ECONOMIC REGULATION OF CAPACITY EXPANSION AT HEATHROW: POLICY UPDATE AND CONSULTATION

CAA CAP 1658 CONSULTATION

Richmond Heathrow Campaign Response - 6 July 2018

Introduction

1. This document is the response of the Richmond Heathrow Campaign (RHC) to the CAA Consultation on Economic Regulation of Heathrow Expansion as contained in the document: *Economic regulation of capacity expansion at Heathrow: policy update and consultation, April 2018 - CAP 1658.*

2. The Richmond Heathrow Campaign (RHC) represents three amenity groups in the London Borough of Richmond upon Thames: The Richmond Society, The Friends of Richmond Green, and the Kew Society, which together have over 2000 members. The members of our amenity groups are adversely affected by noise from Heathrow Airport's flight paths, poor air quality and road and rail congestion in west London. We acknowledge Heathrow's contribution to the UK economy and seek constructive engagement in pursuit of a better Heathrow. Economic regulation is an important part of this. We are an active participant in the Heathrow Community Noise Forum.

3. Our premise is that it would be preferable to aim for a better Heathrow rather than bigger Heathrow and to capitalise on the world beating advantage of London's five airports, in particular by improving surface accessibility to all five airports, which would be a major benefit to users. London has the world's largest origin and destination market of 160 million passengers annually.

4. Our approach is to continue supporting the case for no new runways in the UK, notwithstanding the Parliamentary vote in favour of Heathrow's Northwest runway (NWR) option on 25 June 2018 and the subsequent Secretary of State's Designation of the National Policy Statement. We believe the evidence produced by the Airports Commission and by the DfT supports our position for no new runways, even though the Commission and the Government recommended (irrationally in our view) the NWR expansion option. Our reasoning is set out in our responses to the DfT on the RHC website at www.richmondheathrowcampaign.org.

5. The CAA's acceptance of the Government's decision to support the NWR expansion and all that goes with that premise, we believe will result in the CAA's economic regulation of Heathrow's expansion being flawed and unfit for purpose.

6. RHC responded to two CAA consultations on economic regulation in 2017 - CAPs 1510, 1541 and to CAP 1610 in 2018. The responses are on the RHC website.

Economic Background to Heathrow Expansion

7. Paragraph 1 of the Consultation says *'The CAA has consistently stated that additional runway capacity in the southeast of England will benefit air passengers and cargo owners. The timely delivery of more aviation capacity is required to prevent future consumers experiencing higher airfares, reduced choice and lower service quality.'* The following DfT and CAA evidence does not support this hypothesis. There is absence of need for a 3rd runway and a 3rd runway harms the aviation market and in turn UK air passengers.

   a. Even without a 3rd runway, the number of passengers terminating their journey at Heathrow will grow by 60% by 2050 from increased aircraft loads and reduced international-to-international transfers. *Heathrow is not full*.

   b. The unsatisfied terminating passenger demand of 37 million passengers per annum (mppa) by 2050 is almost all short-haul leisure, capable of being served many times over by UK spare capacity equivalent to 6 runways in 2050. Unused spare runway capacity in 2050 comprises (mppa):
      i. London airports (Stansted 8, Luton 7),
      ii. Larger regional/nation airports (Manchester 31, Newcastle 22, Liverpool 24, Bristol 19, Glasgow 18 and Edinburgh 10),
      iii. Other regional/nation airports (95 mppa).

      A two-runway Heathrow and other capacity is well able to satisfy UK demand to 2050.

   c. A 3rd runway results at the UK level in not a single additional long-haul or domestic business passenger. *The major economic benefit from additional business travel claimed by Heathrow, the Airports Commission and the Government is absent.*

   d. The 43 million passengers per annum (mppa) served by a 3rd runway is comprised of:
      i. 17 mppa cannibalised growth from other UK airports. Manchester loses 5 mppa, Birmingham 2 mppa and smaller airports lose 10mppa by 2050.
      ii. 16 mppa international-to-international transfers of no economic value to the UK (see g below),
      iii. Just 10 mppa additional mostly short-haul terminating passengers. These represent only 2.3% of UK passengers by 2050 and can be served by other UK airports.

      A 3rd runway harms the regional balance and is used inefficiently.

   e. Heathrow's 3rd runway expansion results in not a single additional destination from the UK. Heathrow's increased frequency of flights to already popular destinations is offset by loss of frequency at other UK airports. *UK connectivity is impaired*.

   f. There is a turnover in destinations at Heathrow of around 10 (5%) a year. *Opportunities for new beneficial routes are available if needed*.

   g. 37% of Heathrow's additional 3rd runway passengers are international-to-international (I-I) transfer passengers but only 300,000 out of 24 million I-I transfers are on less viable or thin routes. I-I transfers do not support otherwise unviable thin routes. They represent 94% of additional passengers on UK long-haul routes, which is highly inefficient use of runway capacity. I-I transfers do provide income for the airlines but the income would be preserved or increased by replacement with terminating passengers, for example in the in the two runway case. *Heathrow's hub value is a myth*.

h. The Commission on Climate Change estimate the need for a cap of 389 mppa at the UK level by 2050, compared to the estimated 435 mppa served assuming a 3rd runway. If the speculative carbon abatement and carbon trading fail to bridge the gap, the necessary demand management will have a substantial negative impact on the regional airports in the case of a 3rd runway, as was demonstrated by the Airports Commission. *The carbon risks are considerable*.

8. In our view it is important that economic regulation of Heathrow takes account of the economic scenario described above, all of which is evidence provided by the DfT and CAA, and not an unrealistic scenario promoted by Heathrow and its lobby of supporters.

Affordability

9. Chapters 1 and 2 of the consultation deal with affordability, to which we respond here.

10. A primary duty of the CAA under regulation CAA12 is to protect and further the interests of consumers (passengers and freight owners). This includes affordability and quality of service.

11. Given the scenario described in paragraph 7 above and the primary duty in paragraph 10, we urge the CAA to focus on terminating passengers and those across the UK and not just at Heathrow. The loss of growth at other UK airports as a result of a 3rd runway needs to be addressed. The risk of further loss through the impact of climate change needs to be mitigated. Also, there is no case we believe for the economic regulation to support international-to-international transfers who already benefit from discounted aero charges and airfares and are exempt from Air Passenger Duty. The UK as an aviation hub would be better served by terminating passengers replacing I-I transfers.

12. Regarding prices, the stated aim of the Government is *'to try and deliver capacity expansion with airport charges remaining close to current levels in real terms.'* We believe this is just not good enough. There is no case for there being anything other than a material reduction in aero charges. We are very concerned at the results of the CAA's economic modelling and indeed our own modelling which shows aero charges reaching £30 or even £40 a passenger (2014 money), compared to around £22 in 2017.

a. Our assessment of Heathrow regulatory accounts in 2016 showed there to be an excess profit of £300 million. Excess profits should be eliminated by the CAA's economic regulation. We included an assessment of this profit in our previous responses to the CAA.

b. We firmly believe that the starting point for considering the path for future aero charges should not be based on 2016 but should be at the end of the Q6 interim extension of say 2 years , i.e. 2020. Also the charge should exclude excess profits. We suggest this means the average nominal starting charge should be around £19 or less per passenger (2014 money); this compares to around £22 in 2016. The reasonableness of £19 is given weight by Figures 2.1 and 5.1 in the consultation.

c. We urge the CAA to ensure the aero charge actually continues to reduce annually in real terms below £19 per passenger to reflect airport productivity improvements that would arise with a two runway airport. These productivity improvements should not be less than those for the UK as a whole, and we urge the CAA and HAL to focus on productivity in determining affordability.

d. We believe a reducing charge from £19 should be possible notwithstanding Heathrow's substantial ongoing core and maintenance capital expenditure.

e. We question why the CAA would seek to allow UK terminating passengers to be burdened with all the inefficiencies created by a 3rd runway. Instead the CAA needs to ensure that passengers across the UK benefit from a reduction in fares and with Heathrow's fares competitively priced against other UK airports. Unfortunately, the expensive expansion of Heathrow creates a high floor under aero charges. We urge the CAA to prevent Heathrow benefiting from using its monopoly powers to keep charges from reducing annually.

13. In our responses to CAPs 1510, 1541 and 1610, we made the case that there is no congestion premium at Heathrow, which the airlines also claim to be the case but this is not the view of the CAA. Airfares at Heathrow may be higher than at other airports on some routes but this is because Heathrow is the most expensive airport in the world. Heathrow's fares are largely driven by cost and not by demand exceeding capacity (i.e. scarcity rent). We therefore believe that any increase in the aero charge arising from expansion will not be absorbed by the airlines but will pass straight through to the passengers. The reverse is not necessarily the case and any reduction in aero charge, as proposed above, may be retained by the airlines. We urge the CAA to consider ways to ensure that aero charges do not increase and that reduced charges benefit passengers.

14. In the section below on surface access, we suggest the per passenger cost could be substantial. In the widest sense, affordability needs to recognise not only the airside costs but the surface access costs to passengers (including air quality costs) and the carbon costs which are estimated to rise considerably over time. This is further reason for the airside cost to be reduced over time if there is to be long-term sustainable pricing for air travel. To focus just on the airside aero charge, we believe fails to recognise the full cost and affordability of air travel using Heathrow. So far, the CAA's emerging economic regulation for a 3rd runway seems to be too narrowly defined. We realise the CAA's scope is restricted by its statutory terms of reference but then these may need to change.

Financeability

15. Consultation Chapters 1 and 2 deal with financability. Based on the figures in the Airports Commission's Final report, we assessed the financial deliverability in our response to CAP 1541. We concluded that the 3rd runway expansion could result in a substantial loss of value for HAL, e.g. from £18bn to £6bn (35 year NPV 2016 money). The loss of around £12bn compares with HAL's current book debt of £12bn and equity of £3bn. We recognise that since then HAL has introduced the Westerly Option with £2.5bn of capital expenditure savings. As highlighted in recent CAA publications and in the current consultation there seemingly is still considerable uncertainty as to the financial viability. We await further evidence from HAL as to the scope and costs of the NWR expansion before revising our assessment. At the moment we have major doubts as to the financiability without State support, which support we are wholly against since Heathrow is privately owned and moreover owned 90% by overseas shareholders.

16. We have looked at various tax issues such as tax allowances and APD and there is one particular issue we wish to raise here concerning interest tax relief and the debt level.

    a. The Airports Commission estimated financing costs in nominal terms between 2014 and 2050 of £26.8bn and £48.6bn, respectively for the Do-Minimum and NWR expansion cases. These costs are mostly interest and at a corporation tax rate of 17% result in tax reduction of £4.6bn and £8.3bn, respectively and assuming a debt ratio as high as over 80% of asset values.

    b. The effect of this debt leverage is to produce relatively high equity rates of return on account of the cost of debt being relatively cheap compared to equity but then the risks are transferred from lenders to shareholders. This is not a financial issue providing the project is successful.

    c. The treasury is exposed on two counts - firstly, to the potential financial default caused by excessive debt leverage and secondly by the substantial support given to the shareholders in the form of the interest tax relief on high levels of debt.

    d. Large airports can be attractive investments. While Heathrow is probably the world's most expensive major airport, it is a monopoly and charges the airline and passengers far more than any other airport. The CAA's economic regulation is intended to prevent HAL exploiting its monopoly position but the control is not achieving this, as is evidenced by the £300 million of excess profits referred to above, and this makes no assumption about Heathrow's costs being inflated, which they almost certainly are as evidenced by airlines in their recent submissions to the Transport Select Committee. The current shareholders and indeed bond-holders have a cash cow investment, this is evidenced not least by the fact that HAL can finance itself with over 80% debt and pay substantial dividends funded by debt. The passengers in the form of inflated airfares and the Treasury in the form of foregone tax are paying the price.

e. This buoyant situation could continue with the NWR expansion. But if aero charges are held at today's level or reduced then, as we suggest above, the financial situation is potentially turned on its head. The shareholders and Treasury are then bearing the costs and risks previously born by the passengers. We argue that not only should aero charges be reduced (given the excess profits and productivity) but that the regulatory control should ensure the project costs are not inflated and that the allowed regulatory profit only supports debt of no more than say 50% of the asset base. In this way passengers and the Treasury would be better protected with the costs and risks placed on the shareholders, which is where they should be.

17. We question the CAA's approach to the expansion in which it appears that the financial modelling appears to look at a combined two and three runway scenario. For example the debt metric tests shown in the consultation appear to be for HAL in totality without an assessment of the 3rd runway increment. Our modelling of HAL's corporate cashflow, as discussed in paragraph 15 above (to be updated with cost and other data when available), shows how the incremental impact of a 3rd runway could be substantially negative. So while the debt metrics and indeed return on equity for HAL as a whole might still meet minimum criteria there could have been a substantial deterioration in both the debt and equity support from Heathrow's business. Bond holders and shareholders will surely wish to assess the incremental impact of a 3rd runway and be very concerned at reduced financial return and resilience, even if the minimum investment criteria are satisfied. We urge the CAA to produce an incremental financial assessment for the 3rd runway.

Surface Access

18. The consultation Chapter 7 deals with surface access. We support the CAA's proposal that the user should pay and we believe this should be at the point of use (ticket sales for public transport and congestion charge for road use). However, HAL has not provided an adequate assessment of the essential investment needed in surface access. We accept this investment does not have to be by Heathrow but could be by a 3rd party promoter or even the State. Our assessment of surface access is presented in a recent report titled *'The Impact of Heathrow Expansion on Surface Access, June 2018',* which is on the RHC website. Attached here in the Annex is a brief summary. Key points as far as economic regulation are concerned are that:

a. Projects currently referred to as providing public transport capacity, such as Elizabeth Line, upgrade to Piccadilly line, Western Rail Access Link and Southern Rail Access Link are only sufficient for the 60% growth in terminating passengers at a two-runway Heathrow. Substantial additional public transport capacity is needed for a 3rd runway and for modal shift from road, which is essential for reducing congestion and air pollution. The NPS failed to define the additional capacity needed. Failure to provide sufficient public transport capacity would result in overcrowding on public transport and additional high levels of road traffic added to background traffic with still higher dis-benefits from delayed journeys and pollution - altogether potentially costing the nation up to £25bn (60 year NPV) and specifically as a result of a 3rd runway.

b. Required road congestion charges of £33 per passenger or more (£20 bn 60 year NPV) should be used to fund additional public transport capacity and not as additional return to Heathrow's shareholders.

c. Heathrow and its passengers and staff are already using surface access capacity they have not paid for and this should not continue with new capacity needed for a 3rd runway.

d. Every effort should be made to avoid there being a shortfall between the cost of surface access and user payments. Any subsidy certainly should not be for the State to satisfy. If subsidies were included in the RAB model then there is likely to be little matching relationship between the fares paid by passengers to the airlines and the benefit received by those using the surface access capacity.

e. We believe that the cost of public transport will be substantial if the £25bn of damages from a 3rd runway is to be avoided. Heathrow and the airlines clearly do not want the cost to go through the aero charge but ultimately the passenger will have to pay and that is what should be taken into account when considering affordability.

f. We appreciate there are difficulties in the CAA incorporating surface access into is regulation, given its terms of reference, but this needs to be overcome.

Timing

19. As we have said in previous responses to the CAA, we believe the affordability and financeability of Heathrow's expansion should be fully determined at an early stage. We had recommended this should be before the recent designation of the NPS. The CAA's timetable stretching out to 2021 is far too late. Heathrow urgently need to update their business case so that proper cost estimates can be included in the economic regulation model.

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Annex: Surface Access

ANNEX

THE IMPACT OF HEATHROW EXPANSION ON SURFACE ACCESS
Richmond Heathrow Campaign (RHC) June 2018
The following is a summary of a report on RHC's website -'The Impact of Heathrow Expansion on Surface Access, June 2018'

1. London Background Traffic
   a. Congestion from growing background traffic continues to increase the dis-benefit from delayed journeys and pollution,
   b. There needs to be a shift to public transport but is there capacity?
   c. The new Elizabeth line (2019) and an upgraded Piccadilly line (mid 2020s) will serve growth and modal shift but overcrowding still results,
   d. This additional capacity is for background traffic and is not intended for passenger and staff growth at a two or three runway Heathrow.

2. Two runway Heathrow
   a. Terminating passengers are expected to increase by 60% between 2016 and 2050,
   b. The Western Rail Access Link (WRAL) and Southern Rail Access Link (SRAL) are not yet committed or funded by a sponsor,
   c. The WRAL and SRAL are needed to serve the two runway passengers and staff growth and are not sufficient also to support 3rd runway growth.

3. Three runway Heathrow
   a. Heathrow has pledged Heathrow related vehicle traffic should not increase,
   b. The resultant public transport modal share would be around 70%, which is a very challenging shift from the current 40%. Daily trips would triple between today and 2050.
   c. Substantial new public transport capacity would be required and there appears to be no published scope, cost or timetable for such capacity - a major failing of the NPS.

4. Failure to achieve 'no increase in vehicle trips'
   a. The pledge of no increase in road vehicle trips related to Heathrow could easily fail because of failure of modal shift or failure to provide sufficient new public transport capacity,
   b. Failure would result in overcrowding on public transport and additional high levels of road traffic added to background traffic with still higher dis-benefits from delayed journeys and pollution - altogether potentially costing the nation up to £25bn (60 year NPV) ,
   c. In the event of failure, Heathrow should be required to take remedial action or curtail its flights and terminating passengers.

5. Heathrow's contribution to surface access costs
   a. Ultimately the user of the surface access should pay,
   b. To the extent fares to/from Heathrow are subsidised on the Elizabeth line, Piccadilly line, WRAL and SRAL then Heathrow and not the tax payer should pay for the subsidies,
   c. Heathrow and its passengers and staff are already using surface access capacity they have not paid for and this should not continue with new capacity needed for a 3rd runway.
   d. Required road congestion charges of £33 per passenger or more (£20bn 60 year NPV) should be used to fund additional public transport capacity and not as additional return to Heathrow's shareholders,
   e. The costs to passengers for surface access capacity needed for a doubling of Heathrow's terminating passengers from today are likely to be substantial and a major addition to the already high and potentially increasing airport costs born by passengers.

End