The Arora Group's response to CAP 1658

Economic regulation of capacity expansion at Heathrow: policy update and consultation

July 2018

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Section 1 - Introduction and Executive Summary

1. This submission is provided by the Arora Group in response to the Civil Aviation Authority (CAA)'s consultation "CAP 1658 Economic regulation of capacity expansion at Heathrow: Policy update and consultation", published in April 2018 (CAP 1658). It builds on our responses to the CAA's previous consultations, "CAP 1541 Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow" (CAP 1541) and CAP 1610 "Regulation of capacity expansion at Heathrow: policy update and consultation" (CAP 1610).
2. We repeat that we fully endorse the CAA's position that additional runway capacity in the south east of England will benefit air passengers and cargo owners. We also continue to support the Government's North-West runway scheme and provide evidence that we can make a positive contribution in ensuring it is implemented and operated in an efficient manner to the benefit of consumers.
3. The Government has now published its NPS for airport expansion at Heathrow and Parliament voted to approve this on 25 June 2018. As previously advised to the CAA, the Arora Group is fully committed to progress its proposals to undertake expansion and to introduce competition into the process and into subsequent ownership and operation at the airport. We believe we have evidenced how this would be in the interests of consumers.
4. The Arora Group is now committing significant resources and investment into development of its proposals, including the full work necessary for our own DCO application. This makes it essential that there is a clear process for alternatives to be evaluated and on a level playing field with HAL.
5. The Arora Group has previously requested the CAA to clarify the regulatory basis and process for its participation in expansion. This is in line with the CAA's position that it considers CAA 2012 to permit alternative delivery mechanisms. The CAA has so far addressed this issue in a number of consultation documents, but has not provided clarity on how it intends to exercise its regulatory powers to allow consideration of proposals put forward by parties other than HAL.
6. Although the CAA makes some welcome suggestions for enhanced engagement in CAP 1658, this is significantly short of the clear guidance requested.

7. We have repeatedly emphasised to the CAA that in taking forward the Heathrow expansion plans, the CAA must act according to its statutory obligations. It has a primary duty to further the interests of users of air transport services and to do so in a manner which promotes competition. We do not believe the CAA's current approach fulfils these obligations. We repeat our previous comments to the CAA that there are substantial risks to expansion and to consumer interests by failing to meet these obligations.

8. In our response to CAP 1610, we set out our view that the CAA has the powers required to incorporate competition into expansion and to fulfil its statutory obligations. We are disappointed that these have not been responded to in detail or embraced and implemented. In fact, CAP 1658 continues to focus predominantly on HAL and placing responsibility on HAL to engage with third parties. We believe that the CAA is focusing on constraints in facilitating alternative delivery mechanisms, rather than the positive actions and opportunities which the CAA can take.

9. Given the timing constraints and the DCO processes moving forward, we submit that the CAA's approach needs to change and that it urgently and proactively needs to provide clarity around the framework in which alternative proposals for Heathrow expansion will be taken forward. In particular, we expect the CAA to provide clear guidance on:

    - The application of the regulatory framework to alternative delivery mechanisms;
    - How it would evaluate proposals put forward by third parties, and on what basis it would seek to evaluate these against HAL's proposals;
    - How the CAA would interact with parallel DCO processes.

10. In Section 2 of this response to CAP 1658, we update the CAA on progress of the Arora Group's design proposals for expansion. These include the options of either developing the full NWR scheme or alternatively the terminal elements. The proposals show that the Arora Group has a highly credible proposal which offers significant cost and efficiency benefits against the HAL alternative. This would be substantially in consumers' interests.

11. In Section 3, we provide comments on the CAA's Approach to Affordability and Financeability. We encourage the CAA to be ambitious and clear in its affordability criteria and to ensure that alternative proposals are

incorporated and measured to assess their benefits. This should commence immediately to allow time for side by side assessment with HAL and to avoid the inherent risks of delays and leverage.

12. In Section 4, we provide comments on the CAA's Initial Assessment of Affordability and Financeability. The CAA must take an early and realistic view on affordability and ensure that the assessment of alternative proposals is included immediately. We request greater transparency on the current assumptions regarding HAL's inputs. The Arora Group's cost estimates provide the most realistic prospect of meeting the Government's and CAA's affordability criteria.

13. In Section 5, we provide comments on the CAA's Evolutions to the Regulatory Framework. The CAA has a clear statutory responsibility to enable competition in the provision of Airport Operation Services, which includes expansion. The CAA's focus on enhanced engagement is welcome and the Arora Group is committed to support this. However, we believe the CAA's proposals for this engagement are incorrectly and unfairly structured. The process must be independent and place HAL and alternative proposals side-by-side. Nor can the CAA's enhanced engagement proposals be a substitute for the open and transparent process requested and appropriate for alternative and credible proposals to be considered. In CAP 1658, the CAA sets out the constraints on its powers in order to achieve this. We do not agree with the CAA's approach and believe the CAA has the necessary powers and that this needs to be pursued by the CAA immediately, proactively and vigorously. We set out the options we believe exist in our response to CAP1610. We haven't repeated them here, but would welcome the opportunity to set these out in detail in separate discussions with the CAA.

14. In Section 6, we provide comments on the CAA's Cost of Capital and Incentives. The cost of capital is important. However, we do not believe the CAA should be adopting a mindset of incentivising HAL to invest, more that it should be proactive in considering the benefits of alternative and credible approaches from other parties. This should be enabled immediately to avoid leverage and to identify the approach which best serves consumer interests. It is premature to be assessing ex ante incentives in the absence of a settled HAL scheme and a clear process for alternatives to be assessed.

15. In Section 7, we provide comments on the CAA's Interim Arrangements to Apply After the End of the Q6 price control. We support the CAA's intention to undertake an interim pricing review, in the context that the Q6 framework is now becoming outdated. We believe there would be advantages in separating the principles of Q6 "business as usual" from expansion. The two issues involve largely separate criteria, one concerned with ongoing airport pricing and controls and the other with development activities and risk. This approach would have the advantage of enabling simpler comparisons with alternative development proposals for expansion.

16. In Section 8, we provide comments on the CAA's Early Category C Design Costs. HAL's early expenditure indications are alarming and there is not even any high-level justification. Any such expenditure must be subject to rigorous scrutiny, transparency and justification and the CAA should be unerring in requiring this. The CAA will recognise the risk that HAL will commit to expenditure because it is easy, rather than because it is justified and appropriate. The CAA should immediately assess alternative comparisons and take guidance from the approach commercial developers would adopt to deal with risk.

Section 2 - Update on the Arora Group's Design Proposals for Expansion

The Arora Group has undertaken significant work to advance its proposals for Heathrow expansion and these have been clearly evidenced to the CAA. Arora is now undertaking next stage work with the intention of submitting its own DCO application. This involves further, significant investment and it is therefore critical that the CAA identifies and follows a clear process for alternatives to be included.

The Arora Group is keen to discuss with and explain to the CAA how its proposals:

- show the potential for significant benefit to expansion, which is potentially in consumers' interests.
- are costed at a level, under half of HAL's equivalent cost. This is not only substantially more efficient and cost effective, but provides the most realistic chance of satisfying the CAA and Government's affordability requirement.
- are highly credible and have the general support of airlines.
- Should be considered and validated on a level playing field with those of HAL.

17. In our response to CAP 1541, we set out the Arora Group's proposals and approach for expansion as a whole. In CAP 1610, we set out our design and cost proposals for the terminal elements within expansion. The latter were subsequently publicised in May 2018. These are alternative means to enable cost effective and affordable expansion and to introduce competition into Heathrow for the benefit of consumers. The proposals were well received by airlines who saw this as a credible alternative plan to HAL and with the potential to meet their objectives.

18. Our terminal proposals were set out in our response to CAP 1610, so are not repeated here in full, but for convenience, we attach a copy of our press release and the related images in Appendix 1. The key messages are summarised below:

- Proposals for an integrated Western Hub to provide additional terminal capacity of 50mppa and meeting the Airports Commission's (AC) target of 130mppa.
- The opportunity to phase this incremental terminal capacity in line with demand.
- The Western Hub approach avoids the need to develop new terminal capacity in the east, which is much more disruptive and expensive.
- The Arora Group's updated cost estimate is £14.4 billion to meet the full capacity requirement of 130mppa.
- This compares with HAL's cost of £31 billion, this cost being the estimate produced by the AC to provide the equivalent 130mppa target.
- Our Western Hub proposals have been developed in partnership with airlines and with their support
- Separate terminal ownership within expansion is a generational opportunity to introduce competition and to break the existing HAL monopoly.

19. In CAP 1541, we argued strongly for the CAA to adopt competitive principles for expansion, as the means to compare and to secure the benefits of alternative approaches. This will provide the ultimate assurance to the CAA, airlines and consumers that expansion is being implemented as efficiently as possible. Furthermore, we have argued consistently that these competitive principles should be adopted immediately to reduce the risk of delays and leverage by HAL.
20. The cost comparisons highlighted above, reinforce the CAA's need to act to give a realistic chance of achieving its affordability and financeability objectives. At a true comparison cost of £31b illion, there is a significant chance that HAL will be unable to meet the CAA's affordability criteria. In turn, users will not provide their support and the affordability/financeability linkage will be broken. Delay would be the inevitable consequence.
21. In contrast, the Arora Group's approach estimates a full expansion cost of £14.4 billion. This is at a level which not only significantly improves the chances of meeting the CAA's affordability criteria, but offers the potential

for a real terms reduction. This is one of the reasons why the Arora Group received a highly positive response to its public proposals.

22. Furthermore, the Arora Group has committed to the principle of sharing development risk with airlines, rather than HAL's approach which will be to pass on risk to airlines through the regulatory structure.

23. It is appropriate to record and comment on HAL's public response to our proposals:

- There was no apparent contradiction of the £31 billion true comparison principle and cost.
- HAL said the Arora Group should have been involved in the Airports Commission (AC) process. This seems completely irrelevant. The AC determined the location and scheme. The Arora Group is now working within that framework and seeking to establish efficient implementation for the benefit of consumers.
- Our proposals were described as "the emperor's new clothes, the more you look, the less there is to see". This is disparaging. Our proposals represent a credible alternative approach, put together by world leading airport and terminal designers and should not be blocked or discounted by HAL. Such a statement is also contradictory, following shortly after HAL's public invitation for partners.
- That the Arora Group cannot be trusted with local communities. There is no evidence for this. In our response to the DfT's NPS we made a clear alignment and commitment to the DfT's requirements and offered enhancements to HAL's offering.
- That the Arora Group had declined to engage with HAL. This is not correct and the CAA is already aware of this and its HAL who are not engaging in an open and transparent basis.

Section 3 - Approach to Affordability and Financeability

The CAA has the responsibility to ensure that affordability criteria are ambitious and clear and it is critical that alternative delivery proposals are enabled and assessed to ensure that the most efficient approach for expansion is encouraged and adopted:

- We expect the CAA to be firm in its requirement that airport charges do not increase and that it should be setting a target for a decrease in real terms.
- Alternative delivery and commercial solutions should be actively enabled and explored to assess their benefits.
  This should commence immediately to allow time for side-by-side assessment and to avoid the risk of delays and leverage.

24. We continue to support the CAA's principle of ensuring expansion is affordable and financeable. In fact, this is essential as expansion will otherwise not happen or will be uneconomic for airlines and consumers.

25. We believe that the issues of affordability and financeability are inextricably linked and there must be a clear and unrelenting focus from the CAA to ensure this is achieved. We repeat our assertion that this requires alternative proposals to those of HAL being considered and given an equal opportunity for assessment. This is necessary to satisfy the CAA's statutory obligations set out in CAA12.

26. We also remain a strong advocate of the Government and CAA's previously stated requirement that there should be no increase in existing charges in real terms. In fact, we believe existing charges should be a ceiling and that the target aspiration should be a real terms reduction.

27. We already notice that HAL has moved away from this required commitment by aligning only to airport charges remaining "close" to current levels. We are also concerned that the CAA adopts similar phraseology in paragraph 1.17. We agree that lowest cost can't be the sole objective and that it is right to balance cost with quality and that resilience is important. However, we do not believe it is sensible or appropriate for

the CAA to move away from the required target of no increase in cost in real terms. Once this requirement is softened, it will become a self-fulfilling prophesy.

28. We also believe that HAL's positioning on air fares and expansion delays is a flagrant and cynical attempt to divert focus away from the need for efficient, cost effective and affordable airport expansion. In effect, HAL is taking the position that they will do their best, but that any impact on the consumer of airport charges will be negated by (i) the benefit to the consumer of early airport expansion, (ii) by airlines (air fares) coming under more competitive pressure.

29. This argument has no credibility as it implies that there is a choice. There may well be consumer benefits from early expansion and increased airline competition, but there is no reason why efficient airport expansion shouldn't deliver additional benefits as an "and". We strongly encourage the CAA not to fall into this flawed view and to be unrelenting in its requirement for efficient and affordable airport expansion.

30. We are therefore strongly supportive of the CAA's views in para 1.19 that it recognises that HAL cannot use the issues of capacity restrictions and delay as an excuse for inaction on alternative commercial and delivery arrangements.

31. HAL's comments also imply an attempt to create a schism between passenger interests and those of airlines and infer that HAL considers that efficiency and costs are not a focus for passengers. Again, we regard this approach as cynical and misguided and we encourage the CAA to continue to regard airline and passenger interests as synonymous. The correct principle appears to be well set out in para 1.8.

32. Whilst we note the CAA's comment that it is important to seek quality passenger facilities and to ensure a resilient airport, this cannot be achieved at any cost. We therefore welcome the CAA's statement in paragraph 1.19 that HAL cannot use costs as a reason for inaction on matters such as alternative commercial and delivery arrangements, that airlines and consumers should expect to see no more than efficient costs reflected in airport charges and HAL should thoroughly explore all approaches to delivery. It is open to the CAA to provide HAL with a simple choice: engage with other parties on alternative delivery mechanisms to explore more efficient expansion models, or be subject to aggressive CAA price controls.

Section 4 - Initial Assessment of Affordability and Financeability

The CAA must take an early and realistic view on affordability and ensure that this includes a balanced and realistic assessment of alternative proposals:

- The CAA 's initial modelling shows that there are substantial unknowns, risks and challenges to HAL's existing proposals meeting the CAA's affordability criteria.
- The CAA's modelling should provide much greater transparency on the current assumptions regarding HAL's inputs, particularly cost.
- The CAA's financial modelling should be extended and made available to assess alternative proposals and how these can improve affordability against current assumptions.
- The analysis of alternative proposals should be undertaken by the CAA immediately, to allow time for alternative commercial and delivery options to be progressed.
- We expect the CAA to actively promote and lead this process as a means to make valid comparisons and to evidence that it has met its statutory obligations.

33. We welcome the CAA's attempts to financially model expansion. This is essential to provide an advanced indicator of the affordability and financeability equation. However, this principle must be extended to assess alternative proposals to enable valid comparisons. This must happen immediately to ensure that valid comparisons can be made at an early stage.

34. We note the CAA's high-level scenario options and the assumptions set out in CAP 1658 (Appendix B). Whilst we accept that these are initial modelling assumptions, the outputs highlight the risks of proceeding with HAL and not incorporating the valid comparison and benefits which may be achieved by alternative parties and credible alternative proposals.

35. In terms of the modelling assumptions, it is not clear whether HAL's cost of £45.3 billion (2014 prices) solely relates to expansion (130mppa capacity) or also includes ongoing business as usual capex. In assessing the

benefits of alternative approaches, this split is essential to enable a valid comparison for expansion alone. We request the CAA to publish this detailed breakdown.

36. However, the magnitude of the figure seems to confirm that HAL's public statements about a cost of expansion being "14-15 billion" is not like-for-like and is strongly misleading. This lends support to our reference to the AC's estimate of £31 billion referred to in Section 2 above.

37. Nor is there any granularity on the commercial inputs for operating costs and commercial revenues. We believe these are too heavily based on inputs from HAL and reflect existing inefficiencies. This is one of the reasons why we believe the benefits of competition and alternative approaches must be properly assessed and compared. Otherwise, there is a risk of inadequate challenge and the existing approach will continue.

38. Our comments above are reinforced in the preliminary outputs from the modelling set out by the CAA in Chapter 2. Although the CAA states that it "could lead to a path of prices that is broadly affordable", we can see substantial challenges and risks. This cannot be a sound and sensible basis for allowing HAL to adopt a privileged position for expansion, whilst failing to judge the merits of alternatives on a level, early and equivalent basis.

Section 5 - Evolutions to the Regulatory Framework

The CAA has a clear statutory responsibility to enable and promote competition in the provision of Airport Operation Services. This includes both delivery of expansion and in operation on completion. Furthermore, we believe the CAA has clear and effective powers to achieve this.

- The CAA's focus on enhanced engagement is welcome and the Arora Group is committed to support this.
- However, placing obligations on HAL cannot be an alternative to an open and transparent process where alternative proposals are evaluated. This approach is required to enable the benefits of alternative delivery and commercial proposals to be assessed alongside HAL on a level playing field.
- The CAA's enhanced engagement proposals as set out in CAP 1658 are not correctly or fairly structured and are short of the clear and transparent process we have previously requested.
- In CAP 1658, the CAA reiterates the constraints on its powers.
- We do not agree with the CAA's approach and believe the CAA has the relevant powers. We believe that a range of options exist and that the CAA must be proactive in using these effectively. We would welcome the opportunity to explain these in more detail with the CAA separately.

39. In our CAP 1610 response, we made the following key points:

- We requested the CAA to open Heathrow expansion to competitive principles, providing the opportunity to assess the merits and credentials of alternative parties and approaches.
- We explained why this is necessary to enable the CAA to satisfy its overriding statutory obligations in CAA12, S.1 and S.2, to carry out its functions in a manner in which it considers will further the interests of users of air transport services and to do so by the carrying out the functions in a manner which it considers will promote competition. We requested the CAA to deliver on this, or to seek the necessary powers to fulfil it (if the CAA considers there to be a shortfall).

- We gave evidence of our expansion development approach and the benefits it would bring, particularly our Western Hub plans and the updated cost for expansion.
- We repeated our long-standing view that competition for Airport Operation Services requires the CAA to consider the benefits of competition for both delivery and subsequent ownership, control and operations and that expansion is a generational opportunity to achieve this. We identified separate terminal development and ownership as an obvious opportunity.
- We pointed out the divergence between the CAA's welcoming of alternative parties and proposals with the absence of any clear means or process to do so.
- We explained the risks and folly of allowing HAL to assume a predominant and sole position for expansion and how this is likely to expose expansion to risks of delay, leverage and unaffordability.
- We set out our view that the CAA is under estimating the powers which are clearly at its disposal to be able to effect competitive principles into expansion, particularly licencing powers.
- Despite our overriding request for competitive principles to be adopted, we explained that the opportunity exists for HAL and the Arora Group to explore working together. However, HAL had declined invitations to do so, despite this being a CAA requirement. We set out recommendations for the CAA's consideration.

From CAP 1658, we note the following:

40. Although there is some interchanging of phraseology in CAP 1658, the CAA does make some references to "alternative <u>commercial</u> and delivery arrangements" and para 3.20 articulates the CAA's views on the criteria to be assessed as indicators of the advantages these might bring. This appears to be a positive response to our assertion that alternative approaches need to be considered in a broader context than just delivery. As such, we strongly welcome this.

41. However, the CAA sets out no meaningful discussion of the regulatory framework in which it would seek to support and facilitate alternative arrangements. Rather, the CAA on the basis that such arrangements displayed 'a lack of detail on the commercial underpinnings of such arrangements', has failed to address with any further clarity its regulatory approach or the comments raised by respondents, including Arora, to CAP 1610. Multiple consultation documents have been published. Whilst these are outwardly supportive of alternative arrangements, there has been no guidance on how the CAA would apply its regulatory powers to facilitate these or the type of structures that the CAA could contemplate as workable. This uncertain position cannot pertain any longer.

42. The CAA's proposals for enhanced engagement (recently accompanied by the CAA's section 16 report to the Secretary of State for Transport) are very welcome and overdue. We are pleased that the CAA recognises the risks of HAL not engaging meaningfully and has gone to lengths to outline its objectives, requirements and expectations. We ask that the CAA takes all necessary measures to ensure that these are adhered to.

43. However, although we accept that the CAA is well intended, it is not appropriate that HAL should lead the enhanced engagement process. The process needs to be objective, independent and impartial. Otherwise, it will be the monopolist deciding if competition is appropriate and what form it should take. The CAA's enhanced engagement process must therefore be administered by the CAA and other appropriate independent parties and in evidence to airlines.

44. At the time of writing this submission, the enhanced engagement process has not commenced. HAL did not meet the CAA's requirement for publication of engagement proposals by the end of May. We have had an invitation from HAL to bid as a potential supplier to HAL but have made it clear that this is neither the requirement nor the spirit of the CAA's enhanced engagement requirements. We have copied the CAA into this correspondence.

45. This reinforces our concerns articulated in our response to CAP 1610, that HAL is playing it long and has no intention of engaging meaningfully with

alternative parties and credible alternative proposals. It is set on maintaining its existing monopoly and squeezing out potential competitors. This position is neither reasonable or acceptable.

46. More recently, the airlines have promoted an alternative third-party approach There are some revised proposals put forward and we reserve comments until this is finalised.

47. We also strongly welcome the CAA's recognition in para 3.33 that it is critical that HAL publishes information which will enable transparency and the development of alternative commercial proposals. The CAA goes on to expect HAL to make this available. HAL is yet to do this.

48. As an alternative party for expansion, the Arora Group requires a range of information to support the development of its proposals, to ensure its compatibility and to avoid duplication. The CAA is fully aware that this information is remunerated by airlines and consumers. At the time of writing this submission we have requested such information from HAL. HAL's reply directs us only to information which was included in its initial public consultation and which is available on their web site. We have copied the CAA into this correspondence. Again, this is a blocking tactic and we encourage the CAA to uphold and enforce the requirement it has set out.

49. We also welcome the CAA's requirement that HAL should provide more granular information on the RAB. This follows a previous request made both by the Arora Group and airlines. At the time of writing this has not been forthcoming and we ask the CAA to confirm the timetable and process for this requirement and to ensure that it is met.

50. Although enhanced engagement is a step forward, there is no guarantee that it will be successful. We welcome the process and will respond positively to it, but it is not a satisfactory alternative to the CAA running a process which allows alternative parties and approaches to be considered and evaluated on a level playing field with HAL.

51. In our response to CAP 1610, we set out clearly our view that the CAA has extensive and sufficient powers to enable this and to put it into effect. This doesn't appear to be responded to in full in CAP 1658 and we would therefore welcome the opportunity to explain these in more detail with the CAA separately.

Section 6 - Cost of capital and incentives

The issue of cost of capital is important. However, the CAA should not be focusing solely on HAL, but instead should be considering the merits of alternative and credible approaches from other parties:

- Competition by open comparison with alternative approaches and providers is the most effective means of ensuring efficient implementation.
- The CAA should commit to this principle immediately to avoid leverage and to identify the approach which best serves consumer interests
- It is premature to be assessing ex ante incentives in the absence of a settled HAL scheme and a clear process for alternatives to be assessed.

52. The risks associated with running a process in which HAL has an incumbent and privileged position is reflected in HAL's comments included in paras 4.7, namely that the PWC returns wouldn't allow them to invest and that the WACC should not be set at the minimum expected level. This is an example of the leverage risk, which we have previously set out to the CAA. Comparison with alternative and credible parties will enable true comparison.

53. Furthermore, we continue to be concerned that the CAA feels it has to incentivise HAL to invest. This appears to be echoed in para 4.09, which reports HAL's view that the WACC should be set in a way that gives it an incentive to invest and deliver new capacity.

54. We note that the CAA considers the PWC report to be an early and preliminary estimate and that it is ultimately concerned to ensure the timely delivery of expansion at the lowest efficient cost to meet the outputs required by consumers and airlines. The Arora Group has made credible alternative proposals and we believe the best means of ensuring this is to make relative comparisons between alternative parties. We are happy to support the CAA in this process.

55. We believe it is too early to commit to any concept of ex ante incentives on expenditure by HAL (paras 4.16 – 4.26). We are pleased that the CAA appears to have reached this same conclusion. In presenting credible alternative proposals the Arora Group has previously committed to the principle of sharing risks with airlines.

56. However, we feel that the CAA's primary focus at the current time should be to work with HAL and other alternative parties to establish a settled expansion scheme and a cost which satisfies the affordability and financeability requirements. Until this happens, it is far too early to contemplate incentives and penalties against an uncertain base.

57. The Arora approach would be to enter into meaningful and productive discussions with airlines to identify risks and to agree the most appropriate means of managing these and sharing them.

Section 7 - Interim arrangements to apply after the end of the Q6 price control

The Arora Group recognises and welcomes the CAA's plans for an interim review.

- Q6 will have run for 6 years and so the CAA's proposals for an interim pricing review are considered appropriate.
- We see merit in the CAA separating the regulatory pricing and licencing provisions for Q6 business as usual and expansion as they relate to different issues and components.

58. We realise that the content of this chapter is primarily of interest to airlines as it relates to issues impacting on the existing regulatory framework and provisions. However, the Arora Group does have a strong interest in ensuring that it is not placed at a disadvantage against HAL as it promotes its credentials as an alternative party for expansion.

59. The CAA's price control activities are of course essential in controlling HAL's excesses as it operates with market power. We appreciate the arguments from some that the normal five-year period is too short for long term planning and from others that it is too long as FBP assumptions become quickly out dated.

60. In this case, the Q6 period has already been extended and will currently run to the end of 2019. This means it will already subsist for six years and the CAA is considering extending further. The important issue is the protection of consumer interests.

61. In reviewing HAL's accounts for the completed years of Q6, we believe HAL has significantly out-performed the Q6 regulatory assumptions and this in itself will warrant an in-depth review of commercial assumptions and forecasts. We encourage the CAA to be thorough on this.

62. We don't feel strongly about whether an extension is one or two years as long as the interim pricing review is thorough and robust. However, we do challenge the principle that expansion activities should be integrated into

overall pricing control. In fact, they have different areas of focus and we can see advantages in keeping them separate:

- Q6+/Q7- It is entirely possible to continue existing regulatory principles assuming a 2R world. This would reflect business as usual assumptions and allow shorter Qs and tight control on HAL's business by the CAA. This would enable the CAA to conduct the depth of review it sees fit and provide the opportunity for a new Q, rather than an extension of the existing Q6.
- Expansion- we believe this would be better served by ring fencing, with separate regulatory control and principles. It would primarily relate to development issues and control, such as capex, risk, engagement, funding and WACC. This is in contrast to the existing range of regulatory criteria for business as usual, which are much broader. It should be remembered that revenue, OPEX and passenger factors for expansion will not come into play for many years yet.

  Such separation would also have the advantage of enabling simpler comparisons with alternative development approaches for expansion.

Chapter 6

Early Category C Costs

The level of HAL's substantial early expenditure of the magnitude set out in CAP 1658 is alarming and there is no clear justification:

- Only expenditure which has clear benefits should be considered and must be rigorously scrutinised and justified.
- All expenditure requests must be fully transparent and justified.
- The CAA should immediately assess alternative comparisons and take guidance from the approach they would adopt.

63. We repeat our comments made in our response to CAP1610 that any such early expenditure should be clearly justified by the benefits realised and that HAL should take an element of risk sharing, as happens in the commercial world.

64. From the information contained within CAP1658, we are alarmed about the scale of HAL's proposed expenditure, which amounts to £672m (para 6.14). This is put forward without even any high-level articulation of the benefits or justification.

65. Furthermore, HAL appears to be indicating that the absence of full underwriting of costs will delay expansion (para 6.8). This presumably means that HAL will not be prepared to take any risk and that expansion will suffer unless it gets its way. This is further case for alternatives to be openly encouraged and considered to avoid leverage.

66. Nor do we accept HAL's assertions that issues of "the highly specialised nature and costs" and "confidentiality" warrant a softening or different approach to governance. The first statement is meaningless and no justification for hiding costs which are being remunerated by consumers. The second sounds like an attempt to smokescreen the transparency and rigour which is essential in holding HAL to account for significant expenditure which is at high risk until at least DCO consent is granted. We

can accept that specific figures may require some confidentiality, but not the important principles of approach and justification.

67. We are pleased that the CAA appears live to the importance of controlling this expenditure. It is easy for an incumbent developer in HAL's privileged monopoly position to make early commitments, which make for an easier process. But, this doesn't make the expenditure appropriate or justified, especially when consumers are picking up the bill. We still believe that the CAA should take guidance from how a commercial developer would tackle the issue; it would be a risk based approach, with careful balancing of risks and benefits. There would no opportunity for others to provide a safety net and this would serve to maintain sharp focus on business justification.

68. These principles align closely with the views put forward by airlines in para 6.10 and with the position within which the Arora Group is operating as it bids for the rights to undertake expansion. We are pleased that the CAA appears to be encouraging alternative parties to come forward, but we believe this should be on a level playing field. As things stand, the CAA is affording an advantage to HAL in providing for its costs and risks to be underwritten, albeit with safeguards. This places alternative parties with credible proposals at a very significant disadvantage. We therefore request the CAA to reconsider and to adopt the principles set out in Para 6.10 (CAP1610).

Appendix 1 – Western Hub Press release

Heathrow Western Hub plans revealed by the Arora Group

- ***New designs would save significant cost & deliver premium experience***
- ***Group puts pressure upon Government to consider more efficient alternative***

The Arora Group has today unveiled its plans for new terminal buildings at London Heathrow Airport, as part of its bid to undertake development of Heathrow's expansion. Known as the 'Western Hub', the new terminals are designed to provide capacity for over 50million additional passengers and will transform passenger experience and efficiency at the UK's premier gateway to the World.

The estimated cost of Arora's airport expansion plans to full capacity is £14.4bn. The competing scheme, from the existing airport company (Heathrow Airport Limited), was recently costed at more than twice this sum by the Airports Commission, at £31bn*. Arora's new plans make airport expansion affordable and give Heathrow the best chance of success when competing with other hub airports, such as Amsterdam Schiphol and Paris-Charles De Gaulle, post-Brexit.

In recent days, HAL said it would allow companies to bid to partner with it on various parts of the expansion scheme. Arora believes this is a step in the right direction but does not yet go far enough in guaranteeing a truly competitive expansion.

Arora's Western Hub plans have been designed by internationally acclaimed architects, Corgan, who are responsible for many of the world's leading airport terminals. The proposals will provide a step change in Heathrow's international standing and competitiveness.

The Arora proposals concentrate new terminal capacity on the western side of Heathrow, between the existing Terminal 5 (T5) and the M25. This avoids the need to redevelop existing terminals in the Heathrow central area (Terminals 2 and 3) which would be far more expensive and disruptive.

Instead of new, independent terminal buildings, the Western Hub integrates new passenger facilities with T5 into a single hub campus. At the heart is a new central concourse, which will serve as a single front door for all 85m passengers using the Western Hub. This building will be a magnificent and vibrant grand space, designed to amaze passengers and capture the excitement of air travel. It will provide efficient check-in facilities and compelling commercial amenities, and will include one of the UK's largest and most important rail interchanges.

The central concourse will provide fast and easy access to both Terminal 5 and to the new Terminal 6, with an elevated bridge concourse providing panoramic views over the airfield for passengers, and easy navigation underneath for aircraft.

Surinder Arora, Founder & Chairman of the Arora Group, said: *"Our approach has been to work closely with airlines and to employ the world's best and most experienced airport designers and these benefits are clearly evident in our Western Hub plans. Heathrow has been in monopoly control for too long and our proposals show what can be achieved through an alternative approach and Heathrow fully welcoming competition.*

"We welcomed Monday's consultation from the CAA. It is helpful to have talks in place and we are eager to work with all parties to realise the best solution for Heathrow.

"We are passionate about developing a Heathrow that delivers a truly world-leading experience; one that works for airlines; one that offers passengers a top-class journey; and one that has the commercial grounding to be a long-term success for the nation to take pride in."

Key features of the Arora Group's Western Hub plans include:

a. ***Strategic Location –*** all new terminal capacity located on the western side of Heathrow, close to the M25, avoiding bottlenecks associated with the M4 spur road and tunnel and far less costly and disruptive to develop.

b. ***Integrated Design –*** stunning architectural design to transform Heathrow. New terminals concentrated in a single Western Hub campus, avoiding the inconvenience and confusion associated with separate independent terminals. This is an innovative approach, providing a single place of arrival for all 85m passengers within Arora's Western Hub and making a step change in ease of passenger access.

c. ***Integrated Rail infrastructure –*** a new integrated rail/air interchange within the central concourse, linking Heathrow to existing and new rail networks; a key factor in enabling the Government's requirement for a step change in public transport use and environmental compliance.

d. ***Passenger convenience –*** integrated design of the Western Hub is designed to minimise walking distances and connection times, and "check-in" at the rail interchange will enable passengers to check-in much earlier in their journey.

e. ***Cost efficiency –*** significantly lower development cost, arising from more efficient design and layout, leading to lower charges for airlines and passengers.

f. ***Operational Efficiency –*** designed in close association with airlines to ensure operational efficiency, including a layout for aircraft to increase operational capacity and to ensure maximum direct access to aircraft for passengers. Location of the terminal maximises the use of the runways, minimises taxi times, and most importantly reduces the hub's environmental impact.

g. ***Superior experience*** - smart experiential-focused design, based on learnings from the best airport terminals in the world to ensure that the Western Hub will be cutting-edge when opened and will transform passengers' ease of journey and experience.

h. ***Robust technology adaptation –*** fully integrated technology to improve passenger experience by boosting operational efficiency and reducing cost. Latest automation technologies will enable:
    1. Aircrafts - to operate more efficiently e.g. systems, automated gates, automated tugs and airbridges
    2. Passengers - Efficient baggage systems, smart security, automated guided vehicle (AGV's) for quick connections

Jonathan Massey, Principal of Corgan's Aviation Studio, commented: *"Our plans maximise the site's potential, incorporating a large number of gates next to T5, reducing passenger connect-times, and including an integrated public transport hub as part of an innovatively designed 'central processor' core area, to develop the best operational solution for Heathrow."*

Arora is competing with the airport company, Heathrow Airport Limited (HAL) for expansion development rights. These proposals move Arora ahead of the game as HAL doesn't yet have a clear proposal and is far more costly. The costs of airport expansion will be passed on to airlines and passengers and Heathrow is already one of the most expensive airports in the world.

Sir Rod Eddington, former British Airways CEO and member of the Arora Group Heathrow Expansion Advisory Board, commented: *"Heathrow used to be the premium global aviation hub but has suffered under the current monopoly, which has seen it drop below other European airports. Arora is best placed to deliver true competition and return Heathrow to its place as the top-tier international airport, which is critical in a post-Brexit Britain."*

Airlines operating from Heathrow have consistently voiced concerns about HAL's ability to undertake Heathrow expansion in a cost-effective manner and have called for competitive principles to be adopted to ensure that expansion is undertaken by the best party and to ensure that it is a success. Airlines have therefore welcomed the Arora proposals.

A spokesperson from International Airlines Group (IAG, the holding company of British Airways, Aer Lingus, Iberia and Vueling) said: *"Competition at Heathrow is critical to keeping costs low and we call on the Government to break up the airport's monopoly and allow third parties to run terminals. The Arora proposal looks very interesting and deserves to be properly evaluated so that customers can get the best facilities at the most affordable price".*

Craig Kreeger , CEO, Virgin Atlantic, said: *"Heathrow expansion is a once-in-a-generation opportunity to challenge the status quo and build the right airport for the future. Arora have developed a plan that will bring down the cost of construction and inject competition at the UK's hub airport. At first look, this plan appears to be a credible alternative. Virgin Atlantic believes passionately in the benefits of competition to consumers, so we urge all involved in Heathrow expansion to give the Arora plan serious consideration."*

- **ENDS -**

NOTES TO EDITORS

***** Figures based on extensive 2-year study carried out by independent consultants: Jacobs report and HAL submission to Davies Commission based on 2014 prices. See paragraph 4 below.

<u>About the Plans</u>

1. **Development Context**

   The Arora Group announced its intention to bid for the right to undertake development of Heathrow expansion in Summer 2017. Since that time, it has produced its terminal design and layout plans which are unveiled today.

   The Arora plans have been carefully developed in close consultation with the major airlines operating at Heathrow to ensure the plans are optimised for their operations, efficient, cost effective and improve the ease of travel and experience for passengers.

Arora
GROUP

2. **Monopoly vs Competition**

Heathrow is currently under the monopoly control of HAL which has to date assumed the sole right to undertake Heathrow expansion. This has been challenged by the Arora Group's bid and by airlines operating at Heathrow, who have provided their support. They believe HAL's current monopoly excesses will mean that expansion will be too costly and inefficient, making it at risk of being a white elephant and notinternationally competitive. They continue to lobby the Secretary of State for Transport (SoS) for competitive principles to be introduced into the expansion programme. This element also featured strongly in the recent Parliamentary Transport Select Committee's process. The SoS is scheduled to provide a response to the Committee's recommendations shortly.

HAL's excesses mean that airlines are currently charged £22.50 for each passenger using the airport. This is one of the highest rates in the World and double that of Gatwick. Although this charge is to airlines, it is effectively passed on to passengers. Airlines believe that expansion costs need to be kept under control and guaranteed to ensure that existing charges won't increase and that Heathrow is affordable for users. This is an objective endorsed by the SoS. Many airlines don't believe HAL is capable of doing this and have asked for competition from other parties to give an expanded Heathrow the best chance of being implemented efficiently, and to maintain its international competitiveness post- Brexit. They also see Heathrow expansion as the ideal opportunity to break the HAL monopoly and to introduce competition into the airport.

As a monopoly, HAL is currently regulated by the Civil Aviation Authority (CAA). HAL's current regulatory model effectively rewards them for expenditure. This, allied to HAL's inefficient track record, has fuelled airline concerns about whether HAL should be entrusted with Heathrow expansion and they have advocated the benefits of competing parties having the opportunity to develop airport expansion more efficiently.

The CAA has called for the necessary powers to introduce competitive principles into Heathrow expansion. However, HAL can currently veto the introduction of competing parties. These powers are required from the SoS. The Arora Group has recently written to the SoS to reinforce this request.

The challenge to HAL's existing monopoly builds on the previous break up of BAA's ownership of a number of UK airports, enforced by the Competition Commission (CC) in 2010. The CC ruling forced BAA into selling other airports and they now only own Heathrow. Most, if not all, of the abuses found by the CC still apply today at Heathrow.The introduction of competition within the airport is the natural extension of the earlier sale and the means to break the monopoly and to bring benefits to passengers.

Although the Arora Group is bidding to undertake Heathrow expansion as a whole, the plans announced today relate to the new terminals only. It is possible that the new terminals can be undertaken separately within expansion overall. The airlines support this approach as a means of implementing the new terminals efficiently and in breaking the HAL monopoly when completed and operational. This model of competition between different terminal owners within airports is increasingly adopted across the world as a means of controlling charges to airlines and passengers. This would not cut across the principle of commonly operated and safe runways.

3. **Passenger Capacity**

Heathrow currently handles close to 80 million passengers per annum (MPPA). The Airports Commission targeted expansion to increase this by 50mppa to 130mppa. This will be enabled by the additional runway and additional terminal capacity. The Arora plans for the Western Hub have been carefully planned to meet this as below:

WESTERN HUB TERMINALS	MILLION PASSENGERS PER ANNUM (MPPA)
Existing T5	35
T6 Phase 1 (T6A and T6B)	35
T6 Phase 2 (T6C)	15
Total Western Hub (Forecast)	85

Arora's plans have a major advantage in providing all additional terminal capacity required for expansion in a single location, the Western Hub. This makes Arora's plans highly efficient and cost effective. In contrast, HAL's plans split the additional capacity between the west and eastern side of the airport, including extending T2 and the need to knockdown and rebuild T3. This makes HAL's plans extremely inefficient, particularly because congestion in the east makes it a much more expensive option.

In addition, Arora's plans for the Western Hub can be phased to enable the 50mppa capacity to be added incrementally and flexibly in line with demand. This is one of the advantages of a Western Hub, rather than separate terminal approach. No changes would be required to existing terminals, making Arora's plans highly cost effective and avoiding massive disruption for passengers.

4. **Cost**

Arora's estimated cost for expansion is £14.4bn. This includes the new runway and terminals to meet 130mppa. This compares with HAL's plans which were costed by the Airports Commission at £31bn. HAL's recent "indications" of "£14-15bn" are not comprehensive and are misleading as they do not achieve the 130 mppa target. HAL will need to invest further in existing terminals in the east to meet the full target. The Arora plans are therefore ultra-efficient and at a cost of under half of HAL's.

5. **Connections and Transfers**

The compact and efficient configuration of the Arora's Western Hub will allow connecting passengers to transfer between flights in a very efficient and time sensitive manner. This configuration will provide connecting times which are almost half of those at some other large hub international airports. Additionally, departing passengers will walk a maximum of 10 minutes from the post-security side of the central concourse to their T6 gate.

6. **Public Transport and Western Hub Access**

The new integrated rail/air interchange will link the Western Hub directly to all existing and planned Heathrow rail services, including Southern Rail, London Underground, Heathrow Express, Crossrail; and the potential future Western Rail.

Rail passengers will also benefit from a dedicated check-in/bag drop area as part of an integrated Public Transport Interface (PTI) at the train platform level, making public transport an appealing option for passengers by offering an efficient means of arrival, and helping to ease congestion elsewhere in the airport.

Road passengers for both T5 and the new T6 will be served by a single drop off and pick-up location, simplifying journeys and reducing the total number of vehicle trips and unnecessary circulation in the terminal complex. Additionally, by locating the new terminals close to the M25, the Arora Group plans avoid the creation of road ‘bottlenecks’ currently associated with the M4 spur road and tunnel.

These design features will support the Government’s requirement for a step change in public transport use and environmental compliance.

7. **Experiential-focused design**

The Arora Group plans, designed by one of the world’s leading aviation architects, Corgan, entail pioneering architectural design to transform Heathrow and ensure a superior passenger experience while being commercially viable. The design takes into account detailed insights on the travel preferences of core passenger groups – such as business travellers, the elderly and families.

For example, the architecture incorporates an elevated ‘high street’. As well as acting as a functional route from the terminal to the gates for passengers, and enabling aircraft to manoeuvre easily underneath the concourse building, the Sky-bridge offers a panoramic view for passengers and a world-class lounge, retail and dining offer, to create a vibrant and inspiring gateway.

Forecasting changes in transportation and technology, Arora’s plans accept future demands and infrastructure—accounting for near-term shifts including the advent of drone baggage deliveries and tracking as well as adaptability for seamless integration of future trends.

8. **Air & Noise Pollution**

Arora’s plans will [at least] match the existing targets for air quality and noise limits. By using 23% less land for the expansion, there will be an improvement in the noise and other impacts from construction itself.

Envisa (the specialists in environmental impacts of aviation), has found that currently, no difference can be observed between the HAL schemes and the Arora Proposal in terms of noise around LHR, based on similar operating scenarios provided by ERCD.

<u>About the developers</u>

The Arora Group

The Arora Group is a successful UK-focused private group of companies, which leverages synergies across its specialist property, construction and hotel divisions to its strategic advantage. Since 1999, the Group has built its standing through meticulously managing projects from inception to delivery and beyond. Today, it owns and manages a diverse portfolio of flagship assets across the nation's key business locations, partnering with some of the world's most recognised brands to deliver consistently high service levels and sustainable growth. For more information please visit www.thearoragroup.com. @Arora_Group.

The Arora Group has assembled the world's leading airport consultants to support its bid for Heathrow expansion, including:

Corgan

Corgan is a leading architecture and design firm with 70 years of Aviation design experience, a human-centered approach, and a reputation for creating environments where our clients thrive. With offices across the United States, China, Hong Kong and Singapore and more than 200 dedicated aviation employees, Corgan has been ranked as the top airport terminal architecture firm by Building Construction+Design in 2016 and is currently working at 12 of the top 30 airports in the world. Building lasting relationships with more than 150 airports around the globe, Corgan boasts a 92% rate of repeat business—working with clients to deliver complex terminal programs and innovative, award-winning experiences. In addition to aviation, Corgan has developed special expertise in commercial, critical facilities, education, healthcare, and interior design projects. For more information, visit www.corgan.com @corgan

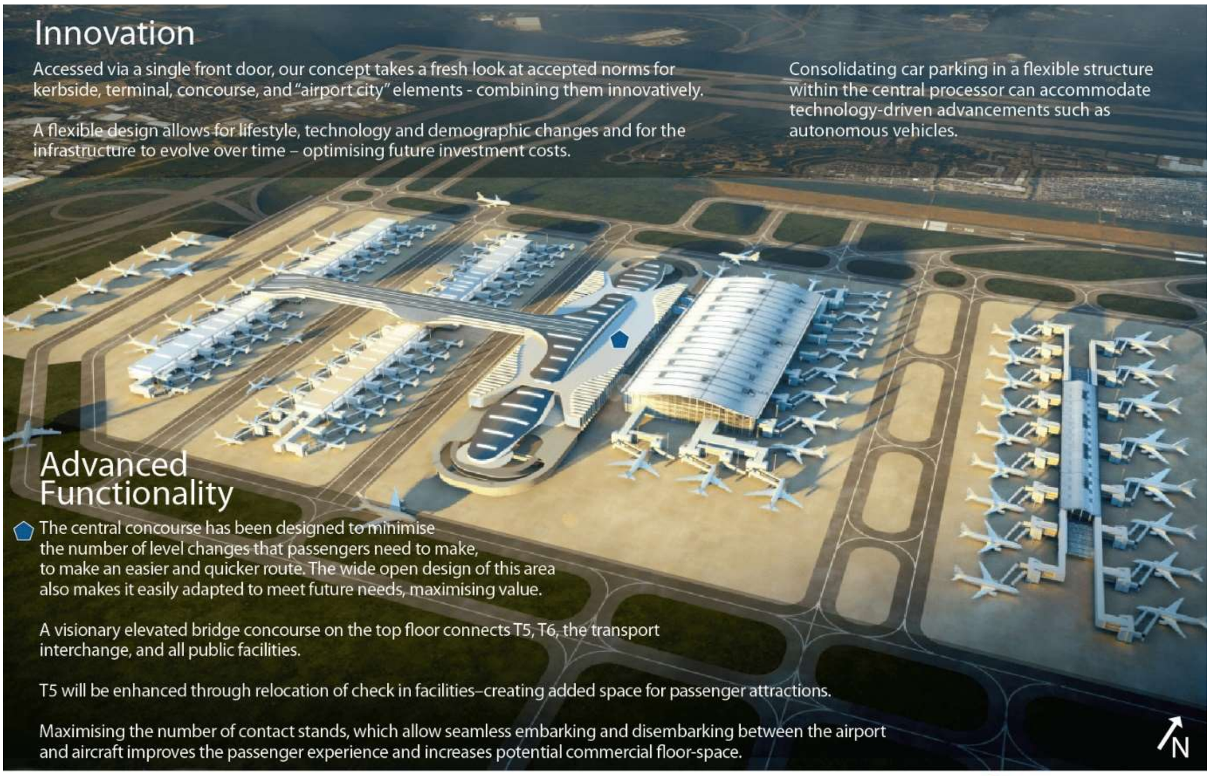
Doig and Smith

Doig+Smith has wide-ranging experience in the management of high-profile construction projects across the Transport, Health, Industrial, Commercial, Retail and Leisure Sectors. With offices in London, Edinburgh, Aberdeen and Glasgow, Doig+Smith can also use its extensive network of contacts to bring together like-minded parties to act as successful project partners.

Envisa

Established in 2004, Envisa is an environmental consulting company specialised in sustainable aviation. Their experts are widely recognised at national and international levels for their proficiency and expertise in issues linked to the aviation sector, as evidenced by our references in institutional, private and airport contexts. Their main focus areas are local air quality, greenhouse gas (GHG) emissions, and noise & energy management.

Western Hub Images


Innovation
Accessed via a single front door, our concept takes a fresh look at accepted norms for kerbside, terminal, concourse, and "airport city" elements - combining them innovatively.
A flexible design allows for lifestyle, technology and demographic changes and for the infrastructure to evolve over time – optimising future investment costs.
Consolidating car parking in a flexible structure within the central processor can accommodate technology-driven advancements such as autonomous vehicles.
Advanced Functionality
The central concourse has been designed to minimise the number of level changes that passengers need to make, to make an easier and quicker route. The wide open design of this area also makes it easily adapted to meet future needs, maximising value.
A visionary elevated bridge concourse on the top floor connects T5, T6, the transport interchange, and all public facilities.
T5 will be enhanced through relocation of check in facilities–creating added space for passenger attractions.
Maximising the number of contact stands, which allow seamless embarking and disembarking between the airport and aircraft improves the passenger experience and increases potential commercial floor-space.
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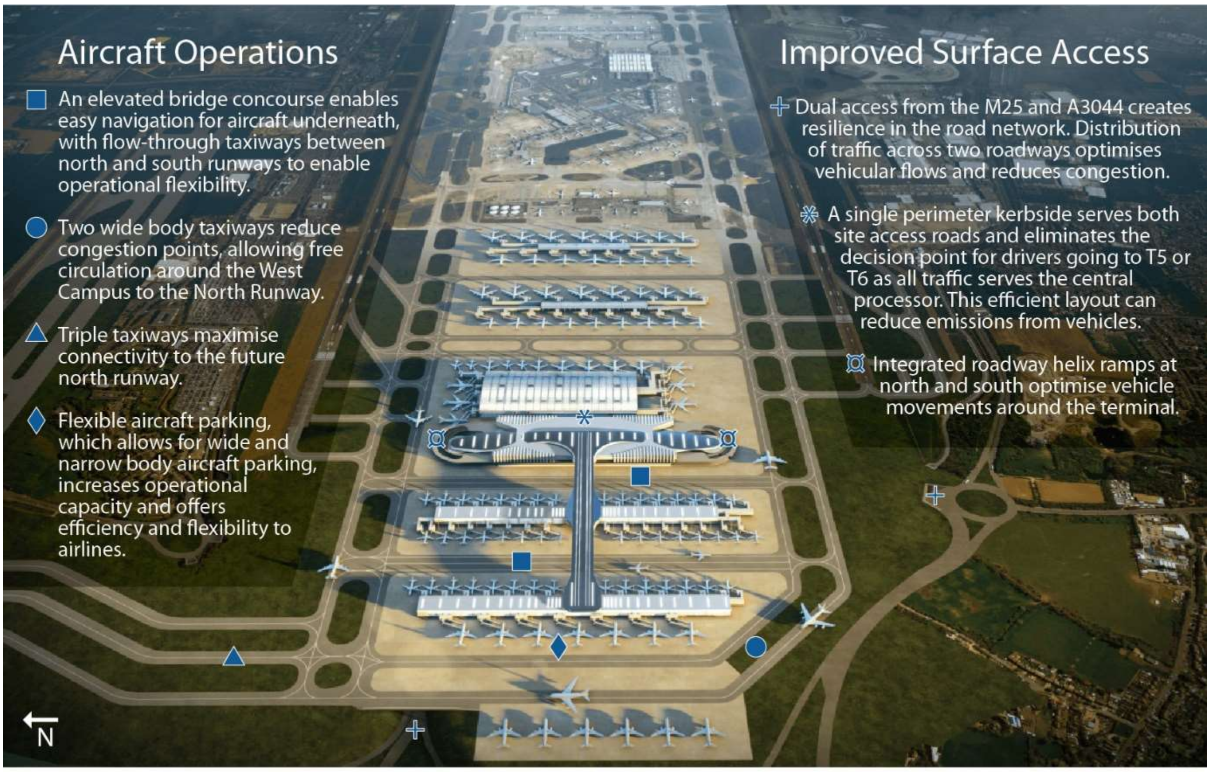
Aircraft Operations
An elevated bridge concourse enables easy navigation for aircraft underneath, with flow-through taxiways between north and south runways to enable operational flexibility.
Two wide body taxiways reduce congestion points, allowing free circulation around the West Campus to the North Runway.
Triple taxiways maximise connectivity to the future north runway.
Flexible aircraft parking, which allows for wide and narrow body aircraft parking, increases operational capacity and offers efficiency and flexibility to airlines.
Improved Surface Access
Dual access from the M25 and A3044 creates resilience in the road network. Distribution of traffic across two roadways optimises vehicular flows and reduces congestion.
A single perimeter kerbside serves both site access roads and eliminates the decision point for drivers going to T5 or T6 as all traffic serves the central processor. This efficient layout can reduce emissions from vehicles.
Integrated roadway helix ramps at north and south optimise vehicle movements around the terminal.
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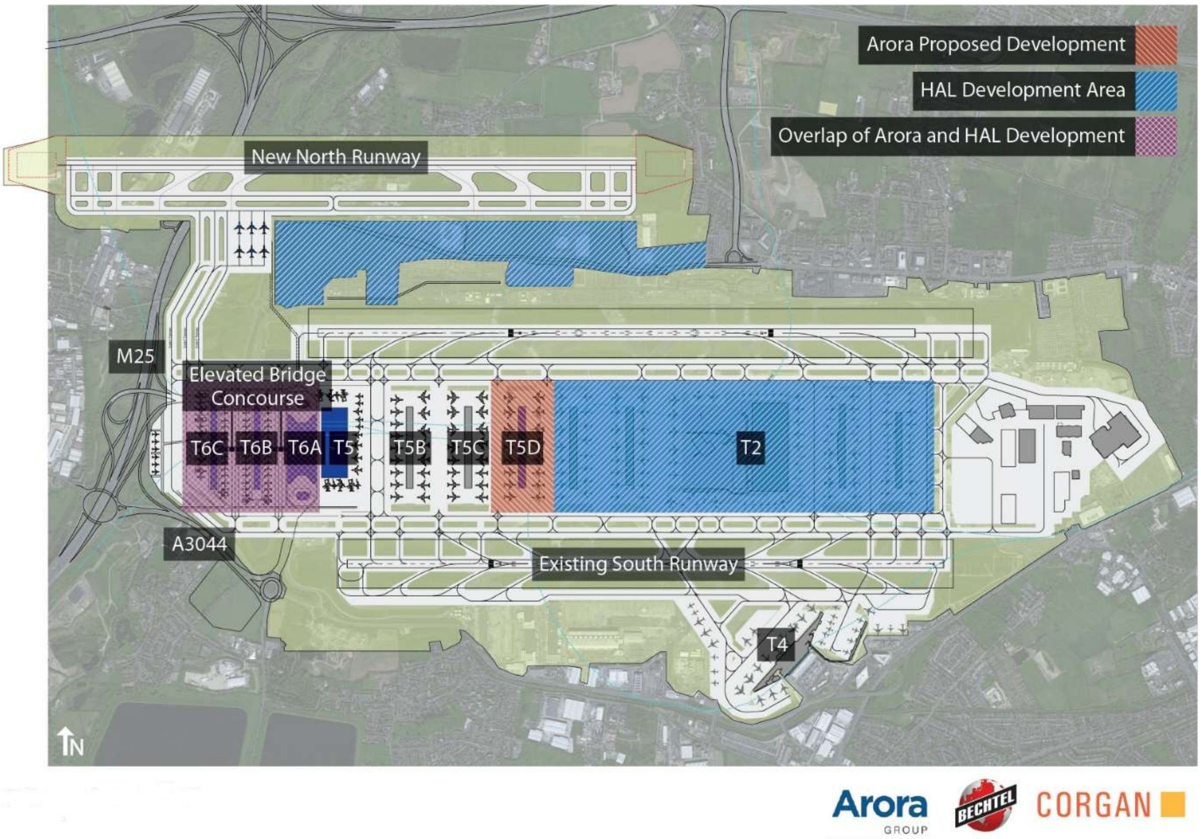
Arora Proposed Development
HAL Development Area
Overlap of Arora and HAL Development
New North Runway
M25
Elevated Bridge Concourse
T6C
T6B
T6A
T5
T5B
T5C
T5D
T2
A3044
Existing South Runway
T4
N
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BECHTEL
CORGAN