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HEATHROW WEST LIMITED'S RESPONSE TO CAP 1871

Economic regulation of Heathrow Airport Ltd: policy update and consultation on the early costs of capacity expansion, December 2019

Executive Summary

The Court of Appeal has today ruled that the designation of the Airports National Policy Statement (ANPS) was unlawful unless and until the Secretary of State has undertaken a review of the ANPS. This response is written on the assumption that the Secretary of State will seek to address the error identified by the Court and / or that an appeal to the Supreme Court is successful. Heathrow West Ltd is intending to appeal to the Supreme Court.

The CAA has proposed that HAL's Category B and Category C costs be limited to "only" £2.1bn rather than the £2.9bn forecast by HAL. The CAA explained that this would lead to a short delay in runway opening. HAL responded by publishing an Initial Business Plan (IBP) that delayed the opening of the new runway by one to three years. In this response, we give an initial view on the IBP. In summary, the IBP appears to show that

- HAL is delaying its statutory consultation
- HAL is delaying the opening of the runway
- The costs of construction are rising
- The amount of capacity provided is reducing
- And, as a result, airport charges are rising to levels that cannot be seen as affordable, and therefore cannot possibly meet the affordability test that was set out by the Government.

In contrast, Heathrow West is on track to deliver terminal capacity much sooner than HAL's proposals, at a lower cost resulting in lower airport charges, enhancing airline competition and leading to lower airline fares than would pertain under HAL's proposals. We hope to demonstrate that a Heathrow West expansion will meet the Government's affordability challenge in a way that HAL clearly cannot.

In this response, we request that the CAA's approach to Category B costs is replicated for Heathrow West. In the light of the Court of Appeal's judgement, we believe that the CAA should not confirm any support for Category C costs at this time.

HAL's Initial Business Plan

In response to the CAA's initial consultation, HAL published its IBP four days later. This put forward new runway opening dates of early 2028 to late 2029. HAL also published a summary of two business plans ("Service" and "Savings") showing that by 2036, traffic is forecast to be between 123.7 mppa and 115.2 mppa. On 7 January 2020, HAL announced that the CAA decision on early costs would lead to a revised construction schedule, and therefore caused the need for further consultation. As a result, the date for HAL's DCO submission has been pushed back by 6 months or so and has resulted in a consequential delay in Heathrow West's statutory DCO consultation.



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The IBP included capital expenditure for the 15 years 2022 to 2036. This amounted to £35.7bn to £38.4bn (at 2018 prices) or £31.5bn to £34.9bn (at 2014 prices)¹. It is not clear how either of these numbers relate to the £31bn expenditure to 2036 (at 2014 prices) used by the Airports Commission. The CAA itself reported “total expansion capital costs” as around £32.5bn (2014 prices) to 2050².

We have repeatedly asked the CAA to explain and reconcile the various estimates of expansion costs that are used by HAL and the CAA and this has to date not been forthcoming. Nevertheless, it appears that HAL’s costs of expansion are rising.

The IBP also delays the date for delivering the runway to early 2028 and late 2029. This seems to have a knock on effect on the number of passengers forecast by HAL. The forecast of 115.2mppa to 123.7mppa by 2036 is markedly lower than the ANPS. Using the DfT forecasts³, passengers were expected to be 132mppa by 2030, 135mppa by 2040 and 136mppa by 2050. While it is clear that passenger forecasts are lower, we cannot see whether this is driven by environmental constraints, terminal infrastructure constraints or some other reason preventing rapid utilisation of the runway capacity.

The business plan also shows the impact of HAL’s capital expenditure on airport charges. The IBP shows that HAL’s business plans would deliver expansion at between £26.20 and £29.91 (at 2018 prices smoothed over 15 years). We believe that on a conventional (ie 5 year) price control calculation, this would lead to airport charges at well over £30 per passenger for some of the succeeding price control periods. Given that costs seem to be rising, and passenger throughput seems to be falling, it is inevitable that airport charges will rise. We note that HAL has also published⁴ annual airport charges (i.e. non-smoothed) which shows airport charges approaching £34 / passenger as the table below illustrates:

¹ Using 0.909 to convert from 2018 prices to 2014 prices.

² CAP 1819

³

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/781281/uk-aviation-forecasts-2017.pdf

⁴ <https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-presentations/Heathrow-Finance-Investor-Presentation-January-2020.pdf>



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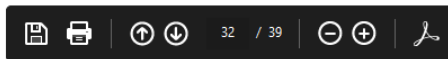
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Expansion – Initial Business Plan ('IBP')

The below tables detail analysis based on the Price Control Model 'PCM' modelling accompanying the plan. This is expected to require additional equity of approximately £3.8 billion or £1.1 billion net equity. From 2022 onwards, we forecast issuing around £3 billion of new debt each year.

Prioritising Savings	(2018p)	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Opening RAB	£m	17,378	19,681	22,886	26,436	29,466	31,793	33,830	35,419	36,177	36,461	36,598	36,244	36,019	36,061	36,357
Capex	£m	3,175	4,077	4,399	3,881	3,307	3,020	2,525	1,762	1,390	1,348	880	1,057	1,318	1,562	997
Depreciation	£m	(872)	(872)	(848)	(851)	(980)	(984)	(935)	(1,004)	(1,106)	(1,211)	(1,235)	(1,282)	(1,275)	(1,265)	(1,353)
Closing RAB	£m	19,681	22,886	26,436	29,466	31,793	33,830	35,419	36,177	36,461	36,598	36,244	36,019	36,061	36,357	36,002
Return on RAB	£m	1,134	1,305	1,512	1,713	1,877	1,870	1,973	2,040	2,069	2,081	2,016	2,000	1,995	2,004	2,002
Operating costs	£m	(1,250)	(1,266)	(1,273)	(1,272)	(1,333)	(1,325)	(1,349)	(1,326)	(1,421)	(1,461)	(1,439)	(1,518)	(1,487)	(1,482)	(1,475)
Commercial revenue	£m	1,344	1,350	1,349	1,345	1,584	1,576	1,640	1,595	1,674	1,743	1,796	1,860	1,902	1,936	1,969
WACC	%	6.1%	6.1%	6.1%	6.1%	6.1%	5.7%	5.7%	5.7%	5.7%	5.7%	5.5%	5.5%	5.5%	5.5%	5.5%
Passengers	m	84.1	85.6	86.4	87.0	87.8	88.4	93.5	98.5	103.5	107.9	112.3	115.8	118.9	121.3	123.7
Est. yield per pax	£	23.2	24.7	26.3	27.9	29.7	29.2	28.8	28.3	27.9	27.5	26.4	25.3	24.3	23.3	22.3

Prioritising Service	(2018p)	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Opening RAB	£m	17,370	19,616	22,410	25,833	29,531	31,766	33,795	35,458	36,752	37,524	38,032	38,188	37,887	38,179	38,530
Capex	£m	3,118	3,666	4,293	4,568	3,203	3,140	2,676	2,330	1,908	1,779	1,533	1,112	1,681	1,802	1,633
Depreciation	£m	(872)	(872)	(870)	(871)	(968)	(1,110)	(1,013)	(1,036)	(1,136)	(1,271)	(1,378)	(1,412)	(1,389)	(1,451)	(1,545)
Closing RAB	£m	19,616	22,410	25,833	29,531	31,766	33,795	35,458	36,752	37,524	38,032	38,188	37,887	38,179	38,530	38,618
Return on RAB	£m	1,131	1,288	1,479	1,697	1,878	1,868	1,973	2,058	2,116	2,152	2,109	2,105	2,105	2,123	2,135
Operating costs	£m	(1,265)	(1,287)	(1,296)	(1,295)	(1,355)	(1,346)	(1,339)	(1,295)	(1,311)	(1,379)	(1,359)	(1,442)	(1,417)	(1,499)	(1,469)
Commercial revenue	£m	1,330	1,338	1,341	1,339	1,573	1,566	1,572	1,490	1,530	1,598	1,653	1,726	1,778	1,846	1,892
WACC	%	6.1%	6.1%	6.1%	6.1%	6.1%	5.7%	5.7%	5.7%	5.7%	5.7%	5.5%	5.5%	5.5%	5.5%	5.5%
Passengers	m	82.32	83.96	85.04	85.76	86.31	86.81	87.24	87.65	91.67	95.57	99.70	103.87	107.92	111.77	115.19
Est. yield per pax	£	23.4	25.2	27.0	29.0	31.0	31.5	32.1	32.6	33.1	33.7	32.3	31.1	29.8	28.6	27.5



The DfT and the CAA have both highlighted the importance that HAL's charges remain affordable⁵. We cannot see how charges above £30 per passenger, compared to c. £21 per passenger today, can in any way be seen as affordable, and therefore how the Government's affordability challenge can possibly be met or the consumer's interest furthered.

As set out in the summary above, the IBP therefore appears to show that:

- HAL is delaying its statutory consultation
- HAL is delaying the opening of the runway
- The costs of construction are rising
- The amount of capacity provided is reducing
- And, as a result, airport charges are rising to levels that cannot be seen as affordable.

In that light, we urge the CAA to carefully consider whether it is appropriate for the CAA to sanction almost £2bn of airlines' and passengers' money on a project that seems to be running late and over budget, and that is currently the subject of an ANPS that has been declared unlawful.

⁵ "We have continued to assume that affordability can reasonably be judged in terms of airport charges per passenger that are broadly consistent with 2016 levels in real terms.", CAA, CAP 1812



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Our caution here arises from the fact that the CAA does in fact have an alternative expansion plan that would address the concerns above by introducing competition, and therefore a means of controlling HAL's rising costs. This is the proposal for construction of the new terminal by Heathrow West Ltd. We strongly believe that Heathrow West can deliver terminal capacity much sooner than HAL's proposals, at a lower cost, and consequently lower airport charges. This would lead to the following implications for the overall expansion of Heathrow Airport:

- Heathrow West still intends to submit a DCO application after that of HAL, in order to amend the HAL DCO, and therefore our statutory consultation has been rescheduled to Q1 2021 to align with HAL's delay (although this is clearly subject to any consequential impacts on the timetable arising from today's judgement);
- Heathrow West was on the verge of issuing the statutory consultation document with respect to our terminal development, and significant extra costs are now being incurred to re-model the impacts of the terminal given the new runway opening dates;
- We believe that our construction programme will still fit around the later runway opening dates;
- We believe our construction costs would reduce the overall cost of expansion by over [£10bn]⁶ compared to HAL's expansion proposals;
- A Heathrow West project can deliver the terminal capacity envisaged by the Airports Commission earlier than envisaged by HAL, and
- Airport charges will be much lower under the Heathrow West proposal, certainly closer to, or in fact meeting, the "affordability challenge" set by the DfT when the Airports National Policy Statement was designated.

To assist with the above:

- HAL should be encouraged to propose just one business plan since, in some years, the difference in terms of expenditure and traffic forecasts are markedly significant, making our modelling very difficult. By way of illustration, forecast capex for 2036 is £997m for 123.7m passengers under one scenario, compared to £1.6bn for 115m passengers under the other.
- The likelihood that the CAA will be able to set H7 from 1 January 2022 now seems remote so the CAA should set out its proposals in this regard.

It is only by allowing and encouraging competition between infrastructure providers at Heathrow that the possibility of the benefits outlined above can be maintained. We believe that the regulatory framework enables such competition. Further, we believe that competition better facilitates the CAA's duties ("the CAA must also carry out its functions,

⁶ To be excised in a public version



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where appropriate, in a manner that will promote competition in the provision of airport operation services”) compared to allowing HAL to retain a monopoly over the infrastructure at Heathrow Airport.

We intend to respond to HAL’s IBP in more detail in due course.

Regulatory treatment of HAL’s early costs

The CAA has decided to cap HAL’s Category B costs at £500m and strengthen the governance of these costs. With respect to Category C costs, the CAA is consulting on a cap of £1.4bn, again with strengthened governance.

The following issues arise from consideration of the CAA’s decision and proposal:

- CAA was expecting a runway opening delay of between 6 and 8 months; whereas HAL’s revised timetable was between 1 and 3 years later. It is not clear why HAL envisages that the CAA’s decision results in such a lengthy delay in runway opening compared to the delay envisaged by the CAA.
- We recognise that the CAA has imposed a lower rate of return on HAL if it fails to achieve the DCO application. Has the CAA considered the situation if Heathrow West is successful in terms of its DCO and the decision is to proceed with the HAL DCO as amended by the Heathrow West DCO? This would represent some of HAL’s costs being associated with a successful DCO (i.e the runway) and some of HAL’s costs being associated with an unsuccessful DCO (i.e the terminal).
- What is the definition of successful? We expect that this would be a decision in favour of the DCO arising from the DfT consideration of the recommendation from the Planning Inspector. However, it is likely that there would be a legal challenge to the DfT’s decision, that might overturn the DfT’s recommendation. The CAA should clarify whether this situation would represent a successful DCO.
- In the light of today’s Court of Appeal judgement, and if the Government does not successfully correct the error and / or an appeal to Supreme Court is unsuccessful, will the CAA still allow HAL to recover Category B and Category C costs to date?
- Given that the CAA has already concluded that HAL can spend up to £500m on Category B costs, there would seem to be no incentive for HAL to re-consider its expenditure on Category B costs, even at a time when the ANPS has been declared unlawful. However, should the deficiencies in the ANPS not be corrected, there would seem to be no grounds for allowing recovery of HAL costs (Category B or C costs) from today’s date.

Category B costs for Heathrow West

The policy outlined by the CAA is that a party, in this case HAL, pursuing a DCO should be entitled to recover Category B costs, subject to oversight and governance of the CAA. We believe that this policy should also be applied to the costs being incurred by Heathrow West in pursuit of our DCO. There are then 2 scenarios:



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If Heathrow West is successful, we should be in the same position as HAL. That is, the CAA should confirm now that, if Heathrow West's DCO application is successful, the CAA agrees that these costs should be recovered from airlines, with the timing of recovery to be agreed with the CAA. This recovery of costs could be at the time of the terminal being operational. Alternatively, following the pre-funding precedent of Terminal 5 and Terminal 2, Heathrow West would be allowed to begin recovering its costs ahead of terminal opening. To the extent the cost recovery was delayed, we would expect a return on these costs, in the way that HAL has been allowed.

If Heathrow West is unsuccessful, the situation is a little more complicated. The CAA policy is that HAL would be allowed to recover its costs, albeit with a lower return, with costs rolled up and added to the RAB (less any revenue recovery associated with the allowed £10m currently). In the situation where Heathrow West was unsuccessful in its DCO application, there would not be a RAB to which costs could be rolled up. To achieve equitable treatment however, Heathrow West should be allowed to recover these costs. This would seem to involve adding a charge to HAL's airport charges in order to allow the recovery of Heathrow West's DCO costs. We look forward to the CAA addressing these issues in its forthcoming consultation on Heathrow West.

We note that Category B costs being incurred by Heathrow West are significantly lower than the Category B costs that have been incurred by HAL to date. This is an early sign that Heathrow West is already pursuing a more efficient project than HAL. The regulatory protection afforded to HAL by the CAA gives little incentive to efficiency.

The definition of "successful" and "unsuccessful" is somewhat complicated by today's judgement and we are considering this matter further.

Category C costs for Heathrow West

The CAA is consulting on its policy with respect to early Category costs. The proposal is that HAL should be allowed to recover its Category C costs, whether or not its DCO consultation is successful. The rate of return differs dependent on whether the DCO application is successful or not.

Clearly, unless and until the Secretary of State corrects the deficiencies outlined by the judgement, the ANPS is unlawful. We do not know if an appeal to the Supreme Court will be successful. We do not know whether the Secretary of State will correct the deficiencies. We do not know when the Secretary of State will correct the deficiencies. Until the fate of the ANPS is decided, we believe it would be reckless and inefficient for HAL to proceed to incur Category C costs. Further, we believe that it would not be appropriate for the CAA to support the recovery of Category C costs until the fate of the ANPS is known.

At this stage, Heathrow West has not incurred Category C costs albeit that the Arora Group owns land that would in fact be used to construct the new terminal and associated airport infrastructure.



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Implementation

The CAA is proposing a licence condition to govern HAL's early Category C costs. This seems appropriate given the magnitude of Category C costs, and the significant (and apparently unforecasted) increase in costs. In principle, Heathrow West would not object to such a licence condition covering any early Category C costs that might be incurred by Heathrow West. We suggest however that the need for any licence condition with respect to Category C costs is premature until the fate of the ANPS is known.

HAL's expansion costs

The CAA has provided some commentary on HAL's expansion costs (in appendix B). The CAA states that "HAL's overall budget for capacity expansion has remained relatively stable". The discussion immediately then moves to a review of the £14bn that has been described as capital expenditure to 2026 to runway opening. This figure is sometimes described as being consistent with the capital expenditure of £17.6bn as used by the Airports Commission. Indeed, HAL often describes the current estimate of £14bn as a reduction from the Airports Commission figure. This is of course incorrect as it is now clear that the "reduction" in costs was in fact achieved by removing the terminal (and we assume a degree of associated expenditure) from the £17.6bn and delaying the provision of that terminal capacity. We note for example that the "Service" business plan in the IBP refers to terminal capacity not being provided until 2031.

We welcome the breakdown of HAL's expansion costs provided in Table B1. This confirms what has been widely assumed, that HAL's "reduction" in expansion costs is achieved by delaying the construction of new terminal capacity. It is possible that HAL is providing incremental terminal capacity by a combination of T5, T3 and T2 expansions. Indeed the Capital Investment Plan (a separate and earlier document than the IBP) refers to projects called T5+ and T3+. However, the clarity of the Airports Commission work has been lost by the differing ways in which both HAL and the CAA are choosing to report costs (at least in public).

As the CAA is aware, we believe there is a fundamental need for the CAA to consider two expansion scenarios. One is where the expansion is provided by HAL alone. The other scenario is where the expansion is delivered by HAL and Heathrow West. We believe that the HAL / HW delivery will lead to lower airport charges, earlier provision of terminal capacity and a superior passenger service, while promoting competition between airlines. We have therefore requested more details on HAL's capital expenditure plans, to a level of detail that was published by the Airports Commission and HAL itself. We repeat our request for transparency over the costs and traffic forecasts included in the IBP. Further, the CAA has in the past discussed expansion costs out to 2050. It is not clear why this expansion timetable is no longer being referenced by the CAA.

We understand that the CAA will publish more detail as part of the HAL price control process, during 2021 (although H7 may be further delayed) to allow a new price control to be set in 2022. However, we believe an assessment of the merits of a Heathrow West expansion will need to be carried out (by the CAA) prior to the DCO process beginning,



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which would imply the CAA coming to initial views on the desirability of a competition to deliver expansion by the end of 2020, as well as developing a Statement of No Impediment.

The CAA mentions that it is to publish two Arcadis reports, one covering expenditure prior to 2026 and one covering plans after 2026. We understand that the CAA is still intending to publish these reports and we look forward to analysing Arcadis' conclusions.

We are content for this submission to be published, subject to the redaction requested.

Heathrow West Ltd 27th February 2020