

# **Response to CAA consultation on CAP 1832: Financial Resilience and ring fencing.**

**From Paul Groves, member of the No 3<sup>rd</sup> Runway Coalition, 11<sup>th</sup> October 2019**

The historical and current environment for Heathrow expansion is one where most major infrastructure projects have exceeded budget typically by around 100% and in some cases significantly more. These include HS2 approaching twice original budget, the Olympics twice initial budget, to the Scottish Parliament costing 10 times original budget, and Crossrail inability to complete ontime and on budget. No doubt Heathrow Airport Ltd (HAL) would say that they have a rigorous project plan and such increases will not occur, however no doubt all the above-mentioned projects also said that they had rigorous plans and such increases would not occur.

HAL's complex and permitted financial structure, allows them to finance expansion mostly by debt or gearing, which in turn is serviced by charges to the public and airport users. Also with HAL being permitted to take dividends based on their Regulatory Asset Base (RAB) or perceived investment (which is largely borrowing serviced as above), then there is no incentive to keep costs under control, but rather a perverse incentive to allow costs to increase and so provide increased dividends to HAL's shareholders, financed by debt which is in turn serviced by charges to the public and airport users.

It has been said that HAL's RAB finance and earnings structure was designed to incentivise them to invest in the UK. However the level of incentive is excessive and unnecessary. Many global investors and organisations are very keen to invest in the UK without needing such overly generous incentives.

What was outlined by the Airports Commission as an £18bn project taking around 5 years from start to completion has now ballooned in HAL's Masterplan to a £32bn project taking 30 years!

As a very relevant example of the way Heathrow expansion is already proceeding, in your own CAA paper "Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable", you have outlined that HAL's estimated £265m for them to reach DCO stage (i.e. Category B costs), but this has now escalated to a likely £500m, i.e. almost doubling. This is a strong precursor to the way Heathrow expansion will continue in future.

In an environment of increasing pressure and government commitment to reduce carbon emissions to zero, to significantly reduce noise and pollution, and to improve the well-being of the public living near Heathrow and under flightpaths which extend up to 10 miles from the airport, with increasing airport charges pricing Heathrow higher than other airports and other means of travel, which will likely lead to reductions in travel via Heathrow, there is a very real risk of a 3<sup>rd</sup> runway not meeting its original business objectives and returns. A similar situation occurred for the Channel Tunnel which could not be completed as originally expected, and had to be bailed out by the government with public money. With current

plans and financing and with increasing need and pressure to reduce aviation, there is a very real chance of similar risks and outcome for Heathrow expansion.

In addition the Sunday Times reported of arrangements whereby passengers, government and the public will carry the risk and costs of unexpected costs and engineering problems of a third runway, as at the following link and the attached pdf.

<https://www.thetimes.co.uk/article/passengers-face-risk-for-heathrows-new-runway-npg2xnqmn>

In the environment just noted, it is highly questionable whether a third runway will provide the expected benefit to the nation. The real beneficiaries are HAL and their shareholders via their method of earning dividends as noted. It is for HAL to assess the viability of the project and take a business decision as to whether they should invest. They want the upside and they need to be willing to take any downside without the government or public bailing them out.

Following lessons learned in the 2009 credit crisis about excessive levels of gearing, the above CAA paper rightly raises concerns about:

1. Heathrow and expansion financial resilience, and
2. Credit Planning

HAL is already excessively geared, to the tune of £11bn in 2014, and their proposed £32bn project would increase this gearing to around £40bn, a four-fold increase which presents a huge risk. This is in comparison with other major and relevant organisations having gearings as follows.

Heathrow as a company has debt of £13.7bn and a £15.8bn asset base — giving it a leverage ratio of 87%. Financing the construction of a third runway would almost double the size of Heathrow's £15.8bn asset base. This would also require stretching its balance sheet further, taking the leverage ratio up to 93%.

By way of comparison, the highly geared utility Thames Water has ratio of 81.5%, and is under pressure to reduce this.

In 2012, the CAA imposed a gearing ceiling on the air-traffic company NATS of 65%. If debt climbs above this level, NATS is banned from paying dividends.

In addition HAL are masters of slow and non-responses when requested to provide information as has been noted on numerous occasions by Highways England. Highways England say that HAL leave meetings full of promise to provide information at the next meeting, but then fail to provide the information previously requested and agreed.

In addition, the Airports Commission determined that associated road and rail infrastructure would cost approximately £5bn. TfL however estimated this infrastructure to cost around £15bn. But when pressed HAL only agreed to contribute just £1bn. And this is for a project

where HAL and their shareholders are THE major benefactors and they are expecting the public to pick up the cost.

The CAA working paper, to which this is a response, also rightly highlights the need for:

3. Sufficiency of Resource, and
4. Obligation to hold an investment grade credit rating

Regarding investment grade credit rating, please refer to the above comments on HAL's excessive gearing. In S&P's August 2019 ratings assessment, they raised concerns about HAL's lack of transparency in their plans regarding financing for third runway. Indeed, they stated that there was insufficient information about exactly how the project would be financed in terms of levels of debt and equity, and how this would be balanced with objective of keeping landing charges close to 2016 levels.

The S&P report also highlighted as a risk the aggressive leveraging and relatively weak credit metrics of HAL.

HAL needs to be held to account, with strong conditions to which they MUST and will comply.

# Passengers face risk for Heathrow's new runway

Airport demands right to raise landing fees if £18bn expansion goes awry

**John Collingridge**

August 13 2017, 12:01am, The Sunday Times



Europe's busiest airport wants higher charges to help cover risks

Flight prices may be pushed higher to cover the financial risk of delays or construction problems on Heathrow's new third runway.

The airport is demanding the right to make airlines and passengers contribute to any unexpected cost overruns or engineering problems on the £18.6bn project.

In an official filing to the Civil Aviation Authority (CAA), Heathrow quietly asked the regulator to factor a huge array of risks from building the 3,500 metre runway across the M25 into the charges it is allowed to claw back from carriers. Although Heathrow insisted that landing charges would remain close to current levels, industry experts said there were few credible alternatives.

The hub's biggest user, British Airways' owner IAG, has warned the move will lead to charges doubling from about £40 to £80 for a return ticket.

Europe's busiest airport, which is owned by mainly overseas investors, wants higher charges to help cover risks including: construction delays; lack of

interest from airlines in taking up the new landing slots; financial markets turning against the airport, leading to a downgrade of its credit rating; higher debt costs; and a political change of heart on the project.

Heathrow recovers the cost of any new infrastructure through airline charges, which are usually passed on by the carriers to passengers in calculations approved by the CAA.

Heathrow's demand was contained in a document submitted earlier this year. The CAA is attempting to tackle one of the big questions ignored by the Airports Commission, which examined how to raise aviation capacity: who should bear the risks of the hugely complex project?

The airport said in the submission that its investors were not “seeking special treatment or risk-free rewards. However, unlike a private enterprise in an unfettered market . . . these risks do need to be addressed or compensated for in the regulatory return.”

Heathrow was told to keep charges “close to current levels” when the government gave permission for the runway in October. While the airport insists it is cutting costs to adhere to this demand, experts said that shifting risks onto travellers would inevitably force up charges.

Martin Blaiklock, an independent infrastructure expert, said the only way Heathrow could keep charges flat would be to significantly increase the number of people going through its terminals. “Anyone using Heathrow today will view such a boast with some scepticism,” he said.

“The responsibility for delivering the expansion to time, cost and specification should be left to Heathrow alone, with no payment from passengers for the expansion until the project is available for use.”