London (Heathrow) Airline Consultative Committee

Response to the Working Paper summarising Affordability and Financeability for capacity expansion at Heathrow Airport

CAA CAP 1812

13 August 2019

Introduction

The Airline Operators' Committee (the AOC) and the London Airline Consultative Committee (the LACC), welcome this opportunity to respond to the CAA's working paper on the affordability and financeability of expansion at Heathrow airport (CAA CAP 1812).

The airline community at Heathrow Airport has been clear that its support for expansion at the airport is conditional on any such expansion meeting three criteria, that it is: affordable; operable; and deliverable. The CAA's Working Paper 1812, thus touches upon a critical aspect that must be met to ensure airline support for expansion at Heathrow airport.

The airline community has conducted its own analysis of affordability, and in this response we share our analysis with the CAA. We also comment upon some of the detail of the CAA's affordability analysis, as well as drawing the CAA's attention to a number of important issues that arise from the affordability assessments.

Airline Assessment of Affordability

Like the CAA, the airline community has been conducting an analysis of the affordability of expansion. And like the CAA, our analysis is highly dependent on, and limited by the availability of data from HAL, and its level of granularity. We are also limited by a lack of clarity from the CAA on key variables such as WACC and the regulatory regime. Consequently, like the CAA's own analysis, our analysis is heavily dependent on assumptions.

The airline community approach has been to model three scenarios: a central case; an upside scenario; and a downside scenario. We provide the CAA with detail of our assumptions at Annex A. However, the scenarios can be summarised as follows:

Central Case – our most likely outcome. All variables are modelled at the levels, which given our current state of knowledge we deem most likely;

Downside Scenario – in this scenario we test affordability against slower passenger growth, higher costs (both capex and opex) and a higher WACC all relative to the Central case;

Upside Case – in this scenario we test affordability against higher passenger volumes, lower costs (opex and capex) and a lower WACC relative to the Central case.

The results of our analysis are shown in the table below (for clarity we have expressed prices in 2017 values).

	Value of X (%)			Average over H7/H8/H9	
	H7 2022-26	**H8 2027-31**	**H9 2032-36**	**Value of X (%)**	**Per pax Price (profiled)**
Central Scenario	-2.36	+14.61	-13.13	+1.74	£22.8
Upside Scenario	-11.29	+21	-18.12	-2.18	£16.4
Downside Scenario	+3.77	+10.72	-8.46	+4.5	£28.9

As the table shows, based on our analysis of the current data available, there are a number of possible outcomes ranging from affordable to unaffordable. However, given the level of maturity of the data available, and the lack of information on key variables such as the regulatory regime and a sensible WACC range, it is almost impossible to determine where in the continuum of unaffordable to affordable we actually are.

Comments on the CAA's Assessment of Affordability

The airline community has a number of comments and observations to make about the CAA's analysis, some of which are high level in nature, and some of which are more detailed. We begin with the high level comments.

The CAA have used the PWC model to make their assessment. The airline community are aware that this model is due to be replaced by the PCM model developed by Grant Thornton. We are grateful to the CAA for their openness and the way they have engaged in the development of this model, and would ask that the CAA replicate their analysis in CAP 1812 on the Grant Thornton model when it is available.

Second, we have had some difficulty in understanding what numbers the CAA have actually plugged into their model. Whilst the CAA have helpfully produced graphs of the data, it would be helpful to see the actual data so that we could attempt to replicate the CAA's analysis on our own model.

Third, it is unclear to us how much independent analysis the CAA has done. The CAA has had to rely on HAL for some data, but has also *'discussed with HAL how best to produce projections for opex and non-aero revenues' (para 1.24)* and *'HAL has engaged with us to help develop meaningful scenarios' (para 1.33).* We would expect the CAA, as the body responsible for ensuring that the expansion of Heathrow airport was efficient and in the passengers' interests, and as the body responsible for determining the levels of opex, capex etc, that the CAA would be best placed to determine opex and non-aero projections and appropriate scenarios. It would be disappointing if the CAA's analysis in 1812 was simply HAL data, and HAL assumptions run through the CAA's PWC model.

Finally, we do not believe that the CAA has tested an appropriate range of scenarios. It seems that the CAA is really testing relatively small differences in timing and capex spend rather than a fuller range of scenarios and risks (such as changes to passenger volumes However, the CAA does state that more work needs to be done, we agree and expect that the CAA will conduct this work as a matter of urgency.

Our detailed comments relate to the CAA's comments on the regulatory building blocks within the model.

Passenger Volumes – the CAA has used the HAL Westerly Option dashboard forecasts. The airline community understands that this forecast assumes that all capacity is 100% used when opened. We do not believe this assumption to be credible. Even today, when LHR Is considered to be full, the airfield does not operate at 100% capacity 100% of the time. Consequently, the airline modelling caps passenger demand at 98% of capacity (with different growth rates according to the scenario). As a result we believe that the CAA analysis overstates the level of passenger volumes, and artificially lowers the regulatory charge.

However, the adoption of this assumption by both HAL and the CAA raises two important regulatory issues. If HAL and the CAA believe that the airport will be 100% full, 100% of the time (in all its scenarios) across the appraisal periods, then there is no volume risk. Consequently, there is no need for the adverse demand shock generator that the CAA uses to artificially depress demand forecasts. There is also no need for the volume risk premium that the CAA applies to HAL's WACC.

The removal of these two regulatory devices would significantly lower the regulatory charge, making an affordable Heathrow more likely. Given the assumptions that it has adopted on passenger volumes, the CAA now needs to inform all stakeholders of the level of volume risk premium that it currently places in HAL's WACC, and confirm that this will be removed from the H7 and future WACCs.

Capex – the CAA put forward three scenarios – a central scenario, and two others that vary capital spend (and in one case the timing of the spend). The CAA has chosen to vary capex spend by making relatively small adjustments to the risk pot assigned to the capex spend. Presumably again this was done on the advice of HAL.

The airline community does not believe that such adjustments are either appropriate, or reflective of the true nature of capital risk. We understand from the IFS, that the IFS is now content that HAL's level of risk allocation is appropriate. Therefore, it is not appropriate to apply scenario changes to the risk allocation, but rather changes should be applied to the underlying capex budget. This is what the airline community has done in its modelling work, using variances in the capex budget based on informal advice from the IFS given the level of immaturity of the HAL proposal.

Opex and non-aero revenues – whilst the CAA have stated that they have derived figures, it is not clear to us what figures, allocations and assumptions have been used. More clarity on the methodology to derive these variables and the assumptions used is required. For example, when deriving opex numbers, what efficiency frontier assumptions (if any) did the CAA apply?

WACC – the CAA has chosen to apply WACCs of 4%, 5% and 6% (all pre-tax real) in its analysis. The choice of WACC is a critical determinant of affordability, and the airline community finds the CAA choice of WACC range to test curious. Given that the CAA has published work from PWC on a business as usual WACC for HAL (late 2017), and a risk premium for the WACC in a 3R world (late 2018), it seems odd that the CAA would choose to not use this work to provide an indicative WACC range. It would be helpful if the CAA could explain the rationale behind this decision.

We note that the CAA has chosen a range higher than the lowest and highest ends of the range implied by the PWC work. Consequently, when compared to the PWC work, there appears to be an upward bias in the CAA's WACC assumptions. The CAA caveats that stakeholders should not read too much into its choice of range, but such statements, rather than generating clarity and certainty simply lead to further uncertainty.

In addition, the CAA states that *'the WACC values of 4% to 5% come from our own analysis.' (para 21).* This analysis has not as yet been shared with stakeholders, and 4% is certainly higher than the lower bound implied by the PWC work. When will the CAA share this analysis with stakeholders, and in the interim, if the CAA believes that the analysis is robust enough to use in such analysis, what level of credibility should stakeholders apply to the range? Is this the CAA's preferred range (which would seem to undermine the CAAs caveat in para 21)?

In short, the CAA's position on WACC, whilst presumably intended to provide the CAA with future regulatory flexibility is both confusing and opaque. The CAA is generating uncertainty on the plausible range of a key variable when certainty is needed. The CAA's failure to provide a meaningful WACC range for expansion renders it almost impossible to conduct a meaningful evaluation of affordability and financeability with any degree of certainty.

Issues arising from the CAA and Airline Community Assessments of Affordability

The airline and CAA assessments of affordability raise a number of issues and we turn to those in this section.

First, it is clear that the CAA and the airline community are using different definitions of affordability. The CAA, have relied on a statement from the Secretary of State for Transport in 2016 laying out an ambition of *'a plan for expansion that keeps landing charges close to current levels' (para 1.12).* The CAA seem to argue that this implies affordable means charges

'close' to 2016 levels and that *'the question of whether charges are 'close' to 2016 levels is a judgmental one…' (footnote 23, page 17).*

It is helpful to understand the affordability definition that the CAA is testing, and no doubt the degree of ambiguity and judgement required to see if the CAA's test is met provides the CAA with a degree of regulatory flexibility. However, the airline definition of affordable unlike the CAA's is not opaque. The airline community has repeatedly made the CAA and other stakeholders aware of the airline community definition of affordable. We have also been clear, and do so again here to avoid any misinterpretation that the airline community test for affordability, and therefore airline support for expansion will be based on HAL and the CAA delivering an assured and sustainable expansion plan and price control that meets the airlines definition of affordable.

Second, the airline community has some concerns around the CAA's analysis of EBITDA and returns to HAL's shareholders. Firstly, the EBITDA analysis presented by the CAA does not seem to allow for outperformance of the regulatory settlement (which has been considerable in Q6 to date), and also seems to be guaranteeing HAL shareholders a return during the construction period. We are not sure that this approach is reflective of reality or indeed what happens in normal commercial companies. There is thus the issue of earnings calculations and the timing of shareholder returns to be addressed.

Third, the airline community wishes to highlight the risk to expansion that the CAA's slow pace of work is generating. The two key components that the CAA is directly responsible for at this stage are the WACC and the regulatory regime. It is 8 months since the CAA published PWC's work on WACC premia for expansion. Yet 8 months on, rather than greater clarity on the credible range for WACC to use in affordability and financeability modelling, the situation is more confused and opaque than before.

In addition, the CAA argue that *'the regulatory framework and price control arrangements have yet to be finalised' (para 1.65)* and that *'there are a number of important matters to be determined , including the cost of capital, incentive framework and the treatment of costs…' (para 1.65).* Given the amount of work to be done and the state of maturity of the CAA's proposals in these areas, the CAA's assessment that things have yet to be *'finalised'* seems a somewhat generous interpretation of the position.

The CAA's determination of those key variables has a potentially dramatic impact on affordability and financeability, as the CAA notes *'all of these factors could have a significant influence on both affordability and financeability' (para 1.65).*

Consequently, until the CAA can provide concrete proposals or perhaps a range of indicative approaches, it is almost impossible to provide any meaningful analysis of affordability or financeability. This in turn raises the prospect that without immediate action by the CAA, stakeholders may draw the wrong conclusions on affordability and financeability.

Our final set of implications revolve around the modelled prices in H7, H8 and H9 that come from the airline modelling work. The first issue that arises is how volatile pricing across the three control periods seems to be. Whilst the output figures themselves are subject to the data inputted, there is a clear and unsustainable trend for airlines and their passengers. The CAA have previously argued that one approach might be to smooth prices by making adjustments to regulatory depreciation to ensure a 'target' price. It is not clear to us that given the scale of likely volatility that credible adjustments to depreciation could achieve sufficient smoothing. Consequently, it seems to us that the CAA, together with stakeholders should be looking at all alternative mechanisms

The airline community is also concerned with the distribution of risks and potential benefits. Whilst HAL's shareholders are rewarded throughout all three control periods, our modelling suggests that the airlines will be asked to bear significant cost increases out to the end of H8 (2031) with the prospect of falling prices in H9. The CAA will be familiar with the idea of 'pay more now for lower prices later', and indeed that in real terms, the reality at Heathrow is pay more now and pay more later. Consequently, the airlines, given their experience place greater probability on the likelihood of more cost now, and less probability of the prospect of significant reductions in charges in H9.

One option might be to set a control period long enough to effectively smooth the price over the H7-H9 period. This would in turn offer HAL the certainty of return, and ensure that the prospect of lower charges in H9 for the airlines is actually delivered (albeit via lower charges in what would have been H7 and H8).

We are aware that both the length and the design of the control period will be critical, together with conditions for re-openers, prospects of outperformance and so on. The airline community is keen to actively engage with the CAA on these issues.

Yours sincerely,

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Annex A

Airline Assumptions for Affordability Modelling

Inputs	Central	Upside	Downside
Passengers	Unconstrained initial forecast, constrained (if necessary) by LHR capacity. Allow LHR to fill to 98% capacity. 2% until 3rd runway open 3% for 5yrs after runway open (HAL initial uptake) drop back to 2% trend	Unconstrained initial forecast, constrained (if necessary) by LHR capacity. Allow LHR to fill to 98% capacity. 2.5% until 3rd runway open 3.5% runway open + 10 drop back to 2.5 %	Unconstrained initial forecast, constrained (if necessary) by LHR capacity. Allow LHR to fill to 98% capacity. 1.5% until 3rd runway open 2.5% runway open + 5 drop back to 1.5 %
Capex: Amount & Phasing	Latest HAL supplied Capex plan and phasing	-5% (as advised by IFS)	+35% applied only to capital value, risk allocation as central case (as advised by IFS)
WACC	3.6% vanilla	2.75% vanilla	4.4% vanilla
Opex	Variable opex grows in line with pax vol; £200m uplift for new terminal (phased) Returns in line with pax vol with 1% frontier efficiency	As per Central case but 2% frontier efficiency post terminal	As per Central case but no frontier efficiency gains
Revenue	No growth in per pax yield. Revenues grow by volume only	As central	As central, post runway opening, per pax yields decline by 0.9%