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Paying for a new Gatwick runway

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A series of research papers on a second Gatwick runway

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GATWICK AREA CONSERVATION CAMPAIGN

Paying for a new Gatwick runway

A new runway at Gatwick would have to be paid for by Gatwick Airport Ltd, and ultimately paid for by the passengers using Gatwick airport. That may seem a statement of the obvious but it is a relatively new situation: until the break-up of BAA in 2009 the cost of any new capital expenditure was shared between travellers at all BAA airports – Heathrow, Gatwick, Stansted, Edinburgh and Glasgow.

In very approximate terms the cost of a new runway at Heathrow is twice that of a new runway at Gatwick, and the number of passengers at Heathrow is roughly twice the number at Gatwick. A simple conclusion is that the extra cost **per passenger** of a new runway at either airport is likely to be of the same order of magnitude.

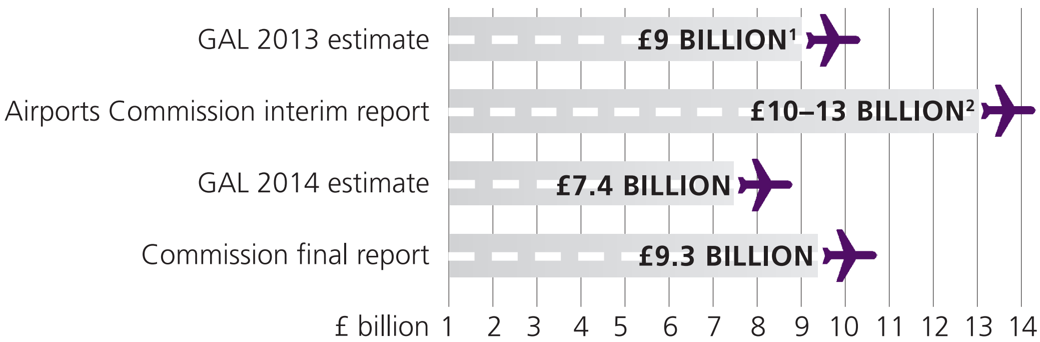
A second simple conclusion is that any airport which has to bear the cost of building a new runway may struggle to compete against airports which do not bear that cost.

Runways are expensive

The company registered as Gatwick Airport Ltd (GAL) was sold in December 2009 to a consortium led by Global Infrastructure Partners (GIP) for £1.5 billion. Lock, stock and barrel – one runway, one subsidiary runway, two terminal buildings, cargo sheds, car parks, shops, restaurants - all for £1.5 billion. This was the highest price offered in a competitive bidding process which had attracted many of the world's leading investment funds and sovereign wealth funds. Moreover, this price was for a going concern with an established customer base. Gatwick had handled 34 million passengers in the previous year – all paying airport charges and spending freely in airport shops, hotels, restaurants and car parks.

The estimated cost of building a new Gatwick runway and terminal is between five and six times the £1.5 billion price which GIP paid for Gatwick. And the first customers won't come through the door until up to ten years after the project gets underway.

COST OF A SECOND RUNWAY AT GATWICK



Full details of the calculations leading to the Commission's estimate were given in the report by consultants Jacobs: *Cost and Commercial Viability: Cost and Revenue Identification Update Gatwick Airport Second Runway* dated 19 June 2015.[3]

The Commission explained that their figure was higher than the GAL estimate 'in large part [because of] differing views of optimism bias and differing construction profiles.'[4]

Optimism bias refers to the experience of large infrastructure projects which has shown that cost estimates tend to be based on the assumption that everything will go right; Sod's Law indicates that anything that can go wrong will go wrong. But GAL argue that as a hard-nosed commercial American-based company their estimates contain no element of optimism.

Whichever figure is correct, it would appear that a new runway would cost around five or six times as much as GIP paid to buy the whole airport. It would therefore not be surprising if passengers found themselves having to pay a substantial premium for the pleasure of using a new Gatwick runway.

The cost per passenger

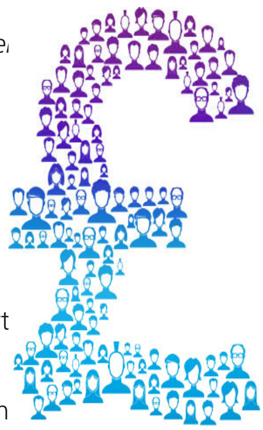
The inevitability that a new runway would lead to substantially higher airport charges, possibly even before the new runway opens, has been of considerable concern to the airlines based at Gatwick. In October 2013 Carolyn McCall (now Dame Carolyn), Chief Executive of easyJet, Gatwick's largest airline customer, said:

'Using GAL's own figures passengers could be paying £28 more per flight for years in advance of the opening of a new £9 billion runway without any real oversight by the CAA.'[5]

The Airports Commission in their Interim Report suggested that the cost of a new Gatwick runway *'would require aeronautical yields per passenger to be about a third more than the level of the proposed Heathrow Q6 settlement.'*[6] That worked out at about £27 per passenger. That is lower than McCall's estimate: hers relates to the additional cost. And the Commission figure includes income from retail, car parking etc.

A downward revision in their forecast of passenger charges was made by the Commission in their Consultation Document published in November 2014:

'Investment of this scale [for the new runway] would entail increases in the airport's charges to airlines. Gatwick Airport Ltd has estimated, for example, that per passenger charges would rise from £9 currently to £12-15 as a result of expansion. This is lower than the charges predicted by the Commission's analysis, which indicate ***average charges rising to between £15 and £18, with peak charges of up to £23*** (emphasis added).



'Peak charges' refer to charges in the year when expenditure reaches its peak, not (as usual in relation the airport charges) to peak times of day. The downward revision appears to have been the result partly of the lower estimate of the total cost, and part to a more optimistic view of the number of passengers.

Worried that these predictions of higher charges might alarm the airlines and diminish Gatwick's chance of success in the runway debate, Sir Roy McNulty, chairman of GAL, wrote to Sir Howard Davies in March 2015 to promise: *Gatwick guarantees that, in return for Government agreeing a 30 year contract, passenger charges will be subject to an inflation-linked £15 limit.*[7]

What was envisaged as being contained in Sir Roy's proposed 30 year contract has never been revealed: one can guess that it would have given Gatwick permission to raise charges in the years before the new runway is opened, and an assurance that no additional runway would be built elsewhere.

Sir Roy's promise did nothing to reassure Willie Walsh, chief executive of International Airlines Group, the parent company of British Airways, who declared a month later that there was no business case for Gatwick expansion: ***'The politics of this will be the main stumbling block – not the only one, because the cost of all three options are excessive and would translate into an unacceptable increase in charges at the airports.'***[8]

Sir Howard Davies, Chairman of the Commission, dismissed the offer with contempt: *'GAL's argument that the lower costs of expansion at Gatwick should inevitably mean lower per passenger charges is entirely misguided. The level of charge is a function not only of the cost of the scheme, but also of the number of passengers paying for it. The higher levels of demand seen at Heathrow significantly reduce the charge required on a per passenger basis.*

'GAL's proposed 'contract' to limit charges to £15 could at best be considered the starting point for a negotiation given its significant areas of omission (including any information on penalties should GAL fail to comply with the contract's provisions), and would in any case do nothing to alter the underlying commercial fundamentals of the project.' [9]

If the Government now decides to approve a second runway at Gatwick, it remains to be seen whether the £15 limit is imposed as a binding condition. Pace Sir Howard, it could be enforced by the CAA through its economic regulatory powers to impose maximum airport charges.

Perhaps GAL is counting on an assumption that if the runway proves unprofitable when capped at £15 the Government would be forced to raise the cap rather than allowing the airport to go broke. There are good precedents for raising caps, albeit on passenger numbers rather than on charges: caps on the number of passengers permitted at Heathrow and at Stansted have been raised each time they looked likely to be reached.

How many passengers?

The level of charges depends crucially on the number of passengers using the airport after the runway comes into operation: the more passengers, the lower the charge.

The differences between GAL and the Commission are in a large part due to the fact that GAL are more optimistic about the number of passengers who will want to use their new runway.

The Commission has produced a whole raft of forecasts, based on two alternative assumptions, and five different future scenarios:

ASSUMPTIONS

Carbon capped: the UK Government keeps aviation CO2 emissions within the limit of the Climate Change Act.

Carbon-traded: an international emissions scheme for aviation has been introduced.

SCENARIOS

Assessment of need: the basic central forecast based on past trends.
Global growth: faster growth in world GDP.
Relative decline of Europe: faster growth in emerging economies.
Low cost is king: low cost capture a substantial share of long haul.
Global fragmentation: decline in world GDP growth rates, higher operation costs.

Forecasts are given for 2030, 2040 and 2050.[10] But for the purpose of this paper it is sufficient to concentrate on 2030, which the Commission assumed would be five years after the opening of a second Gatwick runway.

The situation had subsequently become less clear as the Government has said that they are now envisaging a new runway opening in 2030, not 2025. Transport Secretary Patrick McLoughlin first gave a hint of this less ambitious Government timetable in December 2015 in relation to Heathrow,[11] and in oral evidence to the Transport Committee in February 2016 he clarified that 2030 was the Government's expected completion date for a new runway at either Heathrow or Gatwick.[12]

A further complication is that the Commission's forecasts are compared to a base year 2011 when Gatwick handled 34 million passengers. But in the year 2015 Gatwick reached 40 million which makes some of the lower forecasts look somewhat perverse. Yet not necessarily so: after the opening of the new runway at Manchester in 2000 the number of passengers actually went down.

GATWICK AIRPORT SECOND RUNWAY FORECASTS: 2030

	MILLION PASSENGERS	
	Carbon capped	Carbon traded
Assessment of need	46M	50M
Global growth	44M	58M
Relative decline of Europe	39M	44M
Low cost is king	49M	70M
Global fragmentation	39M	40M

The wide variation in the forecast number of passengers – between 39 and 70 million - would have a substantial effect on the cost per passenger. As the Commission say:

'The Commission's estimates [of airport charges] show significant potential variation reflecting the variation in passenger demand across its scenarios. In the upper end demand scenarios, charges would be close to Gatwick Airport Ltd's own estimates [£12-£15], although still slightly higher, reflecting higher costs and a more conservative view of how the infrastructure delivery might be phased. Conversely, the higher end of the Commission's predicted range of charges reflects lower estimated levels of demand leading to peak charges above £20 ….' [13]

As quoted previously, the Commission ***envisage average charges rising to between £15 and £18, with peak charges of up to £23.***

Heathrow

According to the Commission's final report: *The resulting impact on passenger aeronautical charges across the Commission's four demand scenarios for Heathrow is an increase from c. £20 per passenger to a weighted average charge of c. £28 30 per passenger and a potential peak of up to c. £31.*[14]

The predicted increase of £8-10 at Heathrow is roughly the same in cash terms as the predicted increase at Gatwick. But in percentage terms it is very different: a 50% increase at Heathrow compared to a 100% increase at Gatwick.[15]

The predicted increase is also very different when one takes account of the average ticket price: £8-10 would add less than 3% to the £313 average one-way ticket price at Heathrow but it would add 8-10% to the £100 average one-way ticket price at Gatwick.

Because Heathrow exercises a magnetic attraction for airlines, an increase in charges from just under £20 to around £30 per head would probably not prevent the new runway from soon filling up. Indeed the Airports Commission forecast that in the first five years after a new runway was opened Heathrow would gain 35 million extra passengers while if Gatwick opened a new runway it would only gain 5 million.

Gatwick complained vociferously in advertisements across the national press that this difference was inexplicable. Sir Howard Davies rose to the bait and wrote to Patrick McLoughlin, Transport Secretary, in September 2015:

…. with spare capacity available, Gatwick has grown at less than 1m passengers per year over the past ten years. The provision of significant new capacity, particularly in the morning and evening peak periods, could accelerate this, as our forecasts show, but would not fundamentally alter the underlying demand without broader changes in the economy or aviation industry. In contrast, Heathrow is one of the world's most profitable airports from which to operate and has been capacity constrained for many years. As a result, it is reasonable to assume a high level of suppressed demand for runway slots. The willingness of airlines, most recently Vietnam Airways, to switch from Gatwick to Heathrow as soon as slots become available bears this out. The construction of a new runway would allow this suppressed demand to be met, leading to rapid growth in passenger numbers and services.

Don't forget the competitors!

Forgetting the competition was the mistake that Manchester Airport made when they built their new runway in the late 1990s. The capacity of the existing runway was 40 million, and the new runway was designed to raise this to 60 million. But Manchester forgot to factor in competition from Liverpool and Leeds Bradford airports which, not having to pay for a new runway, had lower costs.

The result was that the number of passengers using Manchester Airport initially fell to 18 million and has only recently recovered to 23 million in 2015. By comparison, the number of passengers using Liverpool and Leeds Bradford airports has more than doubled over the same period.[16] A classic case of optimism bias.

A similar example of forgetting about the competition, and of optimism bias, was the Channel Tunnel Rail Link which failed to cover its costs because it forgot to factor in vigorous competition from the ferries.

Gatwick with a new and costly second runway would be wide open to competition from Stansted and Luton, and from smaller airports such as Southend and Southampton. With the exceptions of Heathrow and London City, the market for air travel in the South East is highly price sensitive and low cost carriers generally call the shots. With mobile assets they can, with relative ease, chase the best deals on airport charges.[17]

Any of these other airports could offer much more attractive rates – at present at Stansted and at Luton, as at Gatwick, airport charges average about £9 per passenger. A number of airlines would be tempted to move, or at least operate new routes from Stansted or Luton. Certainly many of the new airlines which the Commission expect to be using Gatwick would be likely to choose Stansted instead.

Stansted half full

At present Stansted is only half full. In 2015 the total number of passengers was 22.6 million, compared to the theoretical maximum capacity of its one runway, like Gatwick, of 45 million.

The forecasts published by the Commission in July 2016 show Stansted reaching what is described as full capacity of 35 million in 2040.[18] The same date is forecast both on the carbon-traded and on the carbon-capped assumptions. That is on the basic 'assessment of need' forecast: in some scenarios full capacity is reached earlier.

Luton is shown in some scenarios as reaching it full capacity of 18 million in 2040, but in the central forecast full capacity is not reached until 2050.

These forecasts are presumably the basis of the statement by the Government that: *'If no action is taken, the entire London system will be full by 2040.'* [19]

Yet the commission were ingenuous in using the figure of 35 million, and the Government were naïve in accepting that figure without question. 35 million relates to the current limit on the number of passengers imposed by Uttlesford District Council. There can be little doubt that if that figure looked like being reached, it would be raised. Indeed it has already been raised (in 2008), albeit after a hard fought inquiry, from 25 million to 35 million.

Therefore it can be assumed that Stansted will not reach full capacity of around 45 million until near 2050. It will have plenty of spare slots to offer airlines which find Gatwick too expensive.

Financing the runway

The risk of competitive pressure would make the financing of a new Gatwick runway problematic. It would be made more difficult by GAL's rash pledge to keep airport charges below £15 per passenger.

Moody's, the investment analysts, published a special report in December 2014: *'A new runway will have mixed credit implications for London airports. A runway at Heathrow would allow the airport to benefit from growth in future traffic volumes, and a new runway at Gatwick would not take significant traffic from Heathrow. Gatwick, on the other hand, would be vulnerable to airlines switching to an expanded Heathrow, whilst a new runway at Gatwick would increase its airport charges and could alienate its price-sensitive airlines.'*

Written by Xavier Lopez del Rincon, a Moody's Vice President, the report found that: *Gatwick will be more vulnerable to competition if Heathrow were to build a new runway as it would be at risk of losing scheduled airline traffic to Heathrow, where carriers can typically earn more per passenger mile. Conversely, the construction of a Gatwick runway would almost double aeronautical charges at the airport, putting it at a huge competitive disadvantage to Stansted, which is its main competitor in the low-cost airlines segment.*[20]

GIP own 42% of the shares in Gatwick and have made no secret that they wish to sell their share in 2018-20.[21] Their game plan is obviously that permission to build a second runway would enhance the price.

Yet even if the Government were to give the go ahead, would the other owners of Gatwick - the South Korean National Pension Service, the Abu Dhabi Investment Authority, the Californian state pension fund, and an Australian government investment fund – be keen to invest additional funds in such a high risk project? Would new investors come in to provide up to £7 billion when previously the maximum price bid at auction was £1.5 billion?

As the Airports Commission said: *'This level of finance is not unprecedented for infrastructure projects and airports. It is, however, significantly larger than the company's financing to date and may be challenging in a context where there is uncertainty around passenger demand forecasts and where the airport may need to raise its aero charges from £9 per passenger to up to c.£15-18 or more within a competitive environment.'* [22]

Conclusions

What conclusions can be drawn? Or, as the Victorians might say, what morals can be drawn from this cautionary tale?

First, for the past four years there has been unending discussion of where a new runway should be built. Each airport has spent millions on lobbying, newspapers have carried innumerable articles, everyone in every pub has a view on where it should be. But it seems that no one has stopped to ask: "Who will pay?"

Second, the predicted 100% increase in airport charges at Gatwick could cause a substantial shift to Stansted and Luton. This could become a vicious spiral if higher chargers led to fewer passengers at Gatwick which meant fewer to share the cost. Economic analysis reinforces the common sense view that there is no point in building a new runway at Gatwick while Stansted remains only half full.

Third, competitive pressure from other airports could make the financing of a new Gatwick runway challenging.[22]

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Brendon Sewill has a degree in Economics from Cambridge. He has been an adviser in the Treasury, and to the British Bankers Association (in the days when banks were respectable). He has also been a member of the National Trust Council, Vice President of the British Trust for Conservation Volunteers, and a member of the CPRE national executive. Since 1990 he has been chairman of the Gatwick Area Conservation Campaign. His contribution in the Treasury was recognised in the award of a CBE.

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[8] *http://www.theguardian.com/business/2015/apr/30/post-election-indecision-will-halt-airport-expansion-in-south-east-says-ba-boss*

[9] Letter to the Secretary of State for Transport 7 September 2015.

[10] *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/439687/strategic-fit-updated-forecasts.pdf Tables 6.1 and 6.2.*

[11] Statement 14 December 2015.

[12] Rt Hon Patrick McLoughlin. Oral evidence to Transport Select Committee, HC 784, 8 February 2016.

[13] Consultation Document. November 2014.

[14] Airports Commission. Business Case and Sustainability Assessment – Heathrow Airport Northwest Runway. paragraph 4.25. *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/440315/business-case-and-sustainability-assessment.pdf.*

[15] 'Impact of airport expansion options on competition and choice', Frontier Economics, April 2014, p15-18. April 2014.

[16] *https://www.caa.co.uk/Data-and-analysis/UK-aviation-market/Airports/Datasets/UK-airport-data/]*

[17] easyJet are building a new hangar at Gatwick but, perhaps significantly it is a mobile hangar which can easily be dismantled and erected elsewhere.

[18] *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/439687/strategic-fit-updated-forecasts.pdf Tables 6.1 and 6.2.*

[19] Statement by Rt Hon Patrick McLoughlin 14 December 2015.

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[21] Sir David Rowlands, then Chairman of GAL, Gatwick Airport Consultative Committee

[22] Airports Commission Consultation Document November 2014

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