

# Economic regulation of new runway capacity

**CAP 1279**



**Published by the Civil Aviation Authority, 2015**

Civil Aviation Authority,  
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# Executive Summary

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## Duties

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1. The CAA is an independent economic regulator. Our duties in relation to economic regulation, including any required for new runway capacity, are set out in the Civil Aviation Act 2012 (the Act). Under the Act, our primary duty is to ensure that decisions are taken in the best interest of users (passengers and cargo owners). In carrying out our duties, we are required to act in a reasonable and proportionate manner.

## Principles

2. On the recovery of the main construction and implementation costs of runway expansion, we can best meet our duties at this time by setting out a broad framework of applicable regulatory principles rather than by specifying a detailed regulatory regime.
3. The following principles will underpin our future regulatory decisions in relation to new runway capacity:
  - *risk should be allocated to those parties who can best manage it.* There are a number of different players involved with capacity expansion and each has an important role in managing risk. We have a role in managing regulatory risk and Government has a role in managing political risk. By allocating risk to those best able to manage it, users' interests are most likely to be protected by producing the lowest expected out-turn cost (as incentives to manage the cost are maintained) and by revealing information about parties' valuation of risk;
  - *commercial negotiations should be encouraged,* even where substantial market power is present. If a commercial agreement to underpin expansion is possible, including an agreement reached where we have set the broad parameters under which those negotiations should occur, it could incentivise efficiency, ensure that risks are borne by those best able to manage them, reveal information about parties' valuation of risk, and avoid any unnecessary regulation; and
  - *capacity can be paid for both before and/or after it opens.* We consider the two main potential benefits of pre-funding are that it can help reduce the risk of a project, therefore reducing the financing cost, and it can lead to a smoother pattern of charges over time, both of which can be in the interests' of users. We also consider that where there are capacity shortages, price rises can signal to market participants that additional capacity may be required.

## Price control structures

4. Where regulatory intervention is required, we have a range of regulatory tools at our disposal. In selecting the most appropriate tool, we will adopt the least intrusive measure, while also ensuring that users' interests are protected.
5. We do not intend to fully elaborate our potential approach to economic regulation at this time. Providing too much information could undermine innovation and unduly shape any commercial negotiations. However, consistent with our draft policy, if a Regulatory Asset Base (RAB)-based approach is adopted, our current thinking remains that:
  - we are sceptical as to the benefits of a 'split RAB' arrangement as the commercial and operational risks of a new runway seem to be integrated with those of the rest of the airport and cannot, therefore, be easily separated. However, we are open to long term mechanisms by which the financing of new capacity can occur, where they are in users' interests and where the risks of the project are genuinely ring-fenced. Such mechanisms could include, but are not limited to, Special Purpose Vehicles;
  - we consider that allowing unanticipated, efficiently incurred capacity expansion capital expenditure (capex) to be recouped (including the full financing costs) is appropriate. However, we also consider that there is merit in further consideration of mechanisms to improve the incentive on airports to accurately estimate and manage their project costs;
  - we expect to allow efficiently incurred capacity expansion operational expenditure (project opex) to be capitalised. This means that we will treat project opex in the same way that we treat capacity expansion capex. (This is, of course, subject to our proposed approach to the recovery of costs, which is outlined below.);
  - we will consider sculpting depreciation to match recovery of costs to growing demand. However, as this approach is likely to increase risk and the cost of capital, we will need to ensure that it does not have a detrimental effect on users; and
  - we are open to extending the duration of price controls, or to fixing some elements over multiple control periods, although we recognise that there can be challenges with such approaches.
6. We will elaborate further when we consider it will be in users' interests to do so. We are not currently in a position to define when this will be as we face a high degree of uncertainty about how capacity expansion will develop.

## Scrutiny of costs

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7. We will scrutinise the efficiency of any capacity expansion capex. This scrutiny will take place in two, possibly three, phases:
- after the Government decides where expansion can proceed, but before the planning application is lodged with the Planning Inspectorate (or before a hybrid bill process is completed). At this stage, we will review the efficiency of the proposed design of the capacity expansion proposal;
  - possibly after the Planning Inspectorate has considered a capacity expansion proposal and has requested material changes to it. At this stage, where we consider the changes are material, we will undertake an additional review of the efficiency of the revised proposal. (Where we consider the changes are not material, we will consider them as part of any *ex post* scrutiny.); and
  - where cost-recovery through regulation is allowed, an *ex post* scrutiny of the efficiency of the build (e.g. procurement, benchmarking of costs) will be undertaken.

## Recovery of costs

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8. We have categorised costs into three broad categories and will adopt different approaches to the recovery of each of these costs:
- Category A costs: Airports Commission-related and associated lobbying costs incurred by an airport operator or Heathrow Hub Limited (HHL). These are costs that we consider will, in general, be incurred before a Government policy decision on capacity expansion is made;
  - Category B costs: capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision and are associated with seeking planning permission; and
  - Category C costs: those costs incurred by an airport operator, typically after planning permission is granted, in connection with implementation and construction of new capacity, up to entry-into-operation.
9. For Category A, recovery of *most* costs will not be permitted. We do not consider that lobbying costs to influence Government policy or other stakeholders are part of the costs of constructing new capacity, nor part of the planning process. We consider that these costs should be borne by the relevant proposer (airport operator or HHL). However, we do accept that some Category A costs could be viewed as the costs of seeking planning permission. Our policy for these costs is that we will allow them to be re-categorised as Category B provided that the airport operator makes a strong and clear case that the information submitted for planning is not materially different to that submitted to the Airports Commission.

In other words, costs will be permitted provided changes are of a level we consider minor, for example, costs being updated to reflect latest available macroeconomic or inflation forecasts. These costs will also be subject to a *de minimis* level and an efficiency assessment.

10. We see Category B costs as part of the costs of constructing new capacity and, therefore, costs which users can reasonably be expected to carry (in full or in part). However, we aim to avoid users bearing the whole risk of these costs in the event that planning approval is not granted, is rescinded or is withdrawn, as occurred with Stansted Airport Limited's second runway project. Our approach will therefore be:
  - costs up to £10m per annum will be automatically recoverable by an airport operator; and
  - costs over £10m per annum will be subject to an efficiency review. These costs may be recovered by an airport operator, subject to them being efficient and there being risk sharing arrangements in place that mean such charges are (in whole or in part) returned to airlines in the event that planning permission is not granted or is rescinded.
11. The £10m per annum threshold we have proposed for Category B costs is not an estimate of the level of costs that we expect an efficient airport operator in these particular circumstances to incur. The £10m per annum threshold is both intentionally and materially lower than the amount we expect either Heathrow Airport Limited (HAL) or Gatwick Airport Limited to incur in planning its capacity expansion. This threshold will create a strong incentive for them to engage and agree with their airlines on appropriate risk sharing arrangements and the commercial terms of any agreements on capacity expansion.
12. Our arrangements for Category A and B costs will also generally apply if HAL buys the relevant intellectual property from HHL in order to pursue the Extended Northern Runway scheme.

## Market power

13. We do not consider that there would be any benefit in undertaking a market power assessment until much closer to, or even after, the opening of any new capacity. We are unconvinced that an earlier market power assessment would provide greater regulatory certainty at this time.

## Next steps

14. With the broad parameters of our approach outlined, we consider that we have provided sufficient certainty for stakeholders to take forward their plans for capacity expansion. However, we recognise that the capacity expansion debate

will continue to evolve in a way that is fluid and at this time is difficult to predict. Our current intentions are to publish:

- a paper on how we could be involved in commercial negotiations and the parameters of possible commercial agreements. This paper will examine the parameters of possible commercial agreements between airport operators and airlines that could underpin new capacity and our potential role in relation to the negotiation and implementation of commercial arrangements. This paper will be released shortly after the Airports Commission publishes its recommendations; and
- a progress report on commercial negotiations no later than six months after any decision by Government on where expansion can occur.

## Chapter 1

# Introduction

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- 1.1 This document outlines our regulatory policy on capacity expansion at Heathrow or Gatwick.<sup>1</sup> It builds on our October 2014 draft policy document 'Economic regulation of new runway capacity – a draft policy' (CAP 1103), June 2014 discussion paper and May 2014 workshop.<sup>2</sup>
- 1.2 This is the non-confidential version of this document and excisions from the text are marked with [X].

## Consultation responses

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- 1.3 We received 10 responses to our October 2014 consultation and non-confidential versions of these submissions are available on our website. Responses were received from:
- Heathrow Airport Limited (HAL);
  - Gatwick Airport Limited (GAL);
  - Heathrow Hub Limited (HHL);
  - Manchester Airport Group (MAG);
  - Heathrow Airline Operators Committee (AOC);
  - The Airport Consultative Committee at Gatwick (GACC) & the London Airport Consultative Committee (LACC) at Heathrow (the joint airlines);<sup>3</sup>
  - British Air Transport Association (BATA);
  - International Air Carrier Association (IACA);
  - Virgin Atlantic Airways (VAA); and
  - easyJet.

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<sup>1</sup> Heathrow and Gatwick have been identified by the Airports Commission as possible locations for capacity expansion in the South East of England. Information on the role of the Airports Commission is available at: <https://www.gov.uk/government/organisations/airports-commission> (accessed 22 October 2014).

<sup>2</sup> See: <http://www.caa.co.uk/docs/589/CAP1221.pdf>,  
[http://www.caa.co.uk/docs/78/CAP1195\\_capacity\\_expansion\\_discussion\\_paper.pdf](http://www.caa.co.uk/docs/78/CAP1195_capacity_expansion_discussion_paper.pdf) and  
<http://www.caa.co.uk/docs/589/CAA%20Workshop%2014%20May%202014.pdf>.

<sup>3</sup> This submission was endorsed by BATA & IATA.

- 1.4 We have considered all the issues raised by stakeholders and our conclusions are contained in the main body of this document. The appendices also summarise, along thematic lines, the main points made in submissions and our responses to those points.
- 1.5 Although this document is intended to offer a reliable steer on our final policy, in the event that fresh evidence emerges during the process of evaluating any specific project, we will modify our approach if that will better enable us to fulfil our duties.

## Document structure

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- 1.6 This document is structured as follows:
- First, it reviews our duties (chapter 2);
  - It then discusses how we intend to treat different categories of costs:
    - Category A costs, those costs incurred by an airport operator or HHL for work in support of the Airports Commission (the Commission) and any associated lobbying to influence Government policy, before a Government policy decision on capacity expansion is made;
    - Category B costs, those costs incurred by an airport operator, after a Government policy decision, that are associated with seeking planning permission; and
    - Category C costs, those costs incurred by an airport operator, typically after planning permission is granted, for the implementation and construction of new capacity, up to entry-into-operation;
  - Category C costs are likely to be the most material and are therefore considered first (chapter 3). Given current levels of uncertainty, our proposed policy is based on regulatory principles rather than a detailed regulatory regime;
  - Our current thinking on aspects of price control design are addressed in chapter 4 (notwithstanding the principles outlined in chapter 3);
  - Our proposed treatment of costs that fall into Categories A and B is addressed in chapter 5;
  - How and when we will scrutinise capacity expansion costs to ensure they are efficient is discussed in chapter 6;
  - Chapter 7 concludes by explaining why we consider that there would not be any benefit in undertaking a market power assessment (MPA) until much closer to, or even after, the opening of any new capacity;

- Chapter 8 outlines the next steps we intend to take on the economic regulation of any capacity expansion at either Heathrow or Gatwick airports; and
- The appendices cover a number of different issues, including our response to the key themes raised by stakeholders in their responses to our draft policy.

## Contact information

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- 1.7 If you would like to discuss any aspect of this document, please contact Stephen Gifford ([stephen.gifford@caa.co.uk](mailto:stephen.gifford@caa.co.uk)) or Ian McNicol ([ian.mcnicol@caa.co.uk](mailto:ian.mcnicol@caa.co.uk)).

## Chapter 2

# The CAA's duties

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## Introduction

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- 2.1 The Civil Aviation Act 2012 (the Act) sets out the matters which we must have regard to when coming to our decisions as an independent economic regulator. Specifically, section (1) (1) – (3) of the Act states:
1. *The CAA must carry out its functions under this Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.*
  2. *The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.*
  3. *In performing its duties under subsections (1) and (2) the CAA must have regard to—*
    - a) *the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted,*
    - b) *the need to secure that all reasonable demands for airport operation services are met,*
    - c) *the need to promote economy and efficiency on the part of each holder of a licence under this Chapter in its provision of airport operation services at the airport to which the licence relates,*
    - d) *the need to secure that each holder of a licence under this Chapter is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport (“associated facilities”) and aircraft using that airport,*
    - e) *any guidance issued to the CAA by the Secretary of State for the purposes of this Chapter,*
    - f) *any international obligation of the United Kingdom notified to the CAA by the Secretary of State for the purposes of this Chapter, and*
    - g) *the principles in subsection (4).*

2.2 Section 69 (1) of the Act defines user as:

*“user”, in relation to an air transport service, means a person who*

- a) is a passenger carried by the service, or*
- b) has a right in property carried by the service.*

2.3 We also have concurrent powers with the Competition and Markets Authority (CMA) to enforce the UK and European Community competition law prohibitions in relation to the provision of the supply of airport operation services and air traffic services.<sup>4</sup> We are required to consider whether it would be more appropriate to use these powers prior to any regulatory action against an airport operator or air traffic services provider for example in relation to a licence condition breach. We may not take such licence enforcement action to the extent that we consider it would be more appropriate to proceed under the competition prohibitions.

2.4 Many of our regulatory objectives are consistent with the aims of competition law, which seeks to improve choice, quality and value for aviation consumers. However, when acting under our competition powers, we can only take into account our sectoral objectives where the CMA would be able to have regard to those same matters when exercising its competition law functions. So some matters, for example environmental effects and financeability, may not, therefore, be relevant considerations when we apply our competition law powers.

## Passengers are at the heart of our decisions

2.5 Our primary duty under the Act is to users, which includes passengers. 'Users' implicitly includes future users as well as present users. Where conflicts between user interests arise, we must act to protect those interests as we think best.<sup>5</sup>

2.6 To inform our view of users' interests, we consider information from a range of sources, including:

- the CAA Consumer Panel;
- passenger surveys;
- airline-airport operator negotiations; and
- consultation processes.

<sup>4</sup> We are currently consulting on 'Guidance on the Application of the CAA's Competition Powers' CAP 1235, available at:  
<http://www.caa.co.uk/docs/33/CAP1235Guidance%20on%20the%20CAA's%20competition%20powers.pdf>.

<sup>5</sup> See Section (1) (5) of the Act.

- 2.7 Established in October 2012, the CAA Consumer Panel acts (with internal independence) as a 'critical friend', scrutinising and challenging our work. The principal aim of the Consumer Panel is to be a champion for the interests of consumers, and the members of the Consumer Panel have a broad range of skills and experience in this area. Collectively, the Consumer Panel has a deep understanding of the regulatory environment both through the development of policy in the consumer interest, and through practical experience of how business best operates within a regulatory framework.<sup>6</sup>
- 2.8 Passenger research helps us understand passengers' airport experience and better understand passengers' priorities, requirements and expectations in terms of services provided at airports. This research can be undertaken by us or through different providers.<sup>7</sup>
- 2.9 Rigorous consultation processes, combined with an 'open-door' policy, also ensures that we obtain a wide range of views on the issues we need to consider. In particular, by outlining why certain decisions are being considered (and why others are not), we look to be proportionate, transparent, accountable, consistent and targeted in our approach.
- 2.10 While we have to apply judgement when coming to our regulatory decisions, our evidence-based approach ensures that our decisions can withstand scrutiny and can be tested if there are challenges, including through the CMA and/or the Competition Appeals Tribunal.
- 2.11 We have regularly emphasised that the interests of airlines and those of passengers often overlap. This means that we often look to airlines to protect their own interests, and rely on this as also protecting user interests. This approach has helped us to deliver on our objectives.

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<sup>6</sup> The key activities of the Consumer Panel are: (1) to help us understand and to take account of the interests of consumers in policy development and decisions; (2) to undertake new targeted research and to gather intelligence to understand the aviation consumer experience; (3) to provide feedback from a consumer perspective on the effectiveness of our policies and practices; (4) to help us develop our approach to consumer engagement; (5) to challenge us on behalf of aviation consumers, as appropriate; and (6) to maintain an overview of developments in the aviation market from a passenger perspective and developments affecting consumers in other markets. The Consumer Panel publishes the minutes of its meetings and also publishes an annual report. Reflecting the way the Consumer Panel inputs into our policy development process (conversations and other informal means), detailed views on specific issues tend not to be published. However, where we agree with those views, they are reflected in the positions that we take on particular issues. For more information, see: '*The CAA Consumer Panel*', available at: <http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90>.

<sup>7</sup> For example, we undertook passenger research to inform our proposals for economic regulation of airports for the period from April 2014.

- 2.12 We consider that commercial agreements involving airlines have the potential to facilitate better outcomes for passengers, including with respect to price, service quality and new product/service development. This can hold even where an airport operator holds substantial market power (SMP), and where, as a result, we need to establish broad parameters under which such commercial negotiations can occur.<sup>8</sup>
- 2.13 However, airline interests do not always align with those of users. This can be due to:
- airline market power, including potentially a lack of competition in the airline sector;
  - airport operator market power, which can mean agreements are distorted to favour the airport operator (although not all agreements by a company with market power need necessarily be so distorted);
  - the cost of meeting the needs of certain user groups can outweigh the costs to airlines; and
  - airlines focusing more than passengers on the present rather than the future.
- 2.14 This means that commercial agreements between airport operators and airlines do not guarantee that users' interests are protected. We, therefore, review such agreements when making regulatory decisions. Where commercial agreements are not sufficient to protect users' interests, we:
- will not rely on them as the best way to deliver our duties, and will act in other ways; and
  - may intervene to ensure that passengers are adequately protected.
- 2.15 Our ability to rely on commercial agreements is also restricted as commercial agreements between airport operators and airlines may not be possible.

## Intervention should be proportionate

- 2.16 Consistent with our duties under the Act, regulation to protect passenger outcomes should only occur where there is SMP.
- 2.17 Where intervention is required, this should be proportionate.<sup>9</sup> Proportionate regulation will minimise burdens and will be effective in delivering benefits for

<sup>8</sup> Our working assumption for this document is that SMP at Heathrow and Gatwick will continue to be present. Of course, if market conditions change, and there is evidence to support any change of view, we will reconsider our findings of SMP.

<sup>9</sup> Other factors that we need to consider when determining the appropriate regulatory intervention are transparency, accountability, and consistency – see section (1) (4) of the Act.

passengers, businesses and society. More broadly, effective regulation should not be considered a burden, as it can make markets work better and can bring numerous benefits, including reduced prices, improved quality, more choice and innovation.<sup>10</sup>

- 2.18 Where intervention is required, we have a range of regulatory options and, consistent with our duties, our initial preference will be to intervene in a proportionate, light-handed way (e.g. monitoring). However, the better regulation duty is subsidiary to our duty to protect users' interests, and we will give primary weight to ensuring our actions are effective in protecting those interests.

## The interests of users

- 2.19 In delivering our duty to users, and promoting competition, we must consider a range of factors. Set out below are the factors we consider most relevant to the consideration of users' interests where capacity expansion is concerned.
- **Financeability:** This duty implies that when we act, we do so in a manner that does not unnecessarily undermine the ability of the airport operator to raise finance. This does not necessarily mean that the regulatory regime should be tailored to facilitate the raising of capital. Rather, it means we should have regard to the financeability duty when looking to address our primary duty to users.
  - **Reasonable demands:** The scarcity of runway capacity has seriously damaging implications for passengers. We will therefore look to carry out our functions in a manner that facilitates the construction of new capacity. We expect that, after the Commission reports, only one capacity expansion project will have a reasonable likelihood of gaining planning permission in the medium term. We will, therefore, act in a way that promotes the construction of such a project provided it remains in users' best interests.
  - **Economy and efficiency:** We should seek to ensure that the costs of new runway capacity represent good value for money. Our approach to achieving this needs us to take account of uncertainty and risk. This means that:
    - incentives must be created to keep costs low;
    - we should recognise our own lack of certainty about the future, and avoid where possible taking 'big bets'; and

<sup>10</sup> 'Better Regulation', available at: <https://www.gov.uk/government/collections/better-regulation> (accessed 22 October 2014).

- risk should be explicitly recognised and managed. Risk has a price, and there is often a choice between users carrying a risk (which reduces the price but increases the impacts if the downside of risks crystallises) and users paying others to carry a risk.
- Environment: Sound handling of environmental externalities will be fundamental to the planning process for new capacity. This factor also applies within our economic regulation functions insofar as we must ensure that environmental protection built in by the planning process is not frustrated.
- Proportionality and targeting – see earlier discussion.

2.20 The following chapters set out the approach we propose to take to protect these interests and satisfy our other duties.

## Chapter 3

# Treatment of Category C costs – principles

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## Introduction

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- 3.1 This chapter addresses the main costs of building new capacity – Category C costs: those costs incurred in connection with implementation and construction, up to entry-into-operation, and which are typically incurred after planning permission is granted (see also appendix D).
- 3.2 Our regulatory policy on this issue is set out in terms of principles. We consider this approach, rather than setting out a more detailed design for a regulatory regime, will best protect users for several reasons:
- all parties, including us, still have major uncertainties about what expansion will be permitted, and the market context in which expansion will occur. A detailed design published now may well turn out to be wrong and would need to be changed. Therefore, any apparent certainty would be illusory and could be misleading;
  - we hope that uncertainty will be dispelled in part by stakeholders focusing their analysis on the fundamentals of expansion. However, if we published a detailed regulatory design now, there is a risk that effort would be diverted into analysing how best to profit from our decisions; and
  - uncertainty can be dispelled if stakeholders are given incentives to reveal their true preferences. Publishing a detailed design now would not obviously create such incentives, and may stifle them.
- 3.3 We have identified three principles that will underpin our future regulatory decisions (and protect the user interests identified in chapter 2):
- Principle 1: Risk should be allocated to those who can manage it best;
  - Principle 2: Commercial negotiations should be encouraged; and
  - Principle 3: Capacity can be paid for both before and/or after it opens.

## Principle 1:

### Risk should be allocated to those who can manage it best

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- 3.4 Risk means uncertainty as to outcome. At this stage, the uncertainties around airport expansion remain considerable (e.g. planning risk, procurement risk, construction risk, regulatory risk, political risk, demand risk).
- 3.5 Risk relates to cost in two ways:
- it reflects the fact that the out-turn cost is unknown. The party that 'holds' the risk (i.e. will benefit if the out-turn cost is better than expected or suffer if it is worse than expected), has an incentive to make the out-turn cost as low as possible; and
  - risk has a price. Investors price this risk in a relatively transparent way, expecting greater returns for greater risks. Making users carry risk without being paid for it is equivalent to taxing them or charging them more.
- 3.6 There is no one single 'true' price of risk – parties will price risk depending on their risk appetite and their view of prospective out-turn costs. That is, the price of risk will ultimately depend on opinion. Market negotiations can allow parties to reveal the price they place on risks.
- 3.7 There are a number of different players involved with capacity expansion and each has an important role in managing risk. For example, we have a role in managing regulatory risk and an airport operator has a role in managing construction cost, traffic and financing risks. Similarly, Government has a role in managing political risk, particularly in light of recent attempts at capacity expansion in the South East of England.
- 3.8 Reducing risk for one stakeholder (or group of stakeholders) can mean increasing it for others. For example, most proposals for reducing an airport operator's level of exposure to passenger demand risk imply passing that risk on to airlines and, indirectly, to passengers. We will, therefore, carefully consider such effects in any decision that involves the allocation of risk.
- 3.9 As a broad regulatory principle, we consider that risk should be attributed to those who can best manage it (see also appendix A). Such an approach will ensure that:
- final out-turn cost is minimised. This is because the party with the strongest incentive to reduce costs is also the one that can do so. This is particularly important in the case of civil engineering projects, where large cost over-runs are not uncommon;
  - perceived fairness will be strongest. The party that controls the risk can benefit or suffer from its own decisions, rather than those of others; and

- information about the price of risk is likely to be revealed. This is because the risk-holder may act to 'lay off' the risk to parties with a different view of the risk, for instance through insurance or procurement. However, it will only do so if it can find a party with a different idea of the price (perhaps because this party has even stronger capabilities to manage out-turn costs). The price of the transaction will reveal information about the two parties' estimate of the risk.

3.10 We will, in general, only pass risks downstream to users where there is a strong justification. This might be where:

- users are best-placed to manage the risk, or where there are challenges with allocating risk and no other party can or will carry the risk that is best managed by them; and
- this is, overall, in users' interests – for instance, because such an allocation is strictly necessary to get new capacity built.

3.11 We do not accept the view that risk should be allocated to the party with the lowest cost of capital. The next three paragraphs explain why.

3.12 The normal market mechanism is understood as follows. A party with a low cost of capital can raise funds cheaply because it is seen, overall, as a good risk. A company borrowing money can generally be seen as a bundle of different projects with different risks, but lenders assess it as a package (unless there are strong reasons to believe some risks are ring-fenced) and attribute a weighted average. If a substantial new risk (higher-cost than the previous average) is brought into the bundle, then the weighted average will increase.

3.13 Given this model, and assuming the investment market runs efficiently, it makes no difference for users whether the risk of new capacity is paid for through an airport operator's or an airline's balance sheets. In either case, the weighted average cost of capital (WACC) of the risk-bearer will be adjusted to reflect the new risk, and the combination of the two (airport operator WACC plus airline WACC) will come to the same whichever balance sheet bears the risk.

3.14 The exception to this principle would be if the risks associated with the runway were uncorrelated with the other risks of an airline or airport operator. In that case, a portfolio benefit could be identified that would reduce the overall cost of capital. However, as the underlying drivers of risk associated with new capacity appear to be closely linked to the risks of the rest of the airport, we give more weight to the value of effective management of risk factors.

## Principle 2:

### Commercial negotiations should be encouraged

- 3.15 The airline sector is generally competitive and incentives exist for airlines to seek the best deals through negotiations with airport operators. As airline and users' interests are often aligned, airline-airport operator negotiations, even where an airport operator may have SMP, could deliver benefits to users. This issue is also explored in appendix B.
- 3.16 There are several reasons why airline-airport operator negotiations, including those undertaken within a broad framework established by us, could deliver more benefits to users than a regulatory approach where we set all aspects of a determination. These benefits include:
- limits to the regulator's knowledge. Commercial negotiations have the potential to elicit more detailed and accurate information from participants about their opinions about, and appetite for, risk;
  - the dynamism and volatility of the aviation sector, which places a premium on flexibility over time. Regulatory processes cannot be too flexible, since high flexibility means unpredictability, which can have negative implications for cost of capital and the willingness of investors and other companies to participate. In contrast, commercial agreements, including those that are potentially agreed under a broad framework set by the regulator, can often offer greater scope for flexible approaches that are more consistent with commercial risk-management; and
  - the variety of user needs and preferences, which means the optimal outcome is not 'one size for all' but a complex mix of price and quality factors. As the resources of a regulator are often limited, it is likely to be less effective at addressing this variability, compared to the continual optimisation that can be achieved by a market-based system.
- 3.17 As we recently determined that HAL and GAL have SMP, we recognise that they are not operating in perfectly competitive markets. That power means, absent any other constraints, the airport operator is capable of imposing terms that favour it. However, the presence of SMP does not mean that the airport operator will necessarily choose to act in this way, nor that any potential abuse cannot be prevented. It would therefore be illogical to rule out commercial agreements because of the presence of SMP.
- 3.18 Even where SMP is present, provided we can establish an appropriate regulatory framework, there is scope for commercial agreements to be struck that would not necessarily involve an abuse of SMP or a distortion of competition. Indeed, our working assumption for this policy is that SMP at Heathrow and Gatwick will