

Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable

CAP 1510



Page 1 of 1

Published by the Civil Aviation Authority, 2017

Civil Aviation Authority,
Aviation House,
Gatwick Airport South,
West Sussex,
RH6 0YR.

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA.

First published 2017

Enquiries regarding the content of this publication should be addressed to: economicregulation@caa.co.uk

Consumers and Markets Group, CAA, 4th Floor, CAA House, 45-59 Kingsway, London WC2B 6TE

The latest version of this document is available in electronic format at www.caa.co.uk, where you may also register for e-mail notification of amendments.

Contents

Contents	1
About this document	3
Views invited	3
Chapter 1	4
Executive summary.....	4
Our main priorities	5
Next steps and timetable	7
Structure of this consultation	8
Chapter 2	9
Background.....	9
Introduction	9
HAL/stakeholder engagement on the scope, design and costs of the capacity expansion	10
Preparation of the National Policy Statement	10
HAL seeks planning permission through the DCO process and the regulatory treatment of planning costs	11
HAL undertakes preliminary works in advance of planning permission	12
Preparation for the H7 price control review	12
Chapter 3	13
Our duties and vision for the regulatory framework	13
Our duties under the Civil Aviation Act 2012	13
Vision for our work on the regulatory framework	14
Stakeholders' aspirations for the level of airport charges	15
Chapter 4	17
CAA priorities for scheme design and delivery	17
Priority issue 1	17
Our expectations and role	17
Priority issue 2	19
Robust cost estimates	19
Incentives for efficiency	21
Chapter 5	25
CAA priorities for the regulatory framework	25
Priority issue 3	26

How to best develop incentives and allocate risks.....	26
Regulatory arrangements to support efficient financing and long-term investor and consumer confidence.....	29
The cost of capital, financeability and affordability.....	33
Priority issue 4.....	37
HAL provides H7 baseline information	37
CAA provides guidance on the full business plan.....	37
Chapter 6	39
Timetable	39

About this document

This document sets out for consultation our priority issues and timetable for the development of the regulatory framework for the capacity expansion (3rd runway, terminals and associated infrastructure) at Heathrow airport. We will publish a further consultation on these matters in June 2017. We will also report on a quarterly basis to the Secretary of State on Heathrow Airport Limited's (HAL's) engagement with airlines on the development of the preferred option for the new capacity, with a final report due in November 2017. The focus of this document is the regulatory treatment of the costs and financing of the construction programme – what we have called 'Category C' costs. We have previously consulted on the costs that HAL will incur in obtaining planning permission ('Category B' costs).

Views invited

1. We welcome views on all the issues raised in this document and in particular the priority issues set out in the Executive Summary and discussed in more detail in Chapters 4 and 5.
2. Please e-mail responses to economicregulation@caa.co.uk by no later than 14 March 2017. We cannot commit to take into account representations received after this date.
3. We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.
4. If you would like to discuss any aspect of this document, please contact Stephen Gifford (stephen.gifford@caa.co.uk).

Chapter 1

Executive summary

- 1.1 In October 2016 the Government announced that its preferred option for the expansion of airport capacity in the South-East of England was the Heathrow north-west runway. The CAA has consistently stated that additional runway capacity in the South-East of England will benefit air passengers and cargo owners. More aviation capacity is required to prevent future consumers experiencing higher airfares, reduced choice and lower service quality.
- 1.2 We are now consulting on our key priorities for developing the regulatory framework for the capacity expansion (i.e. 3rd runway, new terminal capacity and associated infrastructure) at Heathrow airport. Our intention is to create a shared vision for priorities to facilitate engagement with HAL, airlines and other stakeholders on both the capacity expansion and the development of the regulatory framework for HAL.
- 1.3 Our processes for the development of the regulatory framework for HAL need to be coordinated with and take account of the wider processes associated with the capacity expansion. These include:
- engagement between HAL, the airlines and other stakeholders on the appropriate scope, design and cost of the capacity expansion, to ensure that it meets the reasonable needs of airlines and consumers. The Secretary of State has asked the CAA to advise him on the effectiveness of HAL's engagement with the airline community;¹
 - a Department for Transport (DfT) led process to develop the National Policy Statement (NPS). A draft NPS will be published for

¹ This work will be conducted under section 16 of the Civil Aviation Act 1982 and as outlined in the letter and terms of reference at <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/>.

consultation in early 2017 setting out the Government's rationale for identifying the Heathrow north-west runway as its preferred option for capacity expansion and seeking views from the public on these matters; and

- a HAL-led process to secure planning permission for constructing and opening the new runway through a Development Consent Order (DCO), which starts with an initial consultation in 2017.

1.4 These processes may throw up issues that will have an impact on our timetable and/or approach to the economic regulation of the capacity expansion. We will be alert to this possibility and where appropriate the need to factor such issues into our consultations with stakeholders as we develop policy.

Our main priorities

Priority issue 1: HAL must develop a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders on the potential options, costs and value for money.

1.5 We will focus on the following key themes:

- monitoring and assessing HAL's engagement with airlines and other stakeholders on these matters, including whether HAL has done all it can to meet the aspiration that airport charges do not increase in real terms (over the short and longer term), while delivering robust and resilient infrastructure in a timely way and consistent with the needs of consumers; and
- ensuring that there is sufficient independent challenge and scrutiny from a consumer perspective including, where appropriate, by consulting with the Heathrow Consumer Challenge Board and undertaking our own independent research and assessment.

Priority issue 2: HAL must develop robust cost estimates and we need to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way.

1.6 We will focus on the following key themes:

- reviewing the evidence that HAL and other stakeholders provide on cost efficiency, including evidence on benchmarking and market testing;
- reviewing proposals for ensuring that there is confidence in the independence and robustness of HAL's procurement processes; and
- working with HAL and other stakeholders to develop regulatory arrangements and incentives to drive the efficient and timely delivery of the new capacity.

Priority issue 3: HAL must develop proposals for efficient financing and we need to develop the regulatory framework in a way consistent with efficient financing, affordability and financeability.

1.7 We will focus on the following key themes:

- considering whether there are other long-term regulatory commitments alongside the Regulatory Asset Base (RAB) that will support long-term investor and stakeholder confidence in the regulatory framework;
- ensuring that the package of regulatory incentives on HAL, including those relating to cost efficiency and recovery, provide for an appropriate balance of risk and reward;
- estimating an efficient cost of capital and testing the financeability of HAL's and any alternative proposals; and
- reviewing whether the resulting price path profiles adequately reflect our view of consumers' interests over both the short and longer term.

Priority issue 4: HAL must develop coordinated proposals for existing operations (i.e. for the H7 price control)² alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable.

1.8 We will focus on the following key themes:

- making sure that our testing of affordability and financeability relates to all HAL's activities, as stakeholders care about the overall affordability of its charges and financeability of its expenditure programmes, across HAL's existing business and new capacity.

1.9 We are seeking comments on any aspect of the issues discussed in this paper and in particular:

- whether the four key priorities identified above are the right priorities for us to adopt in developing the regulatory framework for the new capacity at Heathrow;
- whether the key themes identified above (under each of the priority issues) as areas of focus for our work on developing the regulatory framework during 2017 are appropriate; and
- any gaps in the priority issues or key themes and any more detailed points that stakeholders want to make at this initial stage on the more detailed discussion in Chapters 4 and 5.

Next steps and timetable

1.10 Responses to this consultation are due by 14 March 2017.

1.11 We will be hosting a series of briefing sessions on the timetable and the priority elements of the regulatory framework between February and May 2017.

² H7 is the next price control period, which is due to start 1 January 2020.

- 1.12 Having reflected on stakeholder feedback to this document we will publish a further consultation paper on the regulatory framework in June 2017.
- 1.13 We will be report to the Secretary of State on HAL's engagement with airlines on a quarterly basis with a final report in November 2017.
- 1.14 In addition to these initiatives we will:
- publish our policy decision on the remaining element of Category B costs (i.e. costs incurred seeking planning consent through the DCO process) in February 2017; and
 - publish an update on the H7 price control review in April 2017, covering the timetable, our expectations for HAL's business plan and the design principles for a more outcomes-based regime.
- 1.15 Our timetable is discussed in more detail in Chapter 6.

Structure of this consultation

- 1.16 This consultation is structured as follows:
- Chapter 2 sets out the background;
 - Chapter 3 summarises our statutory duties as given by the Civil Aviation Act 2012 and discusses how we will fulfil these in the context of development of new capacity;
 - Chapter 4 explains our priorities for HAL to engage with the airlines on scheme design and costs and the work we will undertake to develop incentives to drive the efficient and timely delivery of the expenditure programme;
 - Chapter 5 describes our priorities for developing the wider regulatory framework for HAL, including the importance of creating incentives that are consistent with efficiency, affordability and financeability; and
 - Chapter 6 sets out our timetable.

Chapter 2

Background

Introduction

2.1 With the Government's recent announcement that Heathrow airport is its preferred location for capacity expansion in the South-East of England, work will now proceed on a number of fronts. This Chapter explains some of the broader processes relevant to our work on developing the framework for economic regulation.

2.2 These include:

- HAL engaging with airlines and other stakeholders during 2017 on the appropriate scope, design and cost of the capacity expansion;
- the DfT will work on its draft airports NPS and develop related policies such as proposals on noise and airspace. The NPS will provide direction to the Planning Inspectorate and is an early part of the DCO process. Development of the NPS is being carried out by the DfT;
- HAL-led activities to secure planning permission through the DCO process;
- the pre-planning construction activities and mitigation measures necessary before planning permission is secured. HAL may seek to purchase residential and commercial properties, acquire land and undertake enabling construction works, as well as agree (and incur) compensation costs for blight and hardship;
- consumers, airlines and other stakeholders are interested in the overall affordability and financeability of HAL's proposals. Therefore, in addition to HAL's proposals on capacity expansion, it will need to develop proposals for its existing business activities. In due course, it will also need to develop a comprehensive business plan for existing

activities that will be used as part of the Constructive Engagement that will be a key part of the H7 price control review.

2.3 These matters are discussed in greater detail below.

HAL/stakeholder engagement on the scope, design and costs of the capacity expansion

2.4 The capacity expansion needs to provide value for money for consumers and the aviation industry. HAL and the airlines have started a detailed engagement process to review the scope, design and costs.

2.5 The aim of the engagement process is to ensure that the plans for capacity expansion meet the reasonable needs of airlines and other stakeholders. As part of this process it will be important that HAL seeks to meet the aspirations of airlines on affordability (in particular that airport charges do not increase in real terms in both the short and longer-term), while delivering robust and resilient infrastructure that meets the needs of consumers.

2.6 We will monitor and report on HAL's engagement with airlines as it carries out the development of scheme design, which must meet the needs of both stakeholders and consumers. We will also work with HAL and other stakeholders to develop arrangements to drive robust, efficient and timely delivery. These issues are discussed further in Chapter 4.

2.7 The Secretary of State has asked us to provide a final report in November 2017 on the effectiveness of HAL's engagement with airlines.³

Preparation of the National Policy Statement

2.8 The purpose of an NPS is to set out an assessment of the need for Nationally Significant Infrastructure Projects (NSIPs) and is published by the Secretary of State under powers from the Planning Act 2008 and

³ Terms of Reference: Assessment of airport-airline engagement on the appropriate scope, design and cost of new runway capacity. See <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/>.

Localism Act 2011. The NPS provides direction to the Planning Inspectorate to make a recommendation to the Secretary of State on DCO applications for NSIPs.

- 2.9 Consultation on the draft NPS for capacity expansion at Heathrow airport is planned for early 2017. Parliamentary scrutiny of the draft NPS will take place by a Parliamentary Select Committee, running at the same time as public consultation. After this scrutiny, the final NPS will be considered by the House of Commons, followed by designation if appropriate.
- 2.10 The NPS is expected to take roughly 12 months to prepare and be designated, although the length of time required is not fixed and could vary from this indicative timetable. The DfT is working towards the designation of the NPS in Winter 2017/2018.

HAL seeks planning permission through the DCO process and the regulatory treatment of planning costs

- 2.11 We understand that HAL will prepare the DCO in 2018 and 2019, and is targeting making an application for development consent in 2020, with a view to securing a DCO in 2021. It aims to consult stakeholders on a draft DCO in the summer of 2017.
- 2.12 HAL will incur expenditure over the next few years in pursuit of planning permission for the capacity expansion. The CAA has recently modified (with effect from 1 February 2017) HAL's licence to allow the recovery of £10 million of efficient Category B planning costs per year.
- 2.13 Category B costs are specifically defined as costs directly connected with, and solely for the purposes of, seeking planning consent through the DCO process.
- 2.14 The licence modification allows costs (up to £10 million per year) to be recovered from higher airport charges in the year they are expected to be incurred or through the K factor in the Price Control Condition. These Category B costs will be subject to an efficiency test by an planning-