The Harpenden Society ("The Society")
Deadline 6 response to Luton Rising's revised Funding Statement
Luton Rising ("LR") Development Consent Order ("DCO") application

LR's revised Funding Statement (REP5-009)

Background

1. LR's submitted a second Funding Statement (REP5-009) ("FS2") at Deadline 5
2. The Society attended Open Forum Hearing 3 and explained that:
    a. For Phase 1, LR are in discussions with London Luton Airport Operations Limited ("LLAOL") to fund Phase 1's capital costs with LR providing the funding for the compulsory acquisition ("CA") costs. We remarked that LLAOL was capable of funding the Phase 1 capital costs. However, as yet no agreement has been signed.
    b. So far as Phase 2 is concerned LR assert that funding (i.e. the capital required to underwrite the compulsory acquisition ("CA") costs and the project's capital costs) will be met from either LR's (CA costs only) or Phase 2's future cash flows.
    c. For Phase 2, we had looked briefly at the material provided by LR and noted:
        i. So far as the CA costs were concerned, LR asserted that the forecast concession fee income was "many multiples" of those costs. We noted that LR did not explain the extent to which that income would be defrayed in expenses. Based on our knowledge of LR's finances (not including the DART as nothing has yet been disclosed) we explained that LR's annual "free" cash flow could be as low as £3 million for the next 10 years based on 2023/24's forecast of concession fee income (and a conservative approach to demand growth);
        ii. So far as the funding of the capital costs for Phase 2 are concerned, none of LR's statements provided any confidence that the capital costs would be funded, only that the forecast, but undiscounted, future cash flows, were (superficially) attractive to an investor.
3. At CAH2 LR's representatives noted that:
    a. Phase 1 was likely to be financed by the operator (LLAOL);
    b. LR's income for 2023/24 should include £12-15 million of other income and noted that our projection of £3 million "free" cash flow was wrong and that the "free" cash flow was £10 million;
    c. Expected passenger growth would generate revenue streams for LR of between £600-800 million over the next 10 years (and noted that the growth was partly a result of passenger demand increasing and part was a function of RPI related increases in the concession fee);
    d. The "free" cash flow would be more than £100 million (but this is not sufficient to cover the expected inflation adjusted compulsory acquisition costs of £171 million).
4. Following the CAH2 hearing, the ExA issued a number of questions to LR.

This paper

5. The purpose of this paper is to address:
    a. The evidence that LR has produced to show that funding is available to meet the costs of CA of land and the capital costs of the Proposed Development; and

b. The ExA's post CAH2 action points.

The evidence that LR has produced to show that funding is available to meet the costs of CA of land and the capital costs of the Proposed Development

The following analysis looks at Phase 1 and Phase 2 separately.

Phase 1

6 As noted earlier, LLAOL is capable of funding the capital costs of Phase 1 and there is a reasonable prospect of LR funding the (limited) Phase 1 CA costs but we note that no agreement is in place yet so LR cannot satisfy the ExA that Phase 1 can be funded.

7 We note:
   a. Approach 1 requires an extension of the concession agreement. This has implications for the timing and economics of Phase 2, which we address below.
   b. Approaches 1 and 2 are dependent on LLAOL achieving an "appropriate" or "agreed" rate of return. Bearing in mind the Force Majeure and Special Force Majeure provisions cost LR £45 million (and LR has no alternative to LLAOL undertaking Phase 1), all the financial risk will be firmly placed at LR's door. This must weigh heavily against LR's ability to fund the CA costs of Phase 2, also discussed below.

8 We have discounted Approach 3 as an option so far as funding from Luton Borough Council ("LBC") is concerned as LR say in box 6 of their covering letter (REP5-001) that "Luton Borough Council is not funding nor financing the expansion". If LR was to raise finance through commercial routes, under this approach, it would also impact on LR's ability to fund the CA costs of Phase 2.

Phase 2

CA costs

9 In FS2 LR assert that the future cash flows of LR will enable it to fund the CA costs in 10 years time i.e. it will retain any surplus income over this period. In the alternative, LR suggest that these costs could be raised alongside the financing of Phase 2's capital costs (which we address below).

LR's ability to fund the CA costs

10 Any assessment of LR's ability to fund the CA costs must be objectively based.

11 LR's claim in para 2.2.7 of FS2 that the concession fee for "the period before this Phase 2 liability will arise is many multiples of these estimated costs" is not objective as it fails to take into account expenses and also relies on future forecasts that are subjective.

12 The ExA asked LR to explain the calls that may be made on the concession fee income (i.e. the expenses) at CAH2.

13 LR noted at CAH2, as set out in paragraph 3 above, that the "free" cash flow for 2023/24 would be more than our estimate of £3 million (based on the stated LR concession fee and known expenses) as we had not taken into account other income (which we assume means DART income). LR estimated that "free" cash flow would be £10 million.

14 LR also noted at CAH2 that total income over the next 10 years could be between £600-800 million (and explained that this was a function of both passenger growth and the RPI uplift to the concession fee) and "free" cash flow over £100 million. We note that this would be equivalent to the total CA costs at today's prices but by then the costs will have increased to £158 million.

15 The concession agreement is heavily redacted so we are unable to comment on LR's statement regarding the concession fee RPI uplift or the DART income (and expenses – although these weren't mentioned) as nothing has been published to date (as it only became operational in March 2023). No verified data on income and expenses will in fact be available until the accounts for 31 March 2024 are published which will be long after the examination has completed.

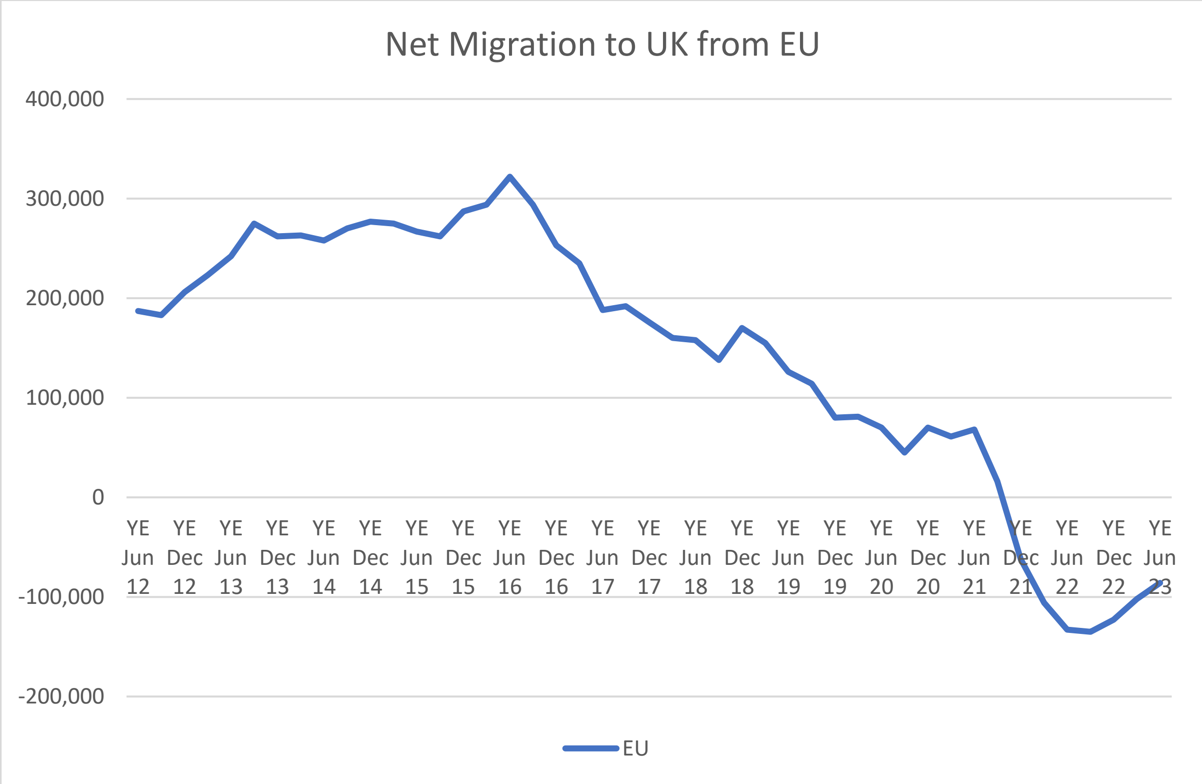
16 We urge the ExA to treat with caution any forecasts LR provides in relation to DART as the asset was written down by £185 million in 2021 to reflect a much lower recoverable amount, from income and expenses over the assets life, of £77 million.

17 We look forward to seeing how LR has calculated the figures it disclosed to the ExA and the extent to which they are caveated and will comment accordingly.

18 That said, it is important to note that all of LR's income figures are forecasts based on passenger numbers and modelled growth in demand. They lack certainty and are therefore subjective. By contrast the expenses figures are fairly certain (we recognise that charitable donations, staff costs and other expenses could be finessed if income falls but the extent to which they can be finessed is limited).

19 Flat or even falling passenger numbers over the next 10 years are not a remote possibility, they are a real risk.

  a. Luton airport's recovery from Covid is not as strong as it was claimed it would be at the 19m Inquiry and it is lagging behind Heathrow and Stansted (they have fully recovered Luton (and Gatwick) are at 90%);
  b. The rolling 12 month passenger numbers up to 31 October 2023 are 16.1 million, closer to slower growth than core growth for 2023 per the Need Case Table 6.5.
  c. Short term (the next two years) Luton airport specific factors may limit its recovery including the car park fire, Wizzair's engine problems and the loss of traffic due to conflicts in Ukraine and the Gaza strip.
  d. In the short and medium term (up to the end of the current concession agreement) the macroeconomic position remains volatile with the threat of recession ever present and the prospect of continuing and even new conflicts or political instability in key Luton airport markets. Europe, Luton airport's overwhelmingly dominant market, is seeing net emigration from the UK (in contrast the rapid growth Luton airport experienced pre-Covid was a result of net immigration from Europe). This is illustrated in the table below (data from ONS tables):



e. Climate change effects are already pinning back the high growth expectations of the original Jet Zero Strategy.
f. In the recent past, Luton airport passenger numbers have fallen substantially, in fact twice in the last 20 years, from 2008 to 2013 and from 2019 to date and remained lower than the previous peak for 4-5 years. Another "shock" over the next 10 years cannot be ruled out.
g. In short, passenger growth at Luton airport is not assured over the next 10 years.

20 We also note that there are other potential calls on LR's income other than expenses, notably loan repayments where the accounts suggest about £28 million of loans needs to be repaid in 2028 and the probability that LBC will extract dividends to finance budget shortfalls already forecast for the next few years and, in all probability, likely to occur throughout the next 10 years, due to LBC's low Council tax charge compared to neighbouring authorities.

Effect of this uncertainty on the ExA's assessment of the availability of funding for the CA costs

21 It is for the ExA, at this examination, to determine the extent that it needs to be satisfied that funding will be available for the CA costs.

22 However, we note that the ExA at Portishead decided that the applicant needed to demonstrate that the funding of the CA costs was available at the time the ExA reported to the SoS. It is clear, for this application, that such funds are not available to LR.

23 Although LR argue in their covering letter that their application is not a publicly funded DCO (as Portishead was) the 2013 Guidance makes no distinction between public and private funding of DCOs. At the Manston airport DCO, a similar but much smaller privately funded project, the ExA satisfied itself that a legal agreement and the deposit of more than enough funds at two financial institutions to cover CA costs was sufficient. This is not an option for LR.

24 We also reviewed a range of other privately funded ExA's decision making on CA costs. For the most part, the applicant was a wholly owned subsidiary (often a special purpose company) of a very large multi-billion turnover utility company. The ExA's invariably considered the pedigree of the parent (whose accounts were often included in the funding statement) in satisfying itself that funds would be available but, even so, often inserted a condition in the DCO that CA could not begin until a guarantee or other form of security was provided. In all the DCOs for which a figure for CA costs was available the quantum was also extremely modest as a proportion of the parent company's annual cash flows. The CA costs for this application, by contrast, appear to be virtually all the applicants free cash flows for the next 10 years.

25 It is clear, today, that LR cannot provide any assurances in relation to the availability of funding for CA costs and it relies entirely on the hope of the funds becoming available during the 10 year period in which CA rights can be exercised.

26 That said, if the ExA is minded to accept LR's claims that the funds will be available within the (extended) statutory period, to avoid a situation where CA rights are granted but then the funding does not materialise, it would be reasonable to include an article in the DCO that requires LR to provide a guarantee or alternative form of security for the CA funds before CA is permitted.

Capital costs

27 LR's evidence that Phase 2 will be funded rests entirely on a third party investor providing the finance to underwrite the projects capital costs in return for the project's future cash flows. LR's covering letter states that LBC will not be funding the Proposed Development – albeit that one of the options still refers to LBC raising the necessary commercial finance.

28 However, no such investor exists presently. Understandably, no investor would be prepared to commit to underwriting nearly £3 billion of capital costs, 10 years in advance of drawdown on the basis of forecasts that will then be 10 years out of date.

29 LR claim that the project's cash flows are attractive and its advisers note that there is a healthy market for airport investment.

30 We address each below.

Project cash flows

31 We have a number of fundamental concerns regarding the cash flows presented in Table 5 of FS2 and LR's notes about them.

32 We set out our overriding concerns with the project cash flows first.

   a. They appear to cover the period 2022-2072 "prepared from the perspective of the airport operator" (paragraph 4.1.2).
      i. This period includes the 10 years remaining on the current concession which, if negotiations are successful in relation to Approach 1, will then be extended anyway.
      ii. The cash flows for this period (whether extended or not) are not project cash flows, they will accrue to LLAOL. LR may well earn a concession fee but that is unrelated to Phase 2's capital costs.
      iii. The language implies it's all the cash flows for that period so the whole exercise is irrelevant for the purposes it has been put forward for.
   b. What ever period the cash flows relate to they are undiscounted. There is no value in undiscounted cash flows for a period of 50 years hence as they take no account of the investors' cost of capital, payments for which may be required on day 1.

c. None of the assumptions underlying the calculations are disclosed. The ExA (and Interested Parties) have no basis on which to make an assessment as to whether the assumptions are valid and therefore whether the cash that flows from the assumptions is valid. We are certain that any attempt to present something similar to investors would not get very far.

33 Acknowledging the shortcomings in the cash flows we decided to review them for any sort of "sense".

34 For the purpose of this review we assumed the cash flows only relate to the direct project period of Phase 2, i.e. 2033-2072. This is, of course, the most beneficial way of interpreting the cash flows as they are concentrated over the shortest period possible.

35 We have, first, allocated the "real" cash flows in Table 5 to those years in the proportion that that year's passenger count is of the total number of passengers over the project period. We have allocated the nominal cash flows similarly using an inflation assumption to reconcile back to the Table 5's figures. For the period up to 2028 we used the OBR's published inflation forecasts and thereafter used the annual inflation rate as the control to reconcile the individual year's data back to the totals. This post 2028 inflation rate is extremely close to 2% for each line in the cash flow so corresponds to the OBR's long term target and is therefore a reasonable basis on which to approach this.

36 On a "real" basis the income per passenger over the life of the project is £18.50. On the face of it this compares unfavourably to the per passenger income of £12.60 in 2019 for an airport whose airline and passenger customers are acknowledged to be "ultra low cost". Our detailed figures for airport aero revenues in 2033 of £193 million appear to be double LLAOL's 2019 "traffic income" (£102 million) and the commercial revenues in 2033 (similarly £193 million – retail revenue and car parking, drop off etc) are also double LLAOL's "commercial income" (£107 million). This doubling of revenues is against a background of passenger growth from 18 million to 21.5 million, i.e. 19%.

37 However, by contrast, the operating costs for the first full year's passenger numbers (2033) are £126 million which is a reduction of nearly £13 million compared to the LLAOL's 2019 operating costs (i.e. administration expenses excluding depreciation etc) of £139 million (including a concession fee of £57 million). The concession on a real basis will increase as a result of passenger numbers (to about £68 million on 19% growth). This implies other operating expenses will fall a little. We think that is highly unlikely given the growth and it would have implications for LR's claims about job growth if true.

38 On a nominal basis, 2033's total revenues are £493 million, compared to LLAOL's 2019 revenues of £227 million and costs are (still) lower, £154 million compared to LLAOL's 2019 costs of £168 million (administration expenses less depreciation etc).

39 For the sake of completeness (not that we believe it is valid) we modelled the LR cash flows across 2022-2072 too. On a "real" basis, it showed 2033 revenues of £346 million on a real basis and costs of £107 million (lower because the same cash flows are allocated over a longer period) and on a nominal basis it showed revenues of £429 million and costs of £133 million. This data does not change the above conclusions i.e. that the income assumptions appear to be extremely bullish and the expenses assumptions extremely "bearish" and, in the absence of any explanation for them, they are likely to significantly overstate the project cash flows.

40 We have not attempted to make an assessment of the net present value LR's cash flows would generate (a proper test of whether they would peak the interest of investors) because it's not clear what period they relate to and the nonsense their results produce even on the most favourable interpretation of the period the cash flows relate to.

41 However, we again note that Ernst & Young, LBC's auditors, who have seen the detailed modelling said that Phase 2 returned a negative net present value.

42 Our overriding concern that the cash flows are nonsense is informed by the outcome for the one other infrastructure project LR has undertaken, the DART.

43 In this case, the business case for that project was prepared by pwc, a, similarly, FCA regulated financial advisor.

44 That project not only experienced a cost overrun of anything between £80-100 million (the actual number will not be known until LR's 2022/23 accounts are produced), i.e. between 35-44% more than the original budget of £225 million but, even before it commenced operations, £185 million, 57-61% of the project costs were written off implying that future revenues and costs were massively overstated.

45 The clear and unambiguous shortcomings in the DART business case, overseen by the LR board of directors, suggests that their ability to evaluate financial forecasts is limited and there is no reason to suppose their ability is any better for the cash flows attributed to this, more complex and significantly larger, project.

46 Thus, we do not believe the ExA can satisfactorily conclude, on the basis of the cash flows and the accompanying notes, that there's a compelling case in the national interest to grant CA rights to LR as there is a very high risk that Phase 2 will never go ahead as LR will not be able to attract investors to underwrite the capital costs due to the poor returns.

Other airport infrastructure investments and Arup's letter

47 We note that LR has provided an analysis of the airport financing market but we do not believe any weight can be attached to that. Firstly, the airports included in the analysis are all the singularly most important airport in the countries or regions referred to (Luton is the smallest airport in the London region by contrast) and all of them, apart from Manchester airport, are considerably larger than Luton airport.

48 A more nuanced look at the UK airport expansion market would include Manchester, where the £0.44 billion is actually part of a larger £1.3 billion project to double capacity from the mid 2010's passenger numbers (mid 20 millions), Stansted where a similarly low hundreds of millions of pounds is being spent to increase capacity from 28 million (2019) to 43 million (mid 2030's) and Gatwick where it is proposed to spend £2.1 billion to increase passenger capacity by 30 million.

49 LR is proposing, by contrast, a much higher £3 billion investment to increase capacity by less than all these airports (in fact less than 10 million). This project therefore represents a materially different and riskier airport project compared to any of the other UK project owing to its cost relative to the forecast growth potential.

50 LR's remarks about infrastructure funds continuing interest in the airport market reflect today's market conditions and not those that might exist in 10 years time which in the UK will be quite different, particularly the London market where Gatwick may well be using the North Runway and Stansted will have built its additional capacity against a backdrop of even the Jet Zero forecasts being scaled back considerably only one year after they were produced. We believe little weight should therefore be attached to this crystal-ball gazing.

51 We do not believe the latter from Arup warrants any weight either. Arup's statement is caveated extensively and cannot be considered objective.

The ExA's post CAH2 action points

52 ExA action point 2 mentions that the capital cost schedule is "very high-level". It refers to the lack of clarity in relation to the cost of the DART extension. In addition to the ExA's requests LR should also answer the following points:

a. The lifecycle costs were not mentioned in the original Funding Statement yet they outweigh the capital costs that were quoted. Furthermore, they outweigh, even on a real basis the total investment that's been made in the airport to date. The only comment on them is in 4.1.3 where they are described as "ongoing lifecycle costs to replace assets". They are clearly of a capital nature and should therefore not be given so little scrutiny. Their timing will have a material impact on the investment return. We note that in 2033 parts of terminal 1 will be several decades old and even the project Curium investments will be 20 years old.

b. The extension of the DART is listed as a third party investment, presumably this means LR, the owner of the existing rail link. We presume this is why the Phase 2a and 2b third party investment expense is so high. The Phase 2 CA costs analysis sets out our concerns with respect to LR's ability to fund the CA costs. It would also appear that LR will need to find a very significant sum to fund the extension too. If, as we are led to believe, LBC won't be funding the project (and we think it's unlikely the Public Works Loan Board will advance the monies as it did for the original DART anyway), it will fall to third parties to do so. This cost should therefore be included in the project costs (if LR is, instead, confident third parties would fund this independently, we're sceptical, the existing DART, as an investment has failed and there's no reason to believe an extension would change that – the modal change isn't very significant – and neither LR nor LBC have a good financial track record recently).

53 ExA action point 4 refers to details of interest rates provided in Table 5 (REP5-009). Whilst we cannot find any such references (only to references to CPI inflation index) the point is valid – have the cash flows been tested against realistic interest rates, or more specifically investors investment returns which will, of course, include a risk premium that will be higher than normal due to the unique risks attributable to this project, in the first place and, then, have those rates of return been stress tested.