

CAP 1469

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Chapter 1

Summary

- 1.1 This consultation document sets out our final proposals on the regulatory treatment of the costs associated with Heathrow Airport Limited (HAL) seeking to obtain planning permission for the development of a new northwest runway at Heathrow Airport. These are termed Category B costs (or planning costs).
- 1.2 The charges that HAL can levy on airlines to recover these Category B costs are subject to economic regulation under the terms of a licence granted by the CAA under the Civil Aviation Act 2012 (the Act).

Summary of CAA's final proposals

- 1.3 Our final proposal is that Category B costs should be defined as costs which are directly connected with, and solely for the purposes of, seeking planning consent through the Development Consent Order (DCO) process.
- 1.4 We propose that up to £10 million per year of efficient Category B costs can be recovered from higher airport charges either in the year they are expected to be incurred (or two years later for 2016 and 2017 through the K factor in the Price Control Condition). This proposal is subject to a separate consultation.¹
- 1.5 Category B costs incurred over £10 million per year should be capitalised and rolled into HAL's existing Regulatory Asset Base (RAB). These costs should be clearly identified within the RAB in order to allow the CAA and stakeholders to track and scrutinise the level of costs incurred.

¹ Available at: www.caa.co.uk/CAP1470.

- 1.6 Category B costs over £10 million per year should be subject to the following cost recovery arrangements:
- A 105 / 85 risk-sharing mechanism, which allows a 5% addition to costs incurred if a DCO is granted, but limits recovery to 85% of the costs incurred if a DCO is not granted.
 - Planning costs in the RAB recovered gradually over 15 years, including a return to cover the weighted average cost of capital (WACC) at the level determined in the Q6 settlement and irrespective of the outcome of the planning process.
 - Cost recovery to HAL via charges to airlines to commence only after the outcome of the DCO process is known.
- 1.7 All Category B costs incurred, including costs up to and above the £10 million per year threshold, will be subject to an efficiency test. The Independent Fund Surveyor (IFS) will provide an ongoing assessment of the efficiency of all Category B costs incurred.
- 1.8 We reserve the right to decide that HAL will be able to recover less than 85% of the Category B costs incurred, if there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process.
- 1.9 HAL should make materials and reports produced for the planning process available to the CAA, the airline community and other stakeholders as soon as practicable. HAL should consult with the airline community at the outset on the rules and principles for classifying any information as confidential and how this should be shared with stakeholders.

Summary of stakeholder views on our initial proposals and our responses

- 1.10 We received ten written responses to our consultation in July 2016²: from HAL, Gatwick Airport Limited (GAL), two airline groups, four airlines,

² CAA, The recovery of costs associated with obtaining planning permission for new runway capacity: initial proposals, July 2016, available at: www.caa.co.uk/CAP1435.

London (Heathrow) Airline Consultative Committee/Airport Operators Committee (LACC/AOC) and one other stakeholder.

- 1.11 Having given due consideration to stakeholders' views, we have slightly modified or clarified our initial proposals. The key points are detailed below.
- 1.12 Our initial proposals indicated our intention to roll up Category B costs into a 'planning RAB' (or pRAB). We accept HAL's argument that the pRAB could introduce unnecessary complexity. We now consider that our objectives can be met by Category B costs being tracked as a single line item in HAL's existing RAB. Category B costs accrued into the RAB need to be clearly identified and reported, as they will be subject to specific treatment (e.g. risk-sharing mechanism, depreciation and delayed recovery) and close scrutiny.
- 1.13 Our initial proposal said that costs in the pRAB should be recovered over a 10 year depreciation period where the DCO is granted, with a shorter period suggested where the DCO is not granted. We maintain the view that our estimate of 10 years is reasonable, but given the uncertainty over the life of a quasi-intangible asset such as planning permission, we are content to extend the depreciation period from 10 to 15 years, to reflect the responses from many of the airlines that this period is too short.
- 1.14 The extension in the depreciation period reduces the amount of Category B costs which are recovered and borne by airlines and passengers before the new runway is open, which was a major concern from airlines in their responses. We also now propose that the same 15 depreciation assumption is used regardless of the result of the DCO process.
- 1.15 There are a number of other areas where we have kept our views largely unchanged after considering stakeholders' views, particularly the principle of risk-sharing, the specific risk-sharing parameters and the time when cost recovery should start.
- 1.16 Our view remains that the risk-sharing principle and the specific 105/85 parameters are appropriate. We note airlines' view that they should not bear any Category B cost risks because of their limited control over the

planning process. However, we consider that our proposal that 85% of costs can be recovered is a balanced proposition, as well as being more favourable to airlines than previous regulatory treatments. For Heathrow Terminal 5 and the (aborted) second runway at Stansted, we (ex-ante) allowed 100% of efficiently incurred planning costs to be recovered from higher airport charges to airlines.

- 1.17 We note proposals by HAL and GAL to increase the incentives and reward for securing a positive outcome of the planning process. We recognise that returns for successful planning applications in the commercial sector could well be much higher than the 5% additional return we proposed and closer to the levels suggested by HAL and GAL. However, in these sectors which are not subject to economic regulation, all of the planning costs would be 'at risk' rather than just 15%. We therefore consider that a 5% additional return balanced against a 15% financial detriment is proportionate and reflects the perceived risk and the likelihood that planning permission being achieved is more likely than not.
- 1.18 The 5% additional return is not intended to be a substitute for Category A costs which we have consistently stated are not recoverable. The 5% return does not serve any other purposes apart from reflecting our judgment of HAL's planning risk exposure and the risk that HAL will not be able to recover 15% of its costs from the DCO process should planning not be successful.
- 1.19 Our initial proposal was that cost recovery should only start when the result of the planning process is known. HAL argued that cost recovery should start as soon as or shortly after they are incurred, whereas the airlines wanted cost recovery to start only when new capacity comes into operation. Our package of proposals mean that the majority of Category B costs will be recovered after the runway is open.

Views invited on our final proposals

- 1.20 We welcome views on the final proposals set out in this document. Having already reflected carefully on responses to our initial proposals, we would especially welcome any new evidence and arguments.
- 1.21 Comments should be sent to economicregulation@caa.co.uk by no later than 17:00 on **Monday 12 December 2016**. We cannot commit to take into account representations after this date.
- 1.22 We expect to issue our decision on the regulatory treatment of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport in January 2017.
- 1.23 If you would like to discuss the issues raised in this document before the December deadline please contact Stephen Gifford (stephen.gifford@caa.co.uk).
- 1.24 Representations will be made available on our website. Any material considered confidential should be clearly marked as such. Please note that we have powers and duties with respect to disclosure of information under section 59 of the Act and the Freedom of Information Act 2000.

Chapter 2

Introduction

Background

- 2.1 In our July 2016 consultation, we set out our initial proposals on the treatment of costs associated with obtaining planning permission for new runway capacity.³ The broad principles were:
- planning costs are defined as those incurred by the successful airport promoter following a government policy decision on location and attributed to activities necessary for it to conduct the planning process;
 - costs up to £10 million per year will be recoverable by the airport operator through an increase in airport charges;
 - costs that are incurred over £10 million per year can be recovered by the airport operator subject to them being efficiently incurred and there being risk-sharing arrangements in place; and
 - risk-sharing agreements to cover the risk that planning permission is not granted, rescinded or withdrawn.
- 2.2 Our initial proposals were built on our March 2015⁴ and September 2015⁵ documents which emphasised the importance of appropriate risk-sharing agreements and our February 2016 document⁶ where we outlined further guidance and some possible principles for the regulatory treatment of Category B costs.

³ CAA, The recovery of costs associated with obtaining planning permission for new runway capacity: initial proposals, July 2016, available at: www.caa.co.uk/CAP1435.

⁴ CAA, Economic regulation of new runway capacity, March 2015, available at: www.caa.co.uk/CAP1279.

⁵ CAA, Economic regulation of new runway capacity – Update, September 2015, available at: www.caa.co.uk/CAP1332.

⁶ CAA, Recovery of costs associated with obtaining planning permission for new runway capacity: policy update, February 2016, available at: www.caa.co.uk/CAP1372.

Government announcement

- 2.3 In July 2015 the Airports Commission published its final report, in which three options for new runway capacity were shortlisted: the Heathrow northwest runway, Heathrow extended north runway (Heathrow Hub) and the Gatwick second runway.
- 2.4 On 25 October 2016, the Government announced that it has identified the Heathrow northwest runway as the preferred scheme, stating that:
- The Government will consult on its preferred scheme in the new year in the form of a draft National Policy Statement (NPS).
 - Expansion costs will be paid for by the private sector, with the CAA, HAL and the airlines working together to ensure the scheme remains affordable.
- 2.5 The final proposals outlined in this consultation are only applicable to HAL seeking planning permission to construct a new northwest runway at Heathrow Airport. We do, however, outline the views made by GAL in their consultation response to our initial proposals.

Stakeholder responses

- 2.6 We received 10 responses to our initial proposals from:
- Gatwick Airport Limited;
 - Heathrow Airport Limited;
 - London (Heathrow) Airline Consultative Committee/AOC;
 - International Airlines Group (IAG);
 - Star Alliance;
 - Virgin Atlantic Airways (VAA);
 - easyJet;
 - Thomas Cook Group Airlines;
 - ABTA – the Travel Association (ABTA); and
 - Lakeside Energy from Waste Ltd.

- 2.7 We have taken into account these stakeholders' views in formulating our final proposals.

Structure of this consultation

- 2.8 The following chapters present in more detail stakeholder views and our responses:

- Chapter 3: definition of eligible costs;
- Chapter 4: recovery mechanism for eligible costs;
- Chapter 5: risk-sharing arrangements; and
- Chapter 6: promoting efficiency and transparency.

- 2.9 Appendix A provides detail on 'our duties' and Appendix B covers 'definitions of Category A and Category C costs'

Chapter 3

Definition of eligible costs

Definition of category B costs

Initial proposals

- 3.1 We said that Category B costs were capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision on the location of new capacity and are directly connected with and solely for the purposes of seeking planning consent through the DCO process. We stressed that Category B costs must be strictly additional to any costs already included in the Q6 allowance as well as being efficiently incurred.

Stakeholder responses

- 3.2 GAL agreed with our defined scope of costs, but considers that property-related costs should be defined as Category B as they are necessary to achieve planning permission.
- 3.3 HAL supported the definition of Category B costs, but is concerned that a prescriptive list which is included in a licence is unnecessarily rigid, as not all planning costs are fully understood at this stage.
- 3.4 LACC/AOC supported the scope of Category B costs but considered along with ABTA that the National Policy Statement (NPS) is the Government responsibility and any of these costs should not be borne by airlines.
- 3.5 IAG broadly agreed with the definition and timing of Category B costs, but suggested that the CAA make it clear that Category B costs cannot be incurred before a Government location decision and are strictly limited to costs related to seeking planning permission through the DCO process.
- 3.6 VAA and easyJet were content with the definition of Category B costs.

Our views

- 3.7 We note the broad consensus on the definition of eligible Category B costs identified in the initial proposals.
- 3.8 Having reviewed the responses, we do not propose at this stage to define Category B in a licence condition but instead that the categories set out in these final proposals act as guidance for HAL and the IFS.
- 3.9 Furthermore, instead of the licence acting as the mechanism for any disputes around the boundaries of Category B, we consider that a Governance group should be set up comprised of HAL, airline representatives and the IFS in a similar fashion to the Q6 capex governance arrangements. HAL should report back to this group on a quarterly basis on the type and level of Category B costs incurred. The IFS will take views from airlines and subsequently advise the CAA if any costs should not be classed as Category B costs or classed as inefficient Category B costs.
- 3.10 We note the concerns about the costs of the NPS process. As the Government is responsible for the preparation of the NPS, we consider that any costs incurred by Government to develop the NPS should be borne by the Government. However, HAL may need to prepare documents (e.g. initial designs, masterplans and planning submissions) and make submissions to the Government to help it prepare the NPS. Any costs borne by HAL to prepare material for the Government's NPS will be classified as Category B costs and therefore recoverable. We consider the NPS process to be an important part of the DCO planning process.
- 3.11 We acknowledge GAL's opinion that property-related costs should be included as Category B costs. We agree that these costs are necessary for capacity expansion. However, we consider these should be classed as Category C costs⁷ but recognised as being incurred before planning permission and with a need for early certainty on our policy and principles.

⁷ Category C costs are defined as 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.