Working paper summarising affordability and financeability modelling for capacity expansion at Heathrow airport

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's working paper of June 2019 summarising affordability and financeability modelling for capacity expansion at Heathrow airport (CAP1812). It sets out the initial views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus, LEVEL and IAG Cargo.

2. It does not seek to comment on every point raised in CAP1812 - rather, it focuses on what appear to be the key issues; however, we may subsequently comment on others. For ease of reference, it broadly follows the structure of CAP1812, from where it draws financial forecasts and estimates. **Emphasis** is added, throughout.

Introduction & context

3. For airlines and consumers, affordability is a critical element of expansion. Airlines are capital intensive businesses operating in a highly competitive air-transport market. During expansion, they will have to earn a sustainable return on invested capital in order to fund the additional growth required to deliver expansion. Without this level of growth, airport charges will rise, which will damage both LHR's attractiveness and airline profitability, which in turn would deter airline investment. This calls into question the viability of an expanded LHR, which in turn has a detrimental impact to financeability; hence the criticality of the CAA ensuring that airport charges stay at or below today's levels.

4. Spiralling estimates of early expenditure are uncontrolled and unexplained - and we have no confidence that HAL can deliver the expansion on budget.

5. In our response to its recent consultation (CAP1782), we explained that the CAA has taken upon itself a non-statutory duty to ensure the financeability of capacity expansion. The focus appears to be on guaranteeing HAL's shareholders' remuneration, despite Government's recognition that affordability means holding airport charges flat.

6. The CAA's support for HAL's approach to expansion pays insufficient regard to capital structure, inefficiency or shareholders' appetite for dividends. Under the proposed approach, HAL would be, in effect, absolved of responsibility for its own financeability, with risks and costs (real and perceived) instead being transferred to passengers.

7. HAL has failed to justify its proposed expansion costs. HAL's estimate of £265m for Category B costs (costs incurred specifically and directly in support of the DCO application) has doubled since February 2017, in response to which the CAA now proposes the introduction of a 'review point' at £500m+, above which HAL is invited to justify further expenditure.

8. A 'subset' of *"early Category C costs"* (construction costs incurred before the granting of a DCO) has been added to Category C costs (construction costs typically incurred after the granting of a DCO). In April 2018 these were estimated by HAL to be £650m, by October this had risen to £1.6bn, while currently HAL puts these at £2.8bn. Furthermore, the CAA suggests that this figure may have to increase.[1]

Executive Summary

9. The CAA continues to differentiate between financeability, affordability and holding charges flat; however, in our view, the three are effectively the same thing. Suppliers of unaffordable goods are unfinanceable, whilst Government has said that affordability means keeping charges flat. If the CAA has a different view, it should properly explain the basis on which is making such distinctions.

10. The current analysis of HAL's costs contains insufficient detail to allow meaningful consideration by airline customers – something that is unacceptable at this stage of development and with such large sums at stake. HAL's information disclosure falls short of what is required for proper analysis by those who will be expected to pay; however, instead of holding HAL to account, the CAA makes increasingly generous allowances without, as far as we can see, sufficiently challenging its revisions.

11. The CAA, in effect, continues to prioritise HAL's shareholders over passengers' interests. HAL incurs debt and pays dividends, while the CAA takes upon itself the responsibility for HAL's financeability. As long as it does so, HAL's shareholders won't.

12. We consider that the CAA has adopted a benevolent approach to escalating CAPEX, forgiving HAL's inefficiencies and allowing a vague approach to risk – in all cases, putting costs onto passengers. In our view, the CAA must put a stop to this behaviour.

Updated assessment of affordability & financeability

13. The choice of words in the DfT's request to the CAA cannot be mistaken – it asks: *"… whether there are **<u>credible scenarios</u>** in which HAL can deliver its proposed masterplan*

[1] Escalating Category B and C costs are discussed by the CAA in CAP1819 – see Appendix

in line with the Secretary of State's ambition on airport charges." Whilst the question may not be unduly demanding, it appears that HAL cannot meet even such a low evidential threshold. The CAA is therefore forced to dilute the Secretary of State's words to an ambiguous *"… capacity expansion that minimises whole life efficient costs should **contribute towards** making charges **affordable**…"*[2]

14. The CAA does not say why it took six months to reply to the DfT's request; however, having been asked to respond: *"… **in advance** of HAL's statuary consultation…",* that it only did so **afterwards**: *"…[i]n the light of the recent publication of HAL's statutory consultation…"* suggests some difficulty. Possibly, the CAA had been waiting for HAL's statutory consultation, because previously it did not have enough information. Significantly, CAP1812 predates the CAA's response to the DfT, which says:

    - *"[o]ur views on this matter are set out in our published June 2019 working paper [CAP1812] that summarises our updated affordability and financeability assessment [but the] **analysis in the working paper is high level and illustrative**…";*
    - *"[t]he analysis indicates that there are a range of credible scenarios that are both affordable and financeable. There are also scenarios where affordability and financeability would be more difficult and unsurprisingly lower costs and a lower cost of capital lead to greater affordability, but a lower cost of capital can also put pressure on financeability…"; and*
    - *"[w]e have continued to assume that affordability can reasonably be judged in terms of airport charges per passenger that are broadly consistent with 2016 levels in real terms."*

15. Taking these points briefly and in turn:

    - at this stage of development *'an illustrative analysis'* is wholly inadequate;
    - as we explained in our response to CAP1782, affordability **is** financeability: *"[i]n well-functioning markets, affordability and financeability are the same thing. If customers can't afford something, they won't buy it; and suppliers of goods or services that customers don't buy, are unfinanceable; however, the CAA has created an arbitrary distinction between the two, using this to justify a focus on what matters to HAL's shareholders, whilst paying lip service to what matters to passengers. The CAA is supposed to protect passengers from the abuse of monopoly airports, not to ensure monopoly airports are able to further consolidate their monopoly power…"*; and

[2] CAP1812, paragraph 1.4

- this requirement ought not to be downgraded to a mere *'assumption'*.

16. In our response to the CAA's most recent consultation (CAP1782), we also explained that *'affordability'* and *'keeping charges flat'* are the same thing – not only in our view, but in that of the Secretary of State. On 24th May 2018 (the eve of a Parliamentary vote on Heathrow expansion), the Secretary of State for Transport, The Rt Hon Chris Grayling MP, gave a speech to industry, in which he said, *"[i]t remains one of my fundamental priorities to deliver the ambition I set in 2016 – to* ***keep airport charges as close as possible to current levels*** *– so price increases are not passed on to airlines, and ultimately consumers."*[3] This was followed by a Statement to the House of Commons on 5th June 2018, in which he said: *"[e]xpansion must also remain* ***affordable*** *to consumers. We took a bold step when I asked the industry regulator, the Civil Aviation Authority (CAA), to ensure the scheme remains* ***affordable*** *while meeting the needs of current and future passengers."*[4]

17. Nothing changed in the period between the Secretary of State's speech to industry and his Statement to the House of Commons; on both occasions he was addressing the same issue and making the same points – so it is consequently clear that **affordability requires that airport charges remain flat**. The CAA should either accept or rebut the point, but ought not to ignore consultation responses from informed stakeholders.

18. It is a substantial understatement to say that: *"…significant uncertainties remain […] in relation to the level of early spending […] and the level of overall programme spending."*[5] This is an entirely unacceptable situation. HAL is unforthcoming with information, in our view because it believes the CAA will (in all circumstances) force passengers to pay whatever it demands.

19. HAL's confidence in the CAA's acquiescence is exemplified in its belief that it will not be challenged: *"**Heathrow expansion is 'a fait accompli'** and will be a 'critical part of any new prime minister's agenda', the airport's chief executive has said. John Holland-Kaye said plans to build a third runway were already underway as **he warned off Tory leadership frontrunner Boris Johnson from interfering**. He refused to reveal when he last discussed the plans with Mr Johnson but insisted **the project 'is now happening'**."*[6]

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[3] https://www.gov.uk/government/speeches/address-to-airlines-uk-on-heathrow-engagement

[4] https://www.gov.uk/government/speeches/proposed-heathrow-expansion

[5] CAP1812, paragraph 1.7

[6] https://www.dailymail.co.uk/news/article-7275969/Heathrow-expansion-fait-accompli-airports-chief-executive-says.html

20. The CAA sums up by saying: "… *we expect that the next assessment of affordability and financeability to [sic] be set out by HAL…"*[7] In our opinion, this is a role of the CAA.

21. In April 2019 the CAA published a report it had commissioned from E&Y on *'Gearing Sharing Mechanisms'*, the principle idea of which is that consumers should share the financial benefits of regulated firms deviating from regulatory assumptions of capital structure, from which a number of broad points emerge:[8]

    - the general thrust appears to be that consumers should pay 50% of costs of cautious regulatory assumptions (on capital structure), which whilst an improvement over the current 100%, would be less desirable than better assumptions;
    - that HAL is generating *"… returns in excess of the regulatory settlement…"* is widely understood, but the proposed methodology to identify the source of these excessive returns is unclear;
    - we question that HAL would be incentivised to *"… vary its gearing levels as a response to the changes…"*, because the optimum remains the optimum, whatever proportion of outperformance HAL would enjoy;
    - we question the basis for an assumed *"… material change in the risk profile of HAL [during R3 development]…"*, which in our view is something best determined by capital markets – notwithstanding which, development risk is already factored into CAPEX cost forecasts, so would be double-counted if catered to in the regulatory rate of return;
    - the CAA does not appear to have published the referenced E&Y *"Equity Financeability Report"* of 23rd October 2017, which concludes that *"HAL's gearing will reduce to maintain an investment grade credit rating…"*;
    - we do not understand how the referenced *'Modigliani-Miller (MM) Capital Structure Irrelevance Proposition'* can be right in a CAPM world, where capital markets play an important role in investment – and in which bankruptcy costs and taxation are real; and
    - in our opinion, the CoD/CoE delta exceeds the tax shield on debt.

[7] CAP1812, paragraph 1.8

[8] https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/CAA%20Gearing%20Sharing%20Mechanisms%20Report-v1.0-issued.pdf

22. It is unclear how, or even if, the CAA intends to develop this work, but it's purpose clearly must extend beyond a demonstration that the CAA's thinking is in tune with that of other regulators (notably Ofwat and Ofgem).

The financial model, data & scenarios

23. In terms of inputs to the CAA's soon-to-be-developed *'price control model (PCM)'*, the CAA says: *"[w]e used HAL's data…"* but then in the next breath: *"… [it] is not a HAL forecast…"*[9] Understanding that passenger forecast data comes initially from airlines, not airports, both statements cannot be true at the same time. Either the data represents HAL's view or it doesn't - and if HAL doesn't agree with airlines' forecasts, then it should come up with its own. What it cannot be allowed to do in seeking to persuade the CAA to a lenient view of early CAPEX, is to adopt an optimistic forecast, before subsequently disowning it as a denominator of airport charges.

24. Whilst understanding that both OPEX and non-aeronautical revenues: *"… will increase as passenger numbers rise…"* we do not believe the two should be 'bundled' in the way the CAA suggests.[10] The issue, of course, lies in degree and relativity. Firms grow to achieve scale economies, spreading overheads over larger customer bases and developing more efficient practices in activities associated with variable costs. So, whilst total OPEX increases with growth, OPEX/passenger reduces – and we anticipate that the CAA will apply these widely understood principles to HAL's forecasts.

25. On the other hand, there is no reason to think that non-aeronautical revenues/ passenger will diminish with growth in passenger volume; indeed, they may well improve, as individual passengers are presented with a wider retail offering. So, the CAA's observation that: *"… historically, OPEX has tended to grow in a manner both equal and opposite to non-aeronautical revenue in the 'single-till'…"* is further evidence of regulatory gaming by HAL.[11] Crucially, a supposition that OPEX and other revenues somehow reciprocate cannot be used as a predictor of future cost/revenue evolution.

26. We accept that the CAA's modelling: *"… requires a cost of capital as an input…"*, but are concerned by the selected range of 4-6% (pre-tax, real). Whilst the CAA caveats its choice of inputs: *"… [they] are not intended to be indicative of the CAA's current or eventual policy on WACC for H7…"*, it must be aware that the it cannot avoid signalling – and so, in our opinion (as signals are unavoidable) it is important that they are

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[9] CAP1812, paragraph 1.22

[10] Ibid, paragraph 1.24

[11] Ibid, paragraph 1.28

accurate.[12] It is therefore important that when the CAA consults on models which incorporate WACC, that the it uses numbers reflective of its thinking. Worryingly, in differentiating between current and eventual policy, the CAA suggests the two are concurrent. Whilst understanding it may end up being the case, denying a relationship between input WACC and eventual policy, suggests that both are known.

27. In April 2019, CEPA responded to the CAA's consultations on RP3 and H7 WACC, saying that the outcome of the CAA's thinking must be a WACC below the bottom of the range used in CAP1812 – and suggesting: *"… that the CAA and its advisors consider any read-across from HAL's chosen capital structure to its view of underlying business risk [and that] highly geared financial structures might be expected to be associated with relatively low-risk, stable and predictable cash flows."*[13]

28. We note that the CAA's modelled scenarios:

    - include *'risk contingencies'* of: base case 27%; lower CAPEX 20%; and higher CAPEX 34%, which, in our view, would overcompensate HAL's shareholders for any development risk; but
    - do not mention unitised depreciation (an issue that airlines have repeatedly raised), instead using HAL's own forecasts, which are blandly referred to as *"… broadly follow accounting principles…"*.[14]

29. In our view, risk comes in three broad types and should be categorised accordingly. We are concerned that HAL is muddling these – and potentially double-counting:

    - 'contingency' is quantifiable, asymmetrical and should be managed at project-level;
    - 'construction risk' is to an extent quantifiable, exhibits a degree of symmetry and should be managed at programme-level; and
    - 'general business risk' sits apart from construction, is broadly symmetrical, should be managed at corporate-level and belongs in the WACC.

30. So, contingency - for example, an allowance held against a potential to damage existing electrical cables when installing replacement taxiway lighting, should be held in a budget for the replacement of taxiway lighting. Construction risk can be thought of as an allowance against changes in commercial circumstances - for example, fluctuating

[12] Ibid, paragraph 1.32

[13] https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airspace/Air_Traffic_Control/iag_costofcapital_RP3response.pdf

[14] CAP1812, table 1

costs of construction materials. Many of the same materials will be used over different projects, in varying quantities over a period of time. Some costs will increase, while others will decrease, so there is consequently a degree of 'netting-off'.[15] General business risk sits apart from any development programme and must not be allowed to be incorporated into CAPEX allowances.

31. At the same time, if the CAA wishes to protect the interests of passengers in the round, then it ought not to force tomorrow's depreciation onto today's passengers. Unitised depreciation could provide a transparent and balanced solution, yet the CAA seems reluctant to consider its use.

Assessment of affordability & financeability

32. We note the indicative price paths derived from the CAA's modelling and agree that: *"… the base case at 4% and the lower CAPEX scenario both broadly keep prices below the level in 2016..."*, while the others exceed it by a considerable amount - and that: *"… a price path which stays below 2016 meets the ambition."*[16] We also see that all scenarios lead to a peak in prices around 2029, by when new capacity is unlikely to be in operation - and so which ought not to be paid for by current passengers. The CAA's modelling covers a period of 20+ years – and so the investment should be considered against a regulatory period of similar duration.

33. The CAA describes: *"… the higher CAPEX scenario [in which it] would expect that a number of mitigations could be deployed to avoid [associated] higher airport charges materialising that have not been considered…"*, including *"… [seeking] out offsetting efficiencies…"*.[17] In our opinion, the CAA should be clear that HAL must develop capacity expansion efficiently in **all** circumstances.

34. We note that the CAA continues to rely on a primary duty to consumers as justification to: *"… demonstrate that the regulatory framework supports financeability so that HAL can continue to access cost effective investment grade finance."*[18] We have addressed

[15] Such risk allowances held at portfolio-level are a function of standard deviation (RMS) over anticipated programme cost. For example, two projects managed separately, one of £9m and one of £16m, each with risk of 1 RMS, would attract require allowances of £3m and £4m, respectively. When managed as a programme of £25m, the same risk of 1 RMS requires an allowance of £5m.

[16] Ibid, paragraph 1.42 & footnote 23

[17] Ibid, paragraph 1.46

[18] Ibid, paragraph 1.47

this point fully and on several occasions, including in our response to CAP1782.[19] The CAA is yet to respond to the issues we raise, so they are repeated here:

- *"The CAA says that it will:* '… help ensure [HAL] can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed.' *This is not the duty imposed on the CAA, which is that it:* '… must have regard to the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted…' *So, the CAA has no duty to help HAL raise large amounts of finance; it is an economic regulator, not a financial fixer. The CAA's duties do not extend beyond being aware of (and by implication, sensitive to) HAL's ability to finance current operations.*
- *"In reference to the Civil Aviation Act 2012, the CAA says:* '[t]his approach should **also** enable us to satisfy our duty under section 1(3)(a) CAA12 to have regard to the need to ensure that HAL is able to finance its provision of airport operation services at Heathrow (often referred to as the 'financeability duty')'. *In recognising that its chosen approach is incremental to its 'financeability duty', the CAA explicitly recognises that it has assumed a role to ensure the financeability of capacity expansion at Heathrow, which goes beyond its 'financeability duty'.*
- *"Notwithstanding the damaging consequences of how the CAA's position affects HAL's behaviour, the CAA segues towards a consumer benefits justification. On one hand, it takes a view that finance costs do not find their way to passengers:* '… [helping HAL] raise the relatively large amounts of capital necessary to allow capacity expansion to proceed […] should deliver benefits to consumers in terms of greater choice, less delay and **lower fares**…'. *In its very next breath, the CAA argues in the opposite direction:* '… [an incentive package would not] inappropriately raise [HAL's] financing costs and, so, **prices to consumers**'. *The CAA cannot have it both ways: either financing costs are passed through to passengers, or they aren't. They are."*

19 https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/International%20Consolidated%20Airlines%20Group%20(IAG).pdf

35. We believe that it is insufficient for *"… overall costs to consumers [to be]* ***no higher than necessary****."*[20] The requirement is that prices should not exceed today's levels – something that at times the CAA seems to accept.

36. In its modelling, the CAA has: *"… assumed a simple notional financial structure with gearing at no more than 60% [and has] not considered HAL's existing business securitisation…"*[21] We previously raised a number of points in our response to CAP1782, which have not been responded to and so are repeated here:

    - *"It is all very well for the CAA to say that* '… it will remain the responsibility of HAL's management to decide on its actual financial structure and ensure that its business is financeable…'*; however, the CAA must set a notional WACC which it considers to be efficient. It must inform itself by, amongst other things, looking at HAL's actual capital structure and understanding what equity/debt ratios are achievable, as well as the true, post-tax cost of debt. We are therefore pleased by the CAA's recognition of HAL's levels of debt being sustainably well above Q6 regulatory assumptions, but remind it that the quoted 78.4% is calculated against a 2017 RAB that was some way ahead of depreciated NBV of assets."*[22]

37. The CAA raises an interesting question of *"… HAL's ability to service debt…"*.[23] As it will know, the vast majority of HAL's debt financing comes from Heathrow Funding Limited (HFL), while 100% of HAL's operating profits can be written off against interest charged by HFL to HAL.[24] It is therefore arguable that HAL has two functions - to inflate the RAB and to service debt interest; and also HFL - to issue debt & channel the proceeds to shareholders. The upshot is that between 2007 and 2019, HAL issued debt-financed dividends of £4.1bn.

38. Continuing the theme, on 23rd July 2019 it was reported that HAL, Europe's busiest airport, posted a 4% rise in half-year **revenue** to £1.4bn and a pre-tax **profit** of just £7m (0.5%).[25]

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[20] CAP1812, paragraph 1.48

[21] Ibid, paragraph 1.50

[22] https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/International%20Consolidated%20Airlines%20Group%20(IAG).pdf

[23] CAP1812, paragraph 1.51

[24] By means of a 'Public Infrastructure Exemption'(PIE)

[25] https://www.telegraph.co.uk/business/2019/07/23/heathrow-third-runway-done-deal-claims-airport-boss/

39. We agree with the CAA's choice of key metrics for assessing HAL's creditworthiness: net debt/RAB; FFO/net debt; and debt/EBITDA.[26] Net debt/RAB is plotted over time – and under all scenarios falls from around 53-56% in 2022 to 38-47% in 2030.[27] It is unclear why the CAA believes HAL will (or how it could) reset its current gearing of 86% down to 56%, over the next two years. By our rough calculation, this would require over £4bn current debt to be replaced by equity, as well as 44% of any further CAPEX being equity-financed:

	2019	2022	Variance
RAB	£13,511m	£13,511m	
Gearing	85.7%	56.0%	
Debt	£11,579m	£7,566m	-£4,013m
Equity	£1,932m	£5,945m	£4,013m

40. As the CAA points out, within its model *"… gearing levels average around 50% [due to] a level of retained earnings […] which does not allow for the level of dividends required to achieve a gearing level of 60% or higher."* In our view – and seemingly in the view of capital markets, HAL can maintain investment-grade credit ratings at significantly higher levels of gearing. We therefore support the CAA's proposal *to "… explore higher levels of gearing…"* and urge it to resist prejudgement, such as by assuming that *"… the efficient level of gearing for capacity expansion may be somewhat below the relatively high levels seen as part of HAL's existing business securitisation model."*[28] As the CAA rightly points out: *"[c]redit rating agencies do have thresholds for regulatory asset ratio* ***[which for A- and BBB ratings] are materially above 60%****."*[29]

41. In any case, it was HAL's choice to increase gearing to levels so far ahead of regulatory assumptions – a decision from which it has derived considerable benefits, including the ability to pay very significant dividends to shareholders, over the course of Q6 (and presumably, will continue to do so over iH7). It would be wrong therefore, should circumstances change such that HAL needs to reduce gearing in order to continue to access capital markets, for its debt to be paid down by passengers; rather, it is for shareholders who benefited from previous dividends to increase their equity stake (or find new investors).

42. The CAA plots FFO/net debt, indicating that: *"… [only in 2026] the scenarios using a 4% WACC produce an FFO/net debt ratio below the level consistent with an A- rating*

[26] CAP1812, paragraph 1.53

[27] Ibid, figure 2

[28] Ibid, paragraph 1.55

[29] Ibid, paragraph 1.56

[so] financeability could be challenging…" Understanding the CAA's point, we would counter that financing of R3 cannot be considered against a one-year timeframe - and the markets will not look at it that way. In any case, the CAA's figures for 2026 indicate a solid BBB rating.

43. The CAA goes on to suggest a number of ways in which HAL and/or the CAA may *"… bolster financeability…"*, including: *"… changing the parameters of expansion, greater cost control, or other measures…"*.[30] In our view, first amongst 'other measures' should be a moratorium on HAL's shareholders taking dividends, which are effectively being financed by customers, be that through a higher WACC resulting from over-leverage, from CAPEX over-forecast, or some combination thereof. The CAA can put such a measure into effect simply by adding a term to HAL's licence, precluding the payment of dividends under specified circumstances - for example, should HAL's gearing exceed a predetermined threshold.

44. In differentiating between *'cash-based'* and *'accruals-based'* approaches to credit rating, the CAA may be referring to the effects of an agreement between HAL and airlines, in which payments accrued in iH7 (almost entirely) would be made in H7. The potential effects of this arrangement on HAL's credit rating are not entirely clear; however, we would urge the CAA to protect passengers from being forced to underwrite dividends paid to HAL's shareholders, which are made possible by an enhanced cash position, itself a result of deferment of payments to airlines.

45. For the stated reasons, we agree with the CAA that: *"… the FFO/gross debt ratio [is not] a particularly meaningful measure of financeability…"*.[31]

46. The CAA rightly points out that HAL's debt/EBITDA ratio would increase during the height of construction, but would subsequently reduce (to very healthy levels) as new capacity comes into operation, allowing passenger volumes to increase.[32] We would add that since 2014 HAL has been enjoying passenger volumes significantly ahead of forecasts – and that had the resulting revenue outperformance been used to maintain regulatory gearing assumptions (rather than fund dividends), then the question of *"… the debt/EBITDA ratio coming under significant pressure during [H7]…"* would not arise.[33] That it does is a problem for HAL and its regulator, not for airlines and passengers.

[30] Ibid, paragraph 1.57

[31] Ibid, paragraph 1.59

[32] Ibid, figure 4

[33] Ibid, paragraph 1.61

47. The CAA's closing commitment *"… to finding an approach to financeability that allows HAL to continue to have access to cost effective investment grade finance…"* is tellingly at the heart of many of the problems at LHR.[34] It is HAL's job to maintain its own financeability: the CAA has no duty to do so – indeed, in our view, the CAA's financeability duty is carefully crafted for very good reasons; however, as long as it knows that it is absolved of responsibility, HAL's shareholders seem likely to continue to extract dividends at every opportunity.

[34] Ibid, paragraph 1.62

Appendix – selected excerpts from CAP1819

48. *"[This document] deals with the new information that has emerged on [costs of expansion incurred by HAL] and notes that there could be significant implications for the wider programme timetable, depending on the levels of this spending and how we propose to treat the expenditure in the regulatory framework."* (About this document.)

49. *"HAL's forecasts of early Category C costs have increased significantly and are now very material. […] HAL has said it needs to bring forward the timing of certain spending [and] now expects to spend [£2.9bn] (in 2014 prices), consisting of over [£500m] of Category B costs and [£2.4bn] of early Category C costs, before it obtains a DCO. In light of these increases, we have asked HAL to consider different options…"* (3)

50. *"… [there have been] sharp increases [and] in light of this escalation in cost, we consult on strengthening the governance and regulatory incentives […] including that: reporting arrangements should be enhanced […]; [we will set] a recovery cap [costs beyond which being] subject to approval […]; we intend to increase the scrutiny […]; and the regulatory incentives should be tightened…"* (10)

51. *"… following the sharp increases in HAL's estimates of these costs, we have asked HAL to look at, and report on, a range of options…"* (11)

52. *"… there are plausible scenarios in which HAL would need to accelerate early Category C spending: [which] should be added to HAL's RAB…"* (12)

53. *"HAL's most recent Category B cost estimate [is] over [£500m] …"* (1.3)

54. *"… our policy on Category B costs may be reviewed if efficiently incurred [costs] exceed [£265m]."* (1.4)

55. *"… the main driver of the cost increase [is] HAL not having developed a sufficiently mature understanding of the scope of work [including that] costs classified as early Category C […] have since been reclassified as Category B…"* (1.11)

56. *"The IPCR has reviewed HAL's Category B costs […] with a view to ensuring that costs have been correctly classified […] and not double counted [and it] considered whether there was a clear and consistent baseline, […] appropriate governance […], [proper reporting and] whether information provided was relevant, complete and timely."* (1.12)

57. *"In each of these areas, the IPCR review highlighted concerns."* (1.13)

58. *"… there is only limited evidence on the efficiency of HAL's Category B costs and we have observed the near doubling of HAL's estimates of these costs."* (1.17)

59. *"Stronger and more robust governance of Category B costs is a high priority…"* (1.21)

60. *"HAL's approach to governance in 2016 and 2017 did not meet [objectives and requirements and] has started to improve [but] needs to make substantial further progress…"* (1.22)

61. *"… it does not seem appropriate to provide HAL with any additional reward for its costs increasing over [£265m]* (1.26, ii)

62. *"[In 2018] HAL's latest estimate was that it would spend approximately [£650m on early Category C costs] …"* (2.2)

63. *"While HAL's forecasts of these costs had, by [the autumn of 2018], increased significantly, suggesting total spending might reach [£1.6bn], it provided only limited information on the reasons [and now] its latest estimate […] has increased further to [£2.4bn] …"* (2.3)