists; however, at some stage, it may become necessary for the CAA to step into discussions. With this in mind, in our view it is not necessary for the CAA to develop structured regulatory formulae at this time: more important is to establish a philosophy aimed at delivering efficiency and value.

Priority issue 3: HAL must develop proposals for efficient financing and [the CAA needs] to develop the regulatory framework in a way consistent with efficient financing, affordability and financeability

11. Affordability and financeability are not separate issues. Financeability is subsidiary to affordability: if something cannot be afforded, it cannot be financed.
12. As Government, the CAA and airlines have repeatedly made clear, affordability means that costs must remain flat in real terms, over the short and long term. Consequently, this is a pre-condition to the financeability of development at Heathrow Airport.
13. Aside from benchmarking, the CAA has available a number of possible regulatory approaches to ensuring affordability. For example, adjustments to the regulated WACC can balance shareholder returns with capital efficiency. It is entirely right that investment in inefficient capital programmes should not deliver returns at similar rates to those associated with efficient capital programmes. In competitive markets, it is not unknown for investors in inefficient programmes to lose money. Of course, should forecasts exceed outturn costs, then investors would realise returns in excess of the regulated WACC. In our view, in the absence of tripartite agreement between the CAA, the airlines and HAL on costs, WACC adjustment could be a useful and appropriate regulatory approach.
14. Equally appropriate, would be an approach which opened development at Heathrow Airport to investors, other than HAL; indeed, with the aim of regulation being to achieve a competitive environment, this represents an opportunity to introduce actual competition consistent with the CAA's key statutory duty to protect the interest of consumers. We deal with potential approaches in our specific comments below.

Priority issue 4: HAL must develop coordinated proposals for existing operations (i.e. for the H7 price control) alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable

15. We agree that not all investment should go into R3 and consider that HAL should seek to maximise passenger traffic during H7, in order to provide the best platform for the forthcoming period of significant investment. One way to do

this, would be through the structure of airports charges, over which HAL has control.

16. In regard to the CAA's points on financeability, in our view it would be inappropriate for the CAA to regulate for HAL's investors to be paid dividends at the same time as they are investing in R3. That is not how normal businesses work. Again, we deal with potential approaches in our specific comments below.
17. IAG agrees with the CAA that HAL needs to develop coordinated proposals for H7 and beyond to sit alongside capacity expansion proposals to ensure its overall business plan in the long term meets the affordability challenge. However at this initial stage IAG is concerned that the timescales for the National Policy Statement being designated in the Winter 2017/18 Parliamentary Session, and the publication of HAL's Initial Business Plan for H7 in November 2017 will not give airlines and other stakeholders the opportunity to properly assess and take an informed view on the overall affordability of expansion over the long-term. This could impact IAG's ability to support the National Policy Statement for expansion.

Specific comments on CAP1510

1. Incentives on HAL to deliver in a timely and efficient way

IAG strongly agrees with the view put forward by the CAA that "HAL will need to work within clear budgets for project delivery". We also endorse the view that ex-post incentives, whereby HAL is judged after the event by the CAA as to whether or not it has spent efficiently, and sanctioned accordingly, are difficult to administer. As the CAA notes "these judgments are not straightforward and there are risks that HAL would focus unduly on process for regulatory approval rather than trying to seek out new efficiencies and deliver in a way that would best protect the interests of consumers". To put it simply, once a project of this scale is delivered, the consumer is saddled with it. Any regulatory sanction at that stage would be too little, and more importantly far too late.

We feel therefore that the most appropriate way to tackle regulation of the construction risk of is ex-ante, with robust cost estimates. Rather than a "risk-sharing mechanism", we would prefer that the CAA designed this as a "return-sharing mechanism". We are not averse to developers earning high returns, if they do their job in delivering the capacity expansion at Heathrow Airport within a budget affordable to consumers. If a period of regulation around the construction phase were to be designed, which incentivises the developer to deliver on time and on budget, then such a system would have the best prospects of protecting the long term interests of the consumer.

The return sharing mechanism should, to the extent possible, match the incentives in a normal construction contract:

- Project delivered within budget – the developer retains the majority of the saving and earns a high return;

- Project delivered on budget – the developer earns a reasonable return;
- Project delivered over-budget – the developer earns a return trending towards zero; and
- Project delivered significantly over-budget – the developer pays penalties, or bears the cost overrun up to the limit of their equity.

The CAA feels that an ex-post approach would have the benefit of avoiding "making arbitrary judgments about cost targets". This is surely the benefit of an ex-ante approach, rather than ex-post approach. The ex-post approach simply postpones the judgement, and makes it more arbitrary as the construction has already taken place when it is made. The success of normal construction projects in the private sector rests on a carefully-considered budgeting and costing process, carried out ex-ante.

We believe the CAA can best achieve compliance with its key statutory duty to protect the interests of consumers by promoting an ex ante regulatory framework.

Such an approach would have two broad implications, which would need to be considered:

- (1) Financing: whatever vehicle delivers the construction phase of the capacity expansion at Heathrow Airport, it would probably need to be financed with a thicker cushion of equity than would be the case for an airport in normal operation. This would suggest a separate vehicle with perhaps a different mix of equity investors to the ones currently invested in the HAL topco. It is up to those investors to make their own judgement of the risks and returns of a construction project of this scale, but these are clearly different to those associated with the operation of a mature operating airport. The CAA will have to be mindful of the fact that, with notable exceptions, many of the current HAL shareholders are pension fund investors with a requirement for a running yield. Treating the construction separately, both from the point of view of regulation and from the point of view of its legal structure, might have the benefit of making it much more financeable, attracting a wider range of equity investors more capable of taking construction risk. Such a structure could be similar to what was seen in the Thames Tideway Tunnel development. That project involved a diverse consortium of investors with extensive experience of investing in and managing infrastructure assets, of which only part are pension funds. The particular structure was chosen to de-risk Thames Water because the size of the project was such that it could impact its ongoing viability. As a result, an independent entity was spun out of Thames Water as an Ofwat licensed and regulated utility. It also had the benefit of certain pre-let construction contracts as a result of a procurement process carried out by Thames Water.
- (2) "One size may not fit all": we entirely endorse the view that "different parts of the capacity expansion are likely to have very different characteristics which in turn could influence the choice of delivery mechanisms and efficiency incentives". We do not believe that an unbundled approach needs to lead to

"the downside of more complexity". The project lends itself to potential unbundling. Our assessment of the construction risk is that it lies primarily in the construction of the runway, particularly if the Government persists in the development of a 3,500m runway and the bridging of the M25. It is not even clear, as at the date of this response, what the technical solution to that question is, let alone the associated construction cost. On the other hand, the terminal construction, both outside the current airport perimeter (development of T6 or expansion of T5) and inside the perimeter (expansion of T2) has far less, if any, civil engineering risk, and construction risk (as demonstrated through the recent delivery of T5 and T2). The runway and associated taxiways have to be delivered first, and used by all current and future users of the airport. We believe that its construction can and should be unbundled and regulated separately – otherwise all future construction and expansion will be commercially compromised.

We would not wish the CAA to wait for HAL's proposals in this regard as these are likely to favour maintain the status quo, subject to ex-post sanctions. We would urge the CAA to consider these points and direct HAL to come up with an ex-ante solution. If HAL is unable to do this, IAG intends to develop an ex-ante alternative.

An unbundled solution would also allow equity investment to do what it is supposed to do, that is to fund growth. Heathrow Airport is currently generating equity free cash flow on Q6 targets of around £400m per annum, or £2.4bn over a six year construction phase. This should be more than enough to fund the equity in runway expansion, even at the current inflated cost estimates. Any normal company seeking to expand its capacity by 50% (in this case by developing a third runway) in six years would be re-investing its dividends and its whole equity free cash flow in that growth. We are keen to ensure that this re-investment of equity returns for growth actually happens, and an unbundled construction vehicle would make that transparent.

2. Enhancing confidence in HAL's procurement process

One key problem in single-till regulation where large capex is involved is that of guarding against "double-dip". Even with the most detailed of cost estimates, and even in an ex-ante world, it is difficult for the regulator and the customer to separate the fundamental costs of the project from the margins being charged by the contractors. Where the contractors are also shareholders in the entity commissioning the project, and that entity is capitalising its own fees into the project, then a single till could rapidly become a triple till. In the water sector, for example, related parties are prohibited from bidding for construction contracts unless approved by Ofwat or the Secretary of State.

Put simply, the risk is that HAL (and potentially some of its shareholders) makes a profit on the construction, capitalises this profit into the RAB, and then earns return on the profit. This is clearly contrary to the interest of consumers.

We believe that a separation as described above at least allows this risk to be managed in a more transparent way. Whatever the regulatory solution, we strongly believe there should be safeguards against "making a profit on the profit"

while allowing all parties to make a fair return, and ensuring that the best and most efficient contractors are involved in this vitally important project.

3. **How best to develop incentives and allocate risks, to ensure efficient financing**

We note the CAA's comment that "with additional capacity becoming available, volume risks could become more of an issue in the future. There may be an important role for airlines in considering whether they can enter into commitments with HAL to help manage volume risks and so reduce the uncertainty about future charging levels".

We wholly agree with the view that airlines – particularly those with labour and capital committed to the airport – should actively support an affordable expansion. To do so would be to reduce the overall risk of expansion, and therefore reduce the cost of and increase the availability of capital. However, we would urge the CAA to consider the fact that airlines have their own capital and financing requirements in providing the aircraft needed at Heathrow Airport. We estimate that the replacement cost, in today's terms, of the aircraft currently serving Heathrow Airport, both in terms of aircraft based there and their equivalents in inbound aircraft, is around £40bn. That is the capital required over the next 25 years simply to replace the existing capacity at Heathrow Airport. Any expansion will require a proportional increase on top of that £40bn. The airlines clearly have to find much more capital than HAL does.

Unlike Heathrow Airport, the airlines do not have a regulator supervising them, and seeking to ensure that their prices to consumers allow them to generate an appropriate return to their investors. Instead, they operate in a highly competitive market place subject to volatile external influences. Not only are they more capital-intensive enterprises than airports, they are also more labour intensive. For both of these reasons, they are more operationally-g geared than airports. In other words, external influences, all other things being equal, have a greater impact on the return of the airlines than they do on the returns of airports (including Heathrow Airport). Compounding this, the range of external unforecastable influences on the airlines (such as exposure to fuel price variations) is much greater than those directly impacting airports.

Put simply, the CAA cannot simply ringfence the assets of Heathrow Airport and allocate to HAL a "reasonable" return commensurate with perceived risk. This does not remove the risk, it simply transfer it to the airlines where it is compounded by their much higher operational and external gearing. We remain strongly of the view that, to fulfill the CAA's key statutory duty to protect the interests of consumers, it must have regard to the financing profile of the airlines as well as that of Heathrow Airport.

Simply expecting the airlines to step in and commit volumes in the future, in order to insulate the investors in HAL from risk, is unfeasible and could lead to potentially ruinous outcomes for airlines unwise enough to adopt this approach. In a simple example, if an airline committed to a multi-year volume delivery to Heathrow Airport (i.e., a fixed minimum number of passengers) and experienced a severe macro downturn (similar to those already seen twice in the past 15 years), then bankruptcy might be the only option for that airline to rid itself of the cash losses generated by such a commitment. Given the fact that the UK airlines, unlike their US competitors, do not have the benefit of the "Chapter 11"

provisions then the consequences could be significant not only for that airline, but also Heathrow Airport as well as consumers.

We believe that there are two kinds of commercial approach which could be sufficiently durable to give the requisite comfort to investors in both Heathrow Airport and the airline community:

- (1) Medium term volume incentives built into the pricing formula, and available to all airlines. The current regulatory formula acts as a passive incentive for HAL in the short term to outperform its volume forecasts, but this benefit needs to be shared with the airlines to function as an active incentive; or
- (2) Ability for airlines to invest. Were the airlines able to co-invest with other developers in new facilities, as happens at numerous airports around the world including at the cargo terminals and maintenance facilities at Heathrow Airport, then their interests would be aligned with those of the airport investors. –Such an ownership stake could be traded or used as long-term collateral should the airline find itself in financial distress. To that extent, it would function as an asset to both the airline concerned, and to the airport investors.

The CAA would of course have to ensure that an open competitive environment operates between airlines at all times. Were an airline to invest in facilities for itself, it would need to ensure that such facilities did not restrict other airlines' access to the rest of Heathrow Airport.

Such separation could clearly only be applied to terminal and related facilities, and not to the operation of the runway itself. We therefore agree with the CAA's view that the operation of the runway is not separable from that of the other runways. Of course, while this is the case for runway *operation*, separation could easily be applied to the *construction* of the runways and taxiways, as outlined above.

As regards terminal capacity, though, we strongly support the view expressed by the CAA that "it might be possible for certain assets to be financed outside the RAB / single till or be designed, developed and delivered by parties other than HAL if there are projects that are reasonably separable from the main investment programme".

We would add two important points:

- (1) That the development and delivery of terminal facilities can be considered separately from that of runway and taxiways, provided a masterplan allowing for separate development is agreed upfront; and

(2) That such development does not necessarily have to exclude HAL. Clearly if HAL were unwilling to consider the airlines as partners in the development of terminals, then it would be prudent for the regulator to construct a system in which other delivery mechanisms could be envisaged. However, we believe it would be in the interests of Heathrow Airport generally to allow airlines to be active partners in the development of the facilities that most specifically concern them.

As outlined above, we believe the construction and financing risk of the runways and taxiways can be mitigated by regulating the construction in a different way to that of the operation of the assets. We also believe that the construction and commercial risk of the terminals would be reduced, were they to be regulated in a more flexible and commercial way than runways and taxiways.

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