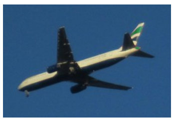

Deliverability

Heathrow Expansion Factsheet 2

Is a new runway at Heathrow deliverable?

With an additional runway, Heathrow is estimated to require £28 billion in debt and £6 billion in equity financing through to 2050 (Airports Commission estimate). Up to £20 billion (Transport for London estimate) will be needed for improved surface access.

So the project may require up to £54 billion in total. This may be difficult to obtain through the markets. For comparison, the total of all investment grade bonds issued by UK corporates in 2013 was around £46 billion.

State aid to fund this may require further Government cuts elsewhere in the economy, and may be contrary to competition legislation. It would also be difficult to justify given the spare capacity at other airports and the prevalence at Heathrow of transfers and leisure passengers from the UK, which provide little benefit to the UK economy.

What's the issue?

1. A major challenge for Heathrow relates to the amount of finance required. The scale of the finance to be raised will mean that the financing will have to command returns sufficient to attract a wide range of investors and be structured in a way to ensure it is of sufficient credit quality. This needs to be tested.
2. Government may need to provide financial support, either in funding or in providing guarantees. The risk to the public purse needs to be assessed.
3. Issues of state aid and whether the Government would itself have the capacity arise, given its own funding requirements and needs of other sectors of the economy. The commitment from Government would have to be at an early stage in the next few years and not wait until the actual major spend occurs.
4. There is a risk that other airports would seek redress under unfair competition rules if Heathrow expansion were to be financially supported by Government.
5. Based on the Airports Commission's forecasts, much of the demand will be a re-distribution of growth otherwise available to airports outside the south-east which have existing spare capacity. Questions arise as to whether this investment in the over-heated South East meets the Government's aim to support growth elsewhere in the UK (See *Fact Sheet 1: The UK Economy*).

What solutions are needed for the Heathrow North West Runway option?

6. The proposer for the Heathrow North West Runway (Heathrow NWR) option, Heathrow Airport Ltd (HAL) would need to increase the maximum debt and equity outstanding in the order of £28 billion and £6 billion respectively [1]. In order to refinance bonds as they reach their scheduled maturity, HAL would need to access a significant amount of financing over the assessment period to 2050.
7. The £34 billion of total funding is required not just for the third runway expansion project costing an estimated £18.6 billion but for ongoing investment to update Heathrow's existing infrastructure. On top of this there is the funding needed for surface access which the Airports Commission estimates as £5.7 billion but Transport for London (TfL) estimates to be as high as £20 billion in order to mitigate overcrowding on the rail, congestion on the roads and pollution [2]. Almost certainly the total investment of £54 billion will require support from the government. The alternative is to reduce surface access investment but run the very

real risk of breaching air quality statutory limits and having to curtail the use of the additional capacity, which would affect the financial returns significantly. Another alternative is for the aeronautical charges to be increased but they are already expected to be high. Any further increase would likely reduce demand economically or be restricted by the regulator and in both cases risk the financial rate of return.

8. State aid in the form of grants, loan guarantees, etc., may well be contrary to EU legislation. Economically and politically it could be difficult to justify for the following reasons:
    - the large UK funding requirements;
    - the inefficiency of investment in Heathrow when there is spare capacity at other airports;
    - use of capacity for international transfers of questionable value to the UK;
    - use of capacity for leisure purposes which has a negative impact on the UK's balance of payments and is predominantly by the more wealthy.
9. It is unlikely that the sterling bond market alone would have sufficient liquidity to fund this scheme. Therefore, HAL would likely need to issue bonds in a number of different currencies to access such liquidity as well as foreign exchange hedging instruments. (HAL's bond programme currently includes GBP, USD, EUR, CAD and CHF bonds).
10. The amount of debt and equity financing required for the HAL proposal should be considered in the context of the wider debt and equity markets. The scheme could put HAL on a similar scale to Network Rail (with long- term debt of c. £35 billion) and beyond that of National Grid (c. £25 billion), both of which also operate in regulated environments. The Heathrow NWR option is a single infrastructure project compared with the incremental enhancements made to an already significant network of assets for Network Rail and National Grid. The Heathrow NWR scheme also increases HAL's debt balance to a similar level of that of BP, which holds the largest debt balance of any UK corporate (excluding financial entities) with c. £40 billion in long-term debt.
11. Of these comparable entities, Network Rail's outstanding debt is guaranteed by the UK government. This guarantee made it easier for Network Rail to access a large amount of financing. From April 2014 Network Rail has borrowed directly from the UK Government rather than issuing debt in its own name. The Heathrow NWR option would also create an asset base that should be considered alongside other regulated markets, including water (c. £60 billion) and rail (c. £50 billion).
12. While the finance for the Heathrow NWR option is to be raised over an extended period, this includes around £28 billion from 2022 to 2027 and just under £25 billion from 2031 to 2035. In any given year the debt funding requirement peaks at around £6 billion, or 13% of the 2013 total bond issuances, much larger than the biggest individual bond issue by a UK corporate since 2013 (around £3.5 billion issued by Vodafone, which also has an A- credit rating). The total size of investment grade bonds issued by UK corporates in 2013 was c. £46 billion.
13. In order to place the amount of equity required by the scheme, the actual rate of return may prove to be different to the 9% nominal, pre-shareholder tax rate of return assumed. Similarly, the actual gearing of the company and level of investment grade debt available would only be determined at the time. Both could only be ascertained once the project risks, regulatory structure, prevailing costs and revenue forecasts and likely levels of demand are better understood.

14. The ability of HAL's existing investors to meet the full equity requirement or their strategy to broaden the shareholder base needs consideration. The Heathrow NWR option requires dedication of large amounts of both debt and equity capital by individual investors and any concentration restrictions would need to be considered. The appetite and capacity of investors (both existing and new) is an important factor in determining the price at which financing is available.
15. The Airports Commission's forecast scenarios do not suggest a high level of demand risk[1]. But the projected weighted average aeronautical charges which range from £28 to £31 per passenger for the assessment period would represent a significant increase from current levels and would be high relative to other global and European comparators.
16. These issues put the HAL Heathrow NWR scheme at the highest end of the range of financing for infrastructure projects and is unprecedented for privately financed airports. Achieving such levels of financing would likely be challenging and very much dependent on the factors outlined above. Accessing such an amount of capital may have an impact on the pricing of both debt and equity. Consultation may inform further analysis of the market capacity and appetite for such levels of financing, including debt, equity and any subsequent hedging requirements.
17. There is a very real risk that the HAL Heathrow NWR scheme will be financially undeliverable.

References

[1] Airports Commission: Cost and Commercial Viability: Funding and Financing - Page 42 (November 2014)
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/372807/funding-and-financing.pdf

[2] TFL response to APPG on surface access (27 March 2015)
http://www.heathrowappg.com/tfl-response-to-appg-on-surface-access/