

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

CAA CAP 1722 CONSULTATION

Richmond Heathrow Campaign Response - 4 January 2019

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, October 2018 - CAP 1722*.
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 less than optimal.
6. RHC responded to CAA consultations on economic regulation in 2017 - CAPs 1510, 1541 and in 2018 - CAPs 1610 and 1658. These responses and other related material are on the RHC website.

UPDATE AND SUMMARY

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.'*
8. **UK Economics.** RHC has made the case in its previous responses to the CAA that Heathrow's expansion harms the UK aviation market and has a substantial negative economic impact on the UK, even before including the environmental harm caused by noise, NOX pollution and carbon emissions. Our conclusion is based on evidence provided by the Airports Commission and by the DfT in its NPS submission to Parliament. The Annex briefly summarises the damage to the UK aviation market and given the Annex summary and our previous submissions, the evidence is not repeated here.
9. **Hub Airport.** We have shown in previous responses to the CAA and on RHC's website through detailed analysis of evidence provided by the CAA to the DfT and in turn to RHC that the idea that Heathrow has value as a hub airport is a myth. The Annex provides brief comment and the evidence is not repeated here.
10. **International-to-International Transfer Passengers.** The evidence demonstrates that a substantial proportion of the additional capacity will be used by International-to-International Transfer passengers, which are of no value to the UK. We question economic regulation that seeks to benefit this segment of the market, especially as it already is exempt from Air Passenger Duty.
11. **Surface Access and Air Pollution.** We believe the surface access and related cost of air pollution is undervalued by the CAA, the DfT and Heathrow Airport Limited (HAL). RHC's response to CAP 1658 referred to our estimated cost of £25bn from road congestion and air pollution caused by inadequate surface access. We remain highly doubtful of the ability of HAL, the Government and the road and rail organisations to produce the required surface access, at least in a timely manner. The Crossrail delays that have come to light in the last year add to these doubts.
12. **Scarcity Rent.** We support the airlines' arguments reported in CAP 1722 and elsewhere that the scarcity rent currently born by passengers due to lack of Heathrow capacity, and on which the CAA places so much value, does not exist. There is neither the need nor urgency to add capacity at Heathrow or any other UK airport. We have argued the case on previous occasions.
13. **Gaps in Developing Economic Regulation for Expansion.** In spite of our deep reservations about the 3rd runway expansion, we recognise the necessity of economic regulation of HAL, given HAL's power in the market place. Broadly we support the CAA in its efforts to achieve a framework that benefits passengers and freight owners and is

fair to other stakeholders. But we believe there is much still to be done. We have said in previous responses to the CAA that :

a. Environment. We are concerned that the environmental issues in terms of targets, costs and impact on health and climate change are not being given sufficient weight in developing regulation of an expanded Heathrow. Over the last year we have seen an increasing risk of a climate change dampening and possibly capping aviation growth. The WHO has recently produced its more challenging guidance on noise and its impact on health.

b. Surface Access. We remain concerned that while the CAA is moving broadly in the right direction on surface access by recognising the principle of ‘user pays’, the enormity of the issue of modal shift and lack of public transport capacity is not being sufficiently recognised in developing the economic regulation. Surface Access is a weak link in which HAL can seek to minimise its responsibilities leaving these to be shouldered by the public purse, which situation we oppose.

c. UK Aviation Market. While we endorse the CAA in seeking to promote benefits to the consumer, the focus on benefits of price, choice, etc. at Heathrow fails to recognise the substantial negative impact the expansion of Heathrow has on the rest of the UK aviation market, as we have previously highlighted and summarise in the Annex. Also, we referred in paragraph 10 to the unnecessary inclusion of International-to-International Transfers in the regulatory support of Heathrow.

d. Financial Viability. We remain doubtful that HAL can finance the expansion project while reducing the aero charges to competitive levels. We believe not enough attention is being paid to the incremental expansion and its negative rate of return. Even were HAL able to support the overall corporate return why would shareholders support dilution of their steady state returns. A Ring-fence and Non-recourse financing would expose this dilemma.

14. **Recourse to the Public Purse.** We believe that by ignoring the anomalies in the above paragraphs 8 to 13, the DfT and CAA are distorting the decisions on expansion going forward and in particular how to reconcile affordability and financability. We believe the risk is that ultimately the UK Treasury will have to support the viability of the project, which would be unacceptable given that HAL is a private company and is owned 90% by overseas shareholders. The risks pose difficult challenges for economic regulation.

CHAPTER 1 - OVERALL TIMETABLE AND INTERIM PRICE CONTROL

15. You have asked for views on:
- *the changes to the timetable for developing the regulatory framework and whether we should have a single price control business plan submission from HAL with targeted and focused updates of this information; and*
 - *if it were to become clear that a three year interim price control is required, what*

broad approach we should adopt to establishing these arrangements.

15. **Design Delays.** We note HAL's expressions of confidence in publishing its Master Plan in June 2019, already delayed by 6 months, but we also note the current absence of airside and surface access plans and capital cost estimates. The rate of growth in use of additional capacity is still not known with any certainty. To what extent the growth rate will be determined by demand, HAL's finances or environmental constraints, for example, is far from certain. Even the available capacity is unclear; while the NPS requires a minimum of 740,000 flights a year, the modal operation of three runways could provide capacity for 850,000 flights a year but on the other hand, the lack of airspace could reduce the total below 740,000 flights. In other words, the scope and nature of the expansion is seemingly surprisingly uncertain at this stage. Resolving these issues seems likely to cause further delays in the overall timetable.
16. **Multiple developers of capacity.** We note the frustration of the airlines and indeed the CAA in having to wait for more reliable design and cost estimates from HAL. From CAP 1722 and other sources, it seems that the substantial issue of parties other than HAL developing the facilities, such as the Arora Group, is still sought by the Arora Group and the airlines against the wishes of HAL. The physical and commercial complexities of multiple developers are substantial in our view and are likely to delay expansion.
17. **Judicial Review.** The current judicial review of the NPS by certain parties further risks the timetable. It would seem that the chances of the development timetable slipping further are considerable, with the possibility of the NPS being quashed.
18. **Interim Period Extended.** The issues raised here increase the challenges of developing an economic regulatory framework for the main H7 development but also for Category B and C costs. Under the circumstances, we believe the revised timetable illustrated in Figure 1, CAP 1722, is optimistic and that there is a high chance the period covered by interim price control will need to be extended to 3 years and possibly beyond.
19. **Costs of delay.** We are not closely enough involved with the control process to comment in detail on the various options for control in an extended interim period resulting from delay. However, we do believe HAL and its shareholders should be responsible for the risks of delay and project complexity, and that the associated costs should not be a burden on the airlines and in turn on the consumer as category B and C costs.
20. **Excess Profits and Interim Period.** In previous responses to the CAA we have argued that currently HAL is making excess profits, notwithstanding the price controls. We urge the CAA to seek to remove these profits and not perpetuate them in carrying forward the current price controls without evidence of there being no excess profits in an interim period.

CHAPTER 2 - PROMOTING ECONOMY AND EFFICIENCY

21. You have asked for views on:
 - *the merits of a licence condition on economy and efficiency, as discussed in this chapter and Appendix B;*
 - *the initial drafting of the licence condition as set out in this chapter, including the areas of particular focus identified for the period of the interim price control; and*
 - the introduction of such a condition at the end of 2019.*

22. Paragraph 2.1 of CAP 1722 says '*By developing the regulatory framework for HAL we can promote efficiency in a number of different ways, including designing incentive arrangements as part of HAL's price control, promoting competitive and market-based arrangements to support capacity expansion, and developing appropriate licence obligations for HAL.*'

23. **Regulatory weakness.** The economic regulatory framework used to control Heathrow does have a weakness in not necessarily preventing HAL from incurring and claiming expenditure that is either not in the best interests of consumers or is over-priced or both. The desired volume and quality of service comes into this equation. Inefficiencies can extend to financing. Hitherto, the steady state nature of Heathrow's business arguably allows the financial model to be bench-marked. However, there have been sizable projects, such as T5, which the airlines claim involved inefficiencies, and which HAL strongly denies and indeed claims demonstrates its ability to undertake the 3rd runway expansion efficiently.

24. **Regulatory Difficulty.** It is surely difficult for the CAA to judge the efficiency of the expansion plan in meeting expansion objectives and in the efficiency of implementation, even with expert advice.

25. **Competitive Airfares.** Heathrow has the highest aero charges of any major airport in the world and by a substantial margin. We have said in the past that this is partly due to excess profits. The NPS says the charges should not increase in real terms. We have argued previously they should decrease. In theory the economic regulation should ensure this happens and then it is up to HAL to achieve the targeted aero charge and a challenging target should drive out inefficiencies.

26. **Collaborative Joint Venture.** We suggest consideration be given to greater commerciality being introduced, thus reducing the need for economic regulation. This has happened at Gatwick and we note the CAA's support in CAP 1722 for airlines and HAL entering into commercial arrangements. In the oil industry large oil field developments are undertaken by joint ventures in a collaborative approach with a common interest in developing an oil field and where one of several partners is appointed the project operator. Were the airlines and HAL and any multiple developer to form a joint venture with the common aim of bearing down on consumer air fares to competitively match those of other airports, inefficiencies could be driven out or minimised by negotiation within the joint venture. The supply of air travel service is

through vertical integration of the airport and airlines businesses, whereby just the airport is subject to economic regulation and by which its charges are fed through the airlines into air fares. We are not suggesting regulation be extended to airlines but that they are used to competitively bear down on Heathrow's costs while upholding the service level. In seeking air fares that compare competitively with other airports we suggest including surface access costs as well as airside costs. This approach we believe is used to varying degrees in other industries, for example rail, whereby network rail provides the track and the rail franchises provide the rail services.

27. **Additional Competition.** If and when the CAA can encourage or require competition such as in procurement then that is desirable. Introducing another developer, such as the Arora Group, might add competition but could add to the complexity and hence inefficient costs.
28. **Rate of Return.** We doubt the CAA is in a position to judge how to provide capacity of a terminal or how to procure the rate of growth in use of capacity. These involve commercial decisions of both individual items but of the whole integrated project and perhaps the best people to assess the overall financial return and risks are those financing HAL - the shareholders and the lenders. Notwithstanding, the suggestion of matching air fares (including surface access costs) between airports, we suggest that bearing down on the aero charge to a point where the business is just financeable over the short, medium and longer term is the best way to ensure efficiency and is preferable to some licence condition requiring efficiency. It does require a clear objective on the volume and quality of service and we suggest that needs to be clear in HAL's licence. We assume this is determined by the NPS and DCO and not by the CAA.
29. **Implementation.** Implementation of an expansion plan is where the CAA can play a useful role. Projects such as Heathrow expansion clearly require a plan and budget and we suggest it is important that the CAA focuses on the treatment of uncertainty and use of contingencies. Also, it is important for the CAA to ensure that project appraisal includes alternatives and their assessment in meeting the objectives. The allocation and apportionment of indirect costs is a matter requiring close scrutiny. There needs to be an effective project management team with allocation of decisions and accountability. Cost overruns are particularly important. The oil industry, working through joint ventures, uses internal auditing to good effect in overseeing the oil company appointed as operator of the project. These are matters that might be contained in a licence. This is more a matter of efficient implementation of a plan rather than whether the plan is efficient in delivering the overall objectives.

CHAPTER 3 - ALTERNATIVE DELIVERY ARRANGEMENTS

30. You have asked for views on:
 - *the CAA's broad approach to alternative delivery arrangements and focus on understanding more about the proposals from the Arora Group; and*
 - *the steps identified above (the work of Arcadis, progress on the DCO application and understanding initial views on the commercial/regulatory proposition) for testing*

whether we should commit further resources to the detailed work necessary to consider how best to develop the regulatory framework to take account of DCO applications from competing parties.

31. Clearly, HAL seeks to retain the overall lead in developing and operating Heathrow. Arora Group and some airlines seek to introduce a competitive developer. We neither have the evidence nor are we in a position to judge the appropriate structure and resulting performance. We suggested above a collaborative approach and we welcomed introducing competition but we are of the view that adding multiple developers could add risks from additional complexity and issues of responsibility and accountability.

CHAPTER 4 - SURFACE ACCESS

32. You have asked for views on matters raised in chapter 4 and Appendix D.

33. Overview:

- a. In general, we welcome the improvements in the Surface Access Policy as set out in Appendix D, however, we continue to be concerned that to date there has been little detailed assessment of the detrimental impacts on the roads and Public Transport in West London.
- b. TfL in their analysis, which agrees with RHC's, have concluded that Heathrow's aspiration of 'no increase in road traffic' is not achievable without extreme 'congestion charging' and concluded that Heathrow Expansion would result in an additional 90,000 vehicle trips and 100,000 extra public transport trips every day. On the roads, that would result in a 3-5% increase in journey times throughout West London 'as far in as Westminster' and 'significant levels of crowding on the Elizabeth Line, Piccadilly Line and Windsor Line.'
- c. Accordingly, we welcome the Multi modal approach, but note that the modelling and testing will need to be agreed with all affected parties and will need to include the full extent of transport network affected by the increases in transport demands to and from Heathrow.

34. Chapter 4:

- a. Para 4.2; we note the Public Transport modal split targets of 50% and 55% by 2030 and 2040 respectively. Those targets are not consistent with HAL's aspiration for 'no increase in vehicular traffic'. Hence, we seek clarification of whether or not that aspiration has been dropped?
- b. Para 4.22; the first sentence states that it is not CAA 's role to determine if the NPS targets are met, as that 'is a decision for the planning process'. We do not understand how the CAA will be able to 'assess what level of efficient costs be

passed through to airport charges' without making such an assessment. Indeed, the third sentence appears to conflict with the first sentence by stating that HAL needs to demonstrate that 'it has assessed a full range of options.....to meet the targets'. Clarification is sought.

35. Appendix D:

The Surface Access Policy should include a statement to the effect that the Surface Access Strategy should include transport projects that ensure non-airport users incur no additional dis-benefit, resulting from the demands from the expansion of Heathrow, on both the highway and public transport systems.

Paragraph 4a sixth line says *'In this assessment, the relevant costs may include the costs of measures required to: meet planning obligations,'* et al. We would expect the word 'may' to be replaced by 'should'.

Paragraph 4b last sentence says *'These costs may include the costs of compensating – or otherwise accommodating on capacity elsewhere – existing non-airport traffic which would be displaced by additional airport demand;'* Again, the word 'may' needs to be replaced by 'should'. It is only fair and reasonable that existing non-airport users be compensated for any dis-benefits incurred as a result of airport expansion, and/or for those dis-benefits to be mitigated against through the provision of additional transport capacity.

Paragraph 6 first bullet point says *'Overall cost benefit criterion: evidence should be based on the same economic appraisal methodology as used by public transport agencies in assessing road and rail investments;'* The appraisal methodology - will that be Webtag as used by the DfT in its transport assessments or an alternative approach? The assessment will need to cover the whole of the transport network affected by the demands resulting from the expansion of the Airport to ensure the impacts on non-Airport Users are fully assessed and that the assessment complies with standard practice.

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Annex: 3rd Runway Impact on UK as an Aviation Hub

**3RD RUNWAY IMPACT ON UK AS AN AVIATION HUB
THE FOLLOWING IS DFT EVIDENCE**

WITHOUT A 3RD RUNWAY:

- THE NUMBER OF PASSENGERS TERMINATING THEIR JOURNEY AT HEATHROW GROWS BY 60% BY 2050 ***HEATHROW IS NOT FULL.***
- UK SPARE CAPACITY IS EQUIVALENT TO 6 RUNWAYS IN 2050. ***UK CAPACITY IS WELL ABLE TO SATISFY DEMAND THROUGH TO 2050.***

WITH A 3RD RUNWAY:

- NO ADDITIONAL LONG-HAUL OR DOMESTIC BUSINESS PASSENGER ARE SERVED AT THE UK LEVEL. ***ECONOMIC BENEFIT FROM ADDITIONAL BUSINESS TRAVEL IS NON-EXISTENT.***
- THE 43 MILLION ADDITIONAL PASSENGERS A YEAR COMPRISE - 17 MILLION CANNIBALISED GROWTH FROM OTHER UK AIRPORTS AND 16 MILLION INTERNATIONAL-TO-INTERNATIONAL TRANSFERS OF NO VALUE TO THE UK. ONLY 10 MILLION ADDITIONAL MOSTLY SHORT-HAUL TERMINATING PASSENGERS ARE SERVED. ***A 3RD RUNWAY HARMS THE UK REGIONAL ECONOMIC BALANCE AND IS INEFFICIENT USE OF CAPACITY.***
- THERE ARE NO ADDITIONAL DESTINATIONS FROM THE UK AND FREQUENCY OF FLIGHTS AT OTHER UK AIRPORTS IS REDUCED. ***UK CONNECTIVITY IS IMPAIRED.***
- INTERNATIONAL-TO-INTERNATIONAL TRANSFERS USE 37% OF ADDITIONAL RUNWAY CAPACITY AND 94% OF THE UK'S ADDITIONAL LONG-HAUL CAPACITY. ONLY 300,000 OUT OF 24 MILLION ANNUAL TRANSFERS ARE ON THIN ROUTES AND ARE INSUFFICIENT TO SUPPORT OTHERWISE UNVIABLE THIN ROUTES. ***HEATHROW'S INTERNATIONAL TRANSFERS PROVIDE NO UK VALUE AND SHOULD BE REPLACED BY PASSENGERS TERMINATING THEIR JOURNEYS IN THE UK.***
- **THERE IS A SUBSTANTIAL DIS-BENEFIT TO THE UK AVIATION MARKET**