HEATHROW EXPANSION: A RISK ASSESSMENT

A Report by the All Party Parliamentary Group on Heathrow and the Wider Economy.

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INTRODUCTION

This note provides an assessment of the risks associated with Heathrow expansion grouped into three categories:

- **Planning and Construction Risks**
- **Commercial and Financial Risks**
- **Other Government Risks**

The note assumes that the Government will look only at the three options short-listed by the Airports Commission in its Interim Report: two at Heathrow and one at Gatwick. The content of the paper applies broadly equally to both Heathrow options. Certain risks, for example those associated with air quality, are well known and these are therefore covered in less detail than some of the less well recognised risks.

BACKGROUND

The management of Heathrow present a confident case for a third runway and can claim some deep-pocketed shareholders as well as expertise in delivering earlier major projects successfully (Terminal 5 and The Queen's Terminal).

Nonetheless, a Government that backed a third runway (and associated terminal) at Heathrow would be placing its bets on a ten-year-plus planning and construction programme that is attended by a range of risks that could prevent delivery. And even if successfully delivered, there are risks that the charging structure could operate against the public interest and even threaten the commercial viability of the project. There are also risks that the Government could be called on to commit to unexpected public expenditure as a consequence of the project, even if it is successfully delivered. Many of these risks will become apparent early in the planning process: they are not deferred risks that can be left for a future Government to manage, but have the capacity to embarrass the current Government in the early years of the process. Remarkably, some of them were treated only cursorily, if at all, by the Airports Commission.

A – PLANNING AND CONSTRUCTION RISKS

1. Environmental issues

The environmental issues associated with Heathrow expansion are well documented and have been the root cause of previous failures to expand the airport. In brief, Heathrow expansion has significant adverse consequences for air quality and noise outcomes. Noise outcomes will affect a very substantial number of people, who are likely to intervene politically, through the courts and through the planning process and who could present a significant obstacle to a successful development consent. The air quality consequences of expansion engage EU law (which it may be assumed for now will be carried over into post-Brexit UK law).

The risks under this heading are both political and legal and they fall primarily to the Government, as the counterparty to the political and (most of the) legal challenges that can be foreseen.

2. Land acquisition risks

Heathrow can acquire the land necessary for expansion by private treaty or (subject to Planning law) through compulsory purchase, but unresolved issues include who is to pay for the relocation of the energy-from-waste plant (claimed to be £500 million) and the BT datacentre that lie within the curtilage of the land needed.

The risks here are financial and they fall to the Government (if called on to pay) alternatively to the commercial viability of the project (if forced on to Heathrow).

3. Formal Planning risk

Heathrow has stated that it will seek planning permission using the Development Consent Order (DCO) route. This is initiated by the Government's issuing a draft National Policy Statement for consultation and seeking parliamentary approval for the final version. Thereafter a planning application can be submitted to be assessed by the Planning Inspectorate. The Planning Inspectors will require Heathrow to submit full and detailed documents before beginning their work (this is an explicit feature of the relatively new DCO process) and this implies a high level of process risk for a project so complex. As to substance, Inspectors are likely to recommend a planning permission subject to lengthy conditions. In addition to addressing by condition the environmental and land acquisition issues above, they will look to the set of conditions put forward by the Airports Commission. They may also be persuaded to look at the wider planning context, including the blighting by noise of certain areas where housing might otherwise be developed, an acute concern in and adjacent to a growing city. The obtaining of a satisfactory DCO is therefore not a certainty. It is open to the Secretary of State to override the Planning Inspectors' recommendation but the legal and political risks to the Government associated with such an action are evident.

Even after construction, there is a material risk that the runway capacity promised by Heathrow will not materialise (a) because of planning conditions, analogous to those imposed with Terminal 5, and (b) because the complex airspace arrangements proposed in order to minimise the numbers of people affected by noise would make it impossible to deliver the runway throughput assumed.

This is a risk that falls in the first place on the commercial viability of the project and secondarily on the Government as a reputational risk should the required consents make the project unviable.

4. Construction risk

The scale, complexity and expense of the proposed expansion of Heathrow (particularly when compared to the Gatwick alternative), combined with the very constrained site, hemmed in as it is by two crucially important motorways and large residential populations, poses two related types of risk. The first is one of complexity: the scale of the scheme, its interactions with the existing airport and its interfaces with surface connections present a recognisable threat of delay and cost overrun: the Heathrow plan requires a rate of construction spend never before achieved on a single site in the UK, a rate of spend significantly higher than was achieved on the main Olympics site (the highest recorded to date), although the Olympics site didn't have to cope with the constraints of working beside and within a very busy operational airport. The second represents a concentration risk – as stated, the expansion of Heathrow would be one of the largest single site infrastructure construction operations undertaken in this country. Effective management of a project of this scale, in one place, poses a special risk, and of course, if this very large construction project turns into a Berlin-Brandenburg[1], then there will be a real set-back to claimed national prosperity.

These risks go to the economics of the project, in that they pose a threat to its completion date, and to the Government's reputation as well as to the achievement of the claimed benefits for the economy.

1. Originally planned to open in 2010, Berlin-Brandenburg airport has encountered a series of delays due to poor construction planning, management, execution and alleged corruption. It is now hoped that the airport will open in 2018/9. Costs have escalated considerably. The blow to Germany's reputation as an efficient deliverer of major engineering projects has been serious.

B – COMMERCIAL AND FINANCIAL RISKS

5. Commercial risk

The Airports Commission condition which stipulates a restraint on "night flights" reduces the commercial attraction of the new investment, yet there is highly likely to be a planning condition imposed in this regard and, if framed as recommended by the Airports Commission, it would present Heathrow with serious problems. Despite claims to the contrary, Heathrow has NOT accepted in full the Airports Commission's recommendation on "night flights" and envisages flights operating without restriction from 5.30 a.m.

Other commercial risks include:

- the reluctance of incumbent airlines (most crucially and most vociferously BA) to "pre-fund" the investment - that is, to start paying higher charges to fund the project long before it is delivered – and then to see new airlines come into the airport that have made no prior contribution;
- the Government's declared refusal to pay for the re-routing of the M25 (which has no transport benefits in principle and is entirely for the convenience of Heathrow); and
- the possibility that the Government or the Planning Inspectors will acknowledge the need for a higher commitment to new surface access than admitted by the Airports Commission and will require Heathrow to pay a correspondingly higher share.

All these risks fall in the first place to the commercial deliverability of the project and secondarily to the Government's reputation should the project become unviable. All will become apparent in the early years of the process.

6. Financial and governance risk

The new investment required from Heathrow shareholders is enormous: greater than the Regulated Asset Value of the entire existing airport. There is no real "controlling mind" amongst the shareholders. Ferrovial is the lead investor but has the weakest balance sheet and has run its majority ownership stake down to 25%. The other investors are largely passive institutions (only one of which, owning 10%, is British)[2]. While they say they are committed to expansion, there is no clear plan in the public domain as to how finance will be provided. Particularly unclear is whether a yet further increase in the debt/equity ratio is envisaged and how the risk of that is to be managed. Moreover, if the new finance required dilutes Ferrovial's ownership stake even further (because it fails to add new capital pro rata) there will be real doubts as to the governance of management's execution of the project, increasing the risks of cost overruns and delays.

Another aspect of financial risk which has not yet been addressed is the timing of the finance required. Because of the complications of the project, the great majority of the work associated with expansion at Heathrow, and the financing connected to it, must be committed to at its outset. Whether the markets will be prepared to bear the uncertainty that this entails is an assumption that has yet to be thoroughly tested. (As context, the Airports Commission analysis indicates that in the peak year of spend, Heathrow will need to raise £6 billion, a greater sum than any UK private entity has ever raised in the capital markets in a single year.)

These risks go both to the commercial viability of the project and to the Government's reputation. In addition, it is possible that, as a project of national significance, a commercial failure in this respect could translate directly into costs to the taxpayer as the Government is called on to rescue the project.

7. Pricing risk

Related is the question of the reward to investment and in particular the level of charges sought to provide that return. There are two issues: the quantum of charge (per passenger) and whether it can be sustained commercially given airline margins; and Heathrow's desire to escape from CAA quinquennial review. It is unclear whether the blame for what the public might experience as excessively high charges would accrue to the airport, the airlines or the Government. Again this issue is likely to emerge early, analogously to the charge allowed to EdF for electricity generation as and when Hinkley Point C comes on stream.

These risks go to the question of value for money, and are likely to fall on the Government if it is perceived that it has failed to protect sufficiently the interests of passengers in its decision.

2. Heathrow Airport Holdings Limited is owned by FGP Topco Limited, a consortium owned by Ferrovial S.A. (Spain) (25.00%), Qatar Holding LLC (Qatar) (20.00%), Caisse de dépôt et placement du Québec (Canada) (12.62%), the Government of Singapore Investment Corporation (Singapore) (11.20%), Alinda Capital Partners (US) (11.18%), China Investment Corporation (China) (10.00%) and the Universities Superannuation Scheme (UK) (10.00%)

C – OTHER GOVERNMENT RISKS

8. The risk of perverse outcomes from regulation

A further pricing risk arises out of the economic regulation of Heathrow: the airport's quasi-monopoly position tends to encourage "gold-plating" rather than value for money, since all approved expenditure is added to the Regulated Asset Base and a return can be earned on it, leading to higher usage charges. The only corrective to this is the vigilance of the CAA as economic regulator. (There is an important contrast with Gatwick in this respect: Gatwick has undertaken to cap its charges so as to incentivise a value for money approach to design and construction.)

The risk under this heading goes to the public interest in ensuring value for money outcomes in a regulated utility structure.

9. Risk of subsidy for UK regional connections

The Airports Commission was clear in forecasting that, even with a third runway, Heathrow's UK regional connections would fall to four destinations (from eight currently). To address this unsatisfactory consequence of its recommendation, it proposed increasing the number through the use of Public Service Obligations, a device permitted by EU law for ensuring economically disadvantaged areas can be served by air even if not commercially viable. PSOs generally (though not necessarily) require a Government subsidy. Despite this, Heathrow has recruited a great deal of regional support for its expansion by promising increased regional connections, promises it cannot deliver, since it is airlines, not airports, that decide routes.

It is also worth noting that conversations with the European Commission tend to suggest that the Airports Commission may have misdirected itself in thinking that a Government could use a PSO to specify a connection to a particular London airport, as opposed to any airport serving London. The few instances the Airports Commission finds of an airport-specific PSO have been used to direct a flight away from a city's main airport.

If the Airports Commission is right then there is a potential subsidy to be paid by Government (not included in Heathrow's costs); the alternative is that regional cities that expect new connectivity will find themselves disappointed. On the other hand, if, as implied by Heathrow, the Airports Commission is wrong on this point, then the question arises of the robustness of its other connectivity forecasts and the benefits that it claims accrue from them.

The risk by that stage will be entirely on the Government, either financial if a subsidy is required or reputationally if the routes never materialise.

10. Risk that expected long haul routes will not materialise

Business, the regions and the public have been led to believe that there will be a substantial increase in long haul connections to economically fruitful destinations as a result of Heathrow expansion. Heathrow has been claiming that as many as 42 new long haul destinations will be reached. Yet deep in the papers supporting the Airports Commission's report is a forecast that the number of new long haul destinations is expected to be twelve by 2040. (To explain this, the forecasts are that the new capacity will be taken up very heavily by demand for flights to short haul overseas destinations, with very little translating into new long haul destinations – as opposed to a "thickening" of existing routes – and a negative affect on UK regional connections.)

This risk falls entirely to the Government's reputation, though it will only become apparent in the years after the new runway becomes operative.

11. Risk that economic benefits will not materialise

The Airports Commission preference for Heathrow expansion over alternatives rests heavily on claims of substantially higher economic benefits at Heathrow. This differential rests on a report produced by PwC, as equivalent numbers produced under the normally accepted government methodology (WebTAG) show minimal variance between the Heathrow and Gatwick schemes. The use of numbers generated by the PwC report has been criticised by the Airports Commission's own economic advisers, Professor Peter Mackie and Brian Pearce. The PwC report has also been disputed by Gatwick as being subject to misdirection, in that it uses different assumptions from those adopted by the DfT, and error, in that Gatwick claim to have detected both inaccurate passenger classification and actual miscalculation in the workings of PwC's model. The reputational risks associated with decisions based on flawed modelling are evident, the more so in circumstances where those flaws have been brought to everyone's attention.

In addition, it is not doubted by anyone that a further additional runway is likely to be needed in time. The question is merely when it is likely to be required. Growth at Gatwick and elsewhere has recently outrun the predictions of the Airports Commission and there is a real possibility that a further runway will be being called for even before the current project is operational. The Airports Commission has said that that permission for a further runway should not be given at Heathrow, though this cannot be regarded as definitive. If there is a need for a further runway to come on stream sooner than expected, it is likely that a Government decision to expand Heathrow now will be seen retrospectively as a missed opportunity to re-think the architecture of the UK's airports system.

These risks fall entirely to the Government's reputation.

12. General risk to public finances

A number of the risks above have hidden or implicit costs that are not being borne by Heathrow. For example, it is not really in dispute that considerable investment in new surface access (road and rail) will be required to support Heathrow expansion in the context of forecast background growth. (Transport for London suggests the cost will be between £15 billion and £20 billion.) The argument is about how much of this should be attributed to airport expansion.

The Airports Commission produces an underestimated assessment by asserting that none (0%) of any investment that would anyway be required (for example on the M4 and M25) should be attributed to Heathrow, even if some of the demand is due to a larger airport. It is vital that Government understands the full costs to the public purse implicit in any option it supports.

The risk here is that Government will find itself sucked at a future date into public expenditure that it had not planned for, at the expense of other projects which are at a less developed stage.

13. State Aid risk

Assuming existing EU law is carried over[3] , at least in the short term, some of the expenditure referred to above (e.g. re-routing the M25 in tunnel) runs the risk of constituting State Aid if the costs are borne by the Government.

This risk falls to the Government first and then to the airport's commercial viability if subsidies have to be re-paid.

14. Carbon risk

Heathrow would be significantly the more carbon-intensive option (lower load factors, more premium seat spacing, more transfer passengers, older fleet) and this risks imposition of greater constraints on growth at other UK airports if the UK is to remain within its targeted limit for carbon emissions.

This risk falls in the first place on the Government, which is bound by legislation on carbon emissions, and secondly on other economic actors apart from Heathrow, which may lose out as a result.

15. Crash risk

There have been a couple of incidents in recent years when a plane has returned to Heathrow in a dangerous condition – on one occasion (2013) with an engine in flames over Chelsea. Heathrow's location greatly increases the danger to life and property of any significant incident.

The risk here is not merely the obvious one of danger to life and limb, but also the systemic risk that, following a serious incident, it may prove politically unacceptable to re-open Heathrow at all – at least at its full capacity – because of the demonstrated risk to the adjacent population. This could have a crippling effect on UK connectivity to the world for some years as alternatives were put in place.

A note on competition policy

The Government also needs to consider the choice between Heathrow and Gatwick (assuming they are the only choices in scope) in the light of competition policy. Less than a decade ago, the Competition Commission upended Ferrovial's original strategy for the acquisition of BAA by requiring the break-up of the company in order to encourage competition between airports. In May 2016 the Competition and Markets Authority issued a detailed report claiming a range of benefits from the new competitive arrangements. The CMA calls for new runway capacity in the south-east in order to capture further competitive benefits but says the location is outside its remit. Nonetheless, if only one new runway is to be approved, the CMA's views on the competition consequences of expansion at each location should be sought.

3. By way of example, Switzerland and the European Community have concluded a bilateral agreement on air transport. The agreement provides rules concerning State Aid, which have been drafted along the lines of the EU State Aid provisions (articles 107-109 of the TFEU). These rules accordingly introduced State Aid control in Switzerland by way of an international treaty for the aviation sector.

The views expressed in this report do not necessarily reflect the views of all members of the group