The Mayor of London's response to the Airports Commission consultation on shortlisted options

Cost and Commercial Viability

Supplementary Note 13

February 2015

Key findings

- The Commission's approach to assessment is sensible, however elements of the assessment are incomplete and it is not clear if the full range of financing risks or long-term impact on public expenditure have been fully assessed.

- There is uncertainty about the ability to finance each of the three shortlisted options and each has risks associated with its commercial viability.

- Aeronautical charges are expected to be higher for all shortlisted options than was stated by scheme promoters. It is not clear what risks these higher charges may have on airport demand and on the airport's competitiveness – particularly with other European hubs.

Key recommendations for further work

- Further work or publication of data with regards to some core works estimates should be undertaken to ensure full transparency, comparability and validity of input costs.

- The Commission must make a long-term assessment of the impact on public finances (2050+) including all mitigation costs (e.g. long-term surface access costs) and debt guarantees. Failing to do so would mean the long-term benefits are considered without fully appreciating the long-term costs.

- Risks such as the impact of aeronautical charges on demand and competition must be fully assessed in reaching conclusions on the financeability of options.

- Wider input from the financial markets, regulatory bodies and consultancy should be sought given the scale of financing required.

A: Key observations

1. The scale of financing required for the shortlisted schemes is unprecedented for privately run Heathrow and Gatwick airports

1.1. All expansion options will require increased debt and equity to finance expansion. Heathrow will need to increase its borrowings by 200%, and Gatwick by more. At the higher end, the level of debt is comparable with large, multi-asset infrastructure companies such as National Rail and National Grid. The appetite of financial markets to finance this level of debt does not appear to have been explored in sufficient detail at this stage, for example through financial market consultation, to make fully informed conclusions with regards to financeability. This level of growth will be difficult to finance given the associated risks.

2. There are a number of significant financing risks

2.1. All expansion options will result in significant increases in aeronautical charges. Heathrow per passenger charges for both shortlisted options will increase to around £30 whilst Gatwick's would be up to £18. It is still unclear how this increase will impact on demand and is potentially a significant risk to the commercial viability of expansion. There appear to be pointers towards a world where the resulting charges could be too high for a future market to bear.

2.2. The range of aero charges identified for LHR are similar to the assumed circa £30 per passenger charge at a new hub airport in the Inner Thames Estuary (ITE) airport – which was cited by the Commission in their decision on that option as a risk.

2.3. There appears to be insufficient detail available regarding the overall risk to financeability given that the size of each business could more than double whilst concurrently going from stable to speculative revenues.

3. The Commission does not fully consider the potential impact on public finances

3.1. Given the levels of debt required and the potential risks of expansion (for example if the predicted demand levels were not realised), further consideration must be given to the likelihood of the requirement for Government debt guarantees. For example, Thames Water (which is a similar size to Heathrow Airport and has a similar existing financing structure) is unable to finance the Thames Tideway Tunnel project (which would have required a 50% increase in borrowings) on its own balance sheet. The exceptional risks presented have been underwritten by the Government such that the total investor funding requirement are capped at pre-defined maximum[1]). The

[1] http://www.thamestidewaytunnel.co.uk/media/24950/InfrastructureInvestorsForum2014.pdf

Airports Commission needs to assess whether either parent company can sustain these borrowings without explicit support.

3.2. Also, given the CAA's duties under the Act ("In performing its duties under subsections (1) and (2) the CAA must have regard to: (a) the need to secure that each holder of a licence…is able to finance its provision of airport operation services in the area for which the licence is granted,") it should opine how it would secure this in the face of commercial and financial risks.

3.3. Although the Commission allude to the fact that the full cost of surface access, excluding a limited number of schemes related directly to airport operation, will be borne by the public finances, the full impact on public finances can-not be fully appreciated without a firm decision on expenditure across all areas of assessment. Further infrastructure provision may be required, for example, to achieve the long-term outcomes of the Commission's objectives for Surface Access. These long term costs do not appear to have been identified or included in the assessment.

4. There are inconsistencies in core works estimates between the shortlisted options

4.1. The costs of the new airport terminals required, for example, vary significantly between the schemes. Analysis undertaken for the Commission by Leigh Fisher indicates that Gatwick terminal fit out is considered to be £74/m2 (which appears to be extremely low), compared to both Heathrow schemes costing £12,761/m2, the high end of the spectrum. Costs used for assessment should be reassessed to ensure that they are both correct, suitable for assessment of a concept-stage scheme and represent an appropriate level of investment.

4.2. It is a concern that the Commission and Promoter costs and quantities for a number of the core works are aligned. It would be best practice for costs to be calculated independently. Taking account for the fact that the project is still in the early concept stage there is a concern that reliance on promoter estimates may introduce an unquantifiable degree of bias into the assessment of options.

4.3. It also appears that a number of costs are relatively closely aligned with the promoter assessments and a number are assumed equal between the two Heathrow expansion options, when this is not necessarily the case. Overall, further transparency and breakdown of costs is required for a full independent assessment of validity and a comparison of airport options to take place.

5. The Commission's Cost and Commercial Viability assessment has several other weaknesses

5.1. It is unclear whether all costs related to surface access have been appropriately considered in the assessment. For example with respect to Heathrow, costs related to the Western Rail Access, an additional two trains per hour on Crossrail and additional road widening do not appear have not been accounted for, whether being borne by the airport or publicly financed.

5.2. It does not appear that full, long-term surface access costs have been estimated to accommodate full airport expansion beyond 2030. This masks the ‘true’ costs of appropriate surface access provision - whether borne by the airport or publicly financed. The current 2030 assessment and package of infrastructure for surface access improvements that have been developed by the Commission represent only a short-term solution applicable only shortly after runway opening. Medium and long term scenarios (2040 and 2050+ respectively), that account for increased surface access demand could result in the need for £billions of additional investment Further details are provided in TfL’s surface access supplementary note.

5.3. It is disappointing that the approach taken by the Commission is limited to the professional opinion and judgement of PwC and does not take a wider approach with input from econometric consultancies, regulatory bodies and airlines. It is suggested that further econometric modelling and review by the regulators, including the CAA, should be undertaken to further assess the potential economic impact of increased aero charges, including the effect on the financeability of expansion should charges reduce the demand, within the UK aviation economic environment and regulatory framework.

B: Does the Commission's assessment constitute a robust approach?

To be robust, the option appraisal must entail a complete assessment. It must also be consistent across all the options, with the Commission's previous analysis, with best practice in the appraisal of large infrastructure projects – including principles of HM Treasury Green Book – as well being aligned with the Commission's own Appraisal Framework. The table below sets out a summary of the extent to which the Commission's assessment meets these requirements.

Table 1: Does the Airports Commission's assessment constitute a robust approach

Criteria	Met?	Comments/examples
Approach to Assessment		
Aligned with Airports Commission Appraisal Framework?	Partial	The full long-term impact on public finance, value for money and wider risks do not appear to have been be fully assessed.
Consistent approach to assessment: • Between options? • With previously considered options? • With best practice/Green Book?	Partial	The approach does not appear to take detailed input from wider stakeholders such as the financial markets, regulatory bodies or econometric modelling consultancies. Inconsistencies between assessments of previous options. E.g. in the assessment of the ITE it appears that mitigated OB has not been used despite the risks in some areas being lower e.g. Greenfield development.
Assessment complete (evidence gaps addressed, suitable geographic/temporal scope)?	Partial	Fails to fully appreciate the impact of long-term 2050+ impacts on public finances or the potential requirements for debt guarantees in sufficient detail.
Assumptions		
When multiple scenario or assumption sets used, has the most appropriate been identified – or worst case scenario tested?	n/a	
Analysis: impacts and conclusions		
Risks fully stated and impact reflected in conclusions?	Partial	A number of risks to financeability require further assessment. E.g. the impact of aeronautical charges on demand.
Understanding of net/cumulative impacts?	n/a	