

Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable

CAP 1819



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About this document

This consultation document focuses on the costs of expansion incurred by Heathrow Airport Limited (“HAL”) in advance of receiving a development consent order (“DCO”) under the Planning Act 2008 for the expansion of Heathrow airport. It deals with the new information that has emerged on these costs and notes that there could be significant implications for the wider programme timetable, depending on the levels of this spending and how we propose to treat the expenditure in the regulatory framework.

It also deals with issues relating to the regulatory timetable and updates the guidance we provided previously to HAL on the scope and content of its price control business plans.

Stakeholder views invited

We welcome views on all of the issues raised in this document including the issues set out in the Executive Summary and those highlighted in chapters 1 to 3.

Please e-mail responses to economicregulation@caa.co.uk by no later than 22 August 2019. We cannot commit to considering representations received after this date.

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.

If you would like to discuss any aspect of this document, please contact robert.toal@caa.co.uk.

Executive Summary

Introduction

1. Capacity expansion at Heathrow airport is a very large and complex programme and under HAL's existing plans very significant costs will need to be incurred for planning and other pre-DCO¹ costs to support a target date for the new runway opening of 2026.
2. Under our existing policy, planning costs are termed "Category B costs" and are those costs which are directly associated with, and incurred solely for the purpose of, seeking planning permission for the delivery of new runway capacity at Heathrow airport. The other pre-DCO costs termed "early Category C costs" are in addition to Category B costs and are a subset of HAL's overall Category C costs². HAL's most recent estimates of early Category C costs include the costs of relocating certain large commercial/other facilities, community costs (including compensation costs relating to other commercial activities, agricultural activities and residential property) and other enabling costs to prepare for construction.
3. HAL's forecasts of early Category C costs have increased significantly and are now very material. In order to retain a target of 2026 for the opening of the new runway, HAL has said it needs to bring forward the timing of certain spending. HAL now expects to spend a total of £2.9 billion (in 2014 prices), consisting of over £500 million of Category B costs and £2.4 billion (in 2014 prices) of early Category C costs, before it obtains a DCO. In the light of these increases, we have asked HAL to consider different options for this spending and the

¹ HAL will apply for planning permission to permit capacity expansion in the form of a "development consent order" ("DCO") under the Planning Act 2008 ("PA08"). HAL is targeting late 2021 for obtaining a DCO. The DCO must meet the requirements of the Airports National Policy Statement ("NPS") designated by the Government under PA08.

² We are consulting on the regulatory treatment of Category C costs through our wider regulatory framework consultations including the consultation we published in March 2019 CAP 1782: [Economic regulation of capacity expansion at Heathrow: Policy update and consultation](#) ("the March 2019 Consultation").

implications of this spending for the overall programme timetable and the interests of consumers.

4. This document discusses the regulatory treatment of Category B and early Category C costs in the light of these increases and the further options that HAL is considering for this spending and the overall programme timetable. Bearing in mind the uncertainty about the overall programme timetable, this document also discusses the regulatory timetable and updates our guidance to HAL on its initial price control business plan (due in December 2019).
5. Our previous policy documents on these matters include:
 - consultations in July³ and November 2016⁴ on the regulatory treatment of expansion costs;
 - the February 2017 policy statement⁵ and December 2017 policy update on costs;⁶
 - guidance to HAL in April 2017 on its price control business plan;⁷
 - April 2018 guidance document⁸ and policy update on costs⁹; and
 - a consultation in October 2018 that dealt with the regulatory timetable.¹⁰

³ See CAP 1435: The Recovery of Costs associated with obtaining planning permission for a new northwest runway at Heathrow airport: initial proposals ([“the July 2016 Consultation”](#)).

⁴ See CAP 1469: The Recovery of Costs associated with obtaining planning permission for a new northwest runway at Heathrow airport: final proposals ([“the November 2016 Consultation”](#)).

⁵ See CAP 1513: Policy Statement on the Recovery of Category B costs ([“the Planning Cost Recovery Policy Statement”](#)).

⁶ See: CAP 1610: Economic regulation of capacity expansion at Heathrow: policy update and consultation ([“the December 2017 Consultation”](#)).

⁷ See: CAP 1540: Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control ([“the April 2017 Consultation”](#)).

⁸ See: CAP 1651: Guidance on preparation of the annual budget and statement for those costs associated with obtaining planning permission for a new northwest runway ([“the Budget Guidance”](#)).

⁹ See: CAP 1658: Economic regulation of capacity expansion at Heathrow: policy update and consultation ([“the April 2018 Consultation”](#)).

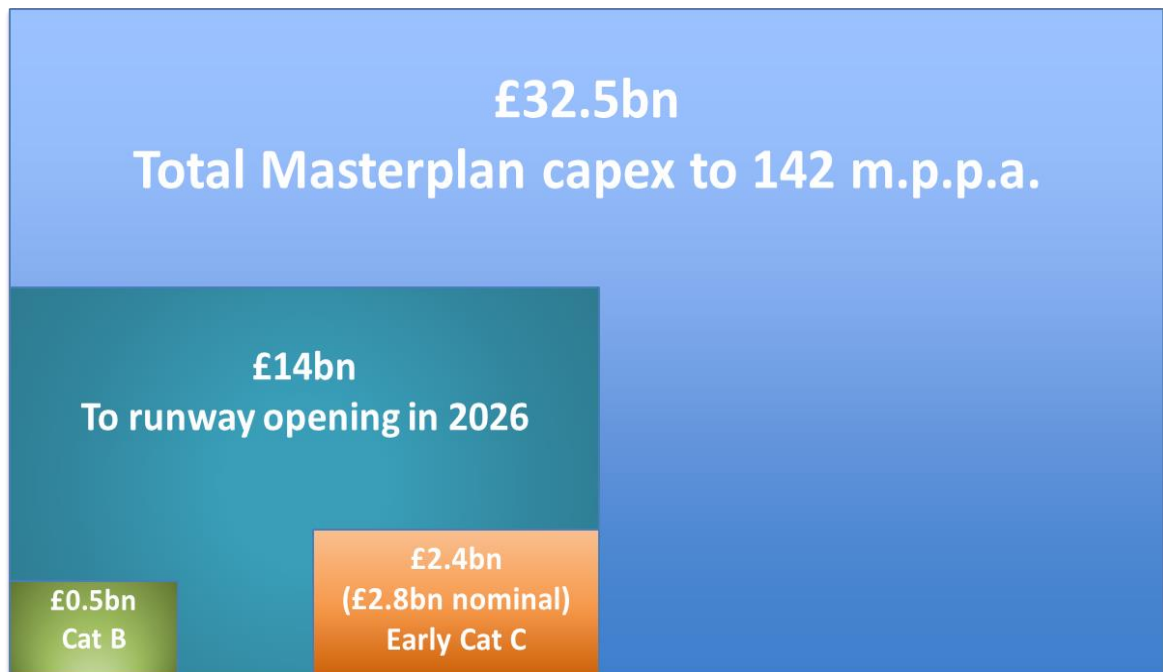
¹⁰ See CAP 1722: Economic Regulation of Capacity Expansion at Heathrow: policy update and consultation ([“the October 2018 Consultation”](#)).

6. The level of Category B and early Category C costs are important to consumers because:
- overall cost efficiency supports both the affordability and financeability of the capacity expansion programme;
 - of the potential impact on the overall timetable and timely delivery of capacity expansion, with early Category C spending promoting timely delivery of new capacity at Heathrow airport that would benefit consumers by promoting choice, greater competition between airlines and increasing resilience;
 - there is a risk that, if early expenditure is passed on to consumers through airport charges, consumers are at risk of those costs becoming sunk¹¹ if HAL's DCO application were not to be successful (or if HAL decided to withdraw from the DCO process); and
 - there may be a difficult trade-off between (i) the timely delivery of capacity expansion and the benefits to consumers that this would bring, and (ii) the potential for sunk costs if HAL were not successful with its DCO application. In practice, this means that a higher level of early spending may lead to earlier opening of the new runway, but at the risk of higher sunk costs if HAL is not granted a DCO. The risks associated with these sunk costs could be reduced by lower levels of early spending, but this would delay the target date for runway opening.
7. Nonetheless, HAL's total forecast costs to deliver the new runway and associated capacity by 2026 remain broadly in line with 2017 expectations (although there are certain changes in the scope of the infrastructure it intends to deliver for 2026). HAL's current estimates suggest that its total capital costs to facilitate the opening of a new runway in 2026 will be in the region of £14 billion (in 2014 prices). Further, HAL's current estimates for total expansion capital costs are around £32.5 billion (in 2014 prices) in the period to 2050 (to provide

¹¹ "Sunk" costs can be considered as costs that have been properly incurred in relation to the runway expansion programme, but which would become wasted or cannot be recouped by the sale of the assets those costs were used to acquire in the event that the DCO is not granted due to the output of these costs no longer being required.

the capacity to accommodate 142 million passengers per annum). HAL's estimates of costs are illustrated in the figure below.

Figure 1: Category B and early Category C costs in the context of expansion costs (2014 prices)



Source: HAL, Cost and Benefit Working Group, March 2019

8. As well as HAL's work to develop its capacity expansion programme it is important to note that other important changes will be required to allow airlines and passengers to take advantage of new capacity at Heathrow airport. In particular, airspace modernisation will be required across the southeast of England to allow for aircraft to make best use of airspace and reduce the impact of increases in air traffic on the environment.

Main issues raised in this consultation

9. As noted above HAL's total forecast costs to deliver the new runway and associated capacity by 2026 remain broadly in line with 2017 expectations (although there are certain changes in the scope of the infrastructure it intends to deliver for 2026). Nonetheless, the estimates of HAL's pre-DCO spending, which are important components of its wider £14 billion programme, have

increased significantly. It is these early costs that are the focus of this consultation.

10. In relation to Category B planning costs, chapter 1 notes the sharp increases in these costs and that when we established the original approach to regulating these costs in 2017 we said we would review our approach to these matters if HAL's forecasts of these costs exceeded £265 million (in 2014 prices). HAL's latest forecasts suggest these costs could be over £500 million. In the light of this escalation in costs, we consult on strengthening the governance and regulatory incentives that apply to these costs including that:

- reporting arrangements should be enhanced so HAL reports every three months on these costs;
- we intend to review the total level of these costs to establish a recovery cap based on our assessment of efficient costs, with any increase in forecast costs beyond this level subject to approval by a governance process involving airlines, or else referred to the CAA for decision;
- we intend to increase the scrutiny of these costs through the work of the Independent Planning Cost Reviewer (IPCR), CAA assessment of these costs and through the work to establish the recovery cap discussed above; and
- the regulatory incentives should be tightened by the use of the recovery cap and we consult on whether a change in the financing costs that HAL should be allowed to recover on the costs would be appropriate.

11. Chapter 2 discusses early Category C costs and explains that, following the sharp increase in HAL's estimates of these costs, we have asked HAL to look at, and report on, a range of options for early Category C spending and the implications of each option for the wider programme timetable and for consumers. These include options that would involve a significantly lower level of early spending. We have asked HAL to complete its initial work on these scenarios by the end of July 2019. It will be particularly important that HAL takes a leading role in engaging with airlines on these matters and actively seeks agreement with airlines on an option that both HAL and airlines can support and is also in the best interests of consumers.

12. There is a need for timely decisions on these matters since there are plausible scenarios in which HAL would need to accelerate early Category C spending in early 2020. So, in parallel to this work on options, we are considering how best to treat these costs in the regulatory framework and are consulting on:

- our view that once a broad programme of early Category C spending that is consistent with the interest of consumers is identified, efficient costs that are incurred consistent with this programme should be added to HAL's RAB;
- a proposal to regulate early Category C costs in a similar way to Category B costs (with the exception of the 85/105 risk sharing mechanism that we intend should only apply to Category B costs), including in relation to allowances for financing costs; and
- the possibility of developing a modification to HAL's licence that would put in place stronger and more formal governance arrangements for the agreed programme of early Category C costs and decisions about whether they should be added to HAL's RAB. This approach could allow each of HAL and airlines the opportunity of an appeal to the Competition and Markets Authority ("CMA") (consistent with the provisions of CAA12) if they thought the CAA's approach in bringing forward the licence modification was wrong.

13. In the light of the potential impact of the decision on early Category C spending on the overall programme timetable, chapter 3 discusses the regulatory timetable and updates our guidance to HAL on its price control business plan due in December 2019. We consult on:

- the proposal to retain December 2019 as the target date for HAL's initial business plan (IBP);
- to the extent it is practicable for the CAA to retain a target of 2021 for its main price control proposals, with greater use of uncertainty mechanisms to deal with those elements of the programme which will inevitably be less certain given a programme of the scale and complexity of capacity expansion at Heathrow;
- retaining the flexibility for the next main price control to include provisions for an interim price control review and to be open minded about the duration of

the price control given the uncertainty with respect to the wider programme timetable; and

- ensuring that the Enhanced Engagement processes that have been put in place between the airport and airlines are sufficiently robust and wide ranging that they also deliver the objectives of the processes we have previously described as Constructive Engagement.

Our duties

14. In developing this consultation, we have had full regard to our statutory duties under the Civil Aviation Act 2012 (“CAA12”), which are set out more fully in Appendix A.

Structure of this document

15. The structure of this consultation document is as follows:
- chapter 1 deals with our policy proposals in respect of Category B costs;
 - chapter 2 deals with our emerging thinking and next steps in respect of early Category C costs; and
 - chapter 3 covers issues relating to the regulatory timetable and preparation of HAL’s price control business plans.

Next steps

16. We invite comments from stakeholders on the issues raised in chapters 1 to 3 of this consultation document by 22 August 2019. We cannot commit to taking account of representations made after this date.
17. Having considered stakeholders views, and emerging evidence, we intend to:
- set out our revised policy for the regulatory treatment of Category B costs in October 2019, as part of our next update on the broader regulatory framework for HAL and capacity expansion;
 - report on the outcome of airport and airline discussions on the options for early Category C spending and the timetable for expansion, together with

the CAA's views on these matters (including next steps) in September or October 2019; and

- finalise the principles for the regulatory treatment and governance of early Category C costs in September or October 2019. If we decide it is appropriate to modify HAL's licence with respect to these matters, then we will consult on a draft licence condition at that time.

CHAPTER 1

Policy proposals for Category B costs

Introduction

- 1.1 Capacity expansion at Heathrow airport involves a very large and complex capital programme. The planning process requires HAL to apply for a DCO and comply with the obligations created by the PA08 and the NPS. In addition to these requirements, the timely and efficient delivery of such a large capital programme requires the assessment of a full range of options for scheme development and consultation with stakeholders (including airlines) on the preferred approach. Taken together, these factors mean that HAL will need to incur substantial planning costs to successfully deliver capacity expansion.
- 1.2 These planning costs were not allowed for when the last main price control (Q6) was set in 2014. Our present policy in respect of the regulatory treatment of these costs (and how costs consistent with our policy should be recovered by HAL through airport charges) is summarised in the Planning Cost Recovery Policy Statement. We described these costs as “Category B” costs and defined these costs as:
- in general, incurred by HAL after the Government policy announcement on its preferred location for new capacity (25 October 2016); and
 - associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow.¹²
- 1.3 When we published the Planning Cost Recovery Policy Statement, HAL expected that the Category B costs that it would incur might be up to £265 million (2014 prices). Since then, there has been a very significant escalation in HAL’s estimates of the overall level of Category B costs that it will incur. HAL’s most

¹² See paragraph 3.10 of the Planning Cost Recovery Statement.

recent Category B cost estimate (in December 2018) suggests that it will, in total, spend over £500 million on these costs.

1.4 The Planning Cost Policy Recovery Statement made clear that our policy on Category B costs may be reviewed if efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million.¹³ We said that the CAA's decision on whether to conduct any review of this policy, and the scope of any review, would have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of spending.

1.5 This chapter invites comments on our review of our existing policy and is structured as follows:

- a summary of our current policy on the regulatory treatment of Category B costs;
- HAL's latest projections of its Category B spending; and
- our policy proposals for the future regulatory treatment of Category B costs.

Current policy for the regulatory treatment of Category B costs

1.6 The Planning Cost Recovery Policy Statement defined Category B costs in the way set out in paragraph 1.2 above. The Budget Guidance¹⁴ provided an example list of categories of costs that would be likely to fall within Category B, drawing on our earlier consultations on these costs.¹⁵ In January 2019 we consulted on the recovery by HAL of Category B costs incurred in 2016 and 2017 and a number of issues that have arisen in relation to the categorisation of costs. These matters are dealt with in Appendix B.

¹³ See paragraph 1.17 of the Planning Costs Recovery Statement. The £265 million is expressed in 2014 prices. This equates to £298 million in nominal prices. Throughout this consultation, all references to £265 million in respect of our existing Category B cost policy relate to 2014 prices.

¹⁴ See paragraph 3.4 and Table 2 of the Budget Guidance for a full list.

¹⁵ However, the CAA made clear that this list is not exhaustive and should be used as guidance. Furthermore, the CAA will make the final decision on whether any costs should not be treated as Category B costs.

1.7 Our current Category B policy, set out in the Planning Cost Recovery Policy Statement, has four key elements:

- scope of policy and the materiality thresholds that will trigger a review of the policy;
- the recovery mechanisms including the treatment of costs that will ultimately be added to HAL's regulatory asset base (RAB);
- incentive arrangements including the treatment of risks around whether HAL will be granted a DCO; and
- the governance processes, including the role of the Independent Planning Costs Reviewer (IPCR).

These are summarised in Figure 2.

Figure 2: Current Category B costs policy

Existing Category B Costs Policy Source: <i>Planning Cost Recovery Policy Statement</i>			
Our published Category B costs policy has 4 main elements			
1. Scope of policy	2. Recovery mechanism	3. Incentive arrangements	4. Governance process
Range of costs Efficiently incurred Category B costs are covered by the existing policy with a review point at £265 million	Treatment of Costs First £10 million per year: Recovered through higher airport charges through the per passenger correction factor in the Price Control Condition in the licence. Above £10 million per year: Capitalised and rolled into HAL's existing RAB. These must be transparently identified and separately reported in the regulatory accounts. HAL should be able to earn the WACC on any Category B costs that are added to the RAB from the date that they are incurred.	Risk sharing Category B costs above £10 million per year subject to a risk sharing mechanism. The risk sharing factors will be 105/85 based on the success or failure of the DCO. If HAL is successful with its DCO application it would recover 105% of its efficient costs. If unsuccessful it will recover only 85% of its efficient costs.	Reporting and IPCR Costs are reported annually and subject to review and scrutiny by the CAA appointed IPCR which will scrutinise and advise the CAA on the inclusion of Category B costs in the RAB. <i>Note: the CAA will make the final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.</i>
Above £265 million (2014 prices) The CAA may conduct a review of our policy for the recovery of costs, depending on: - the expected materiality of any Category B costs over £265 million (2014 prices); and - any emerging evidence on the efficiency of these costs.	The level of the WACC will be the same as that level determined for the price control settlement in force from time to time (currently 5.35%). The WACC will also be applied to the Category B costs in the RAB irrespective of whether the DCO is successful or not (para 2.24 of CAP1513).	Unilateral Withdrawal If HAL withdraws from the planning process the CAA can use its discretion to reduce recovery below the 85% threshold only in certain limited circumstances where there was compelling evidence that HAL had unilaterally withdrawn from the planning process. <i>We would not expect to reduce recovery below 85% where HAL could demonstrate that it used all reasonable endeavours to continue with the capacity expansion programme.</i>	Governance protocol The Planning Cost Recovery Policy Statement specified that HAL should develop a governance protocol. HAL developed and agreed this protocol with the airline community and finalised it in September 2018 in line with the procedures set out in the Planning Cost Recovery Policy Statement.
	Recovery Period Category B planning costs should be recovered after the outcome of the DCO is known, with the profile of regulatory depreciation taking account of our broader approach to affordability and financeability.		

- 1.8 The Planning Cost Recovery Statement also explained that HAL should make available the materials and reports produced for the planning process to the airline community and other stakeholders as soon as practicable and consult the airline community on the rules and principles for the release of confidential information. In the context of the aspirations of the Arora Group and Heathrow West to submit its own DCO application, we have subsequently clarified that HAL should not be required to release information on aspects of its designs or plans that would distort competition or rivalry with Heathrow West (such as the detail of terminal design) but should provide information that is essential for Arora to be able to proceed with its DCO application or where providing information would avoid the substantial duplication of costs that might be recovered from consumers.

Category B cost escalation

- 1.9 Since we published the Planning Cost Recovery Policy Statement, there has been a very significant escalation in the overall level of Category B costs that HAL expects to incur. HAL's most recent Category B cost estimate, made in December 2018, includes a total spend of over £500 million, significantly more than its original £265 million estimate.
- 1.10 As noted above, the CAA's decision on whether to conduct any review of our existing policy, and the scope of any review, will have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of spending.¹⁶

¹⁶ We define efficiency on page 11, paragraph 3.9 of the Budget Guidance as follows:

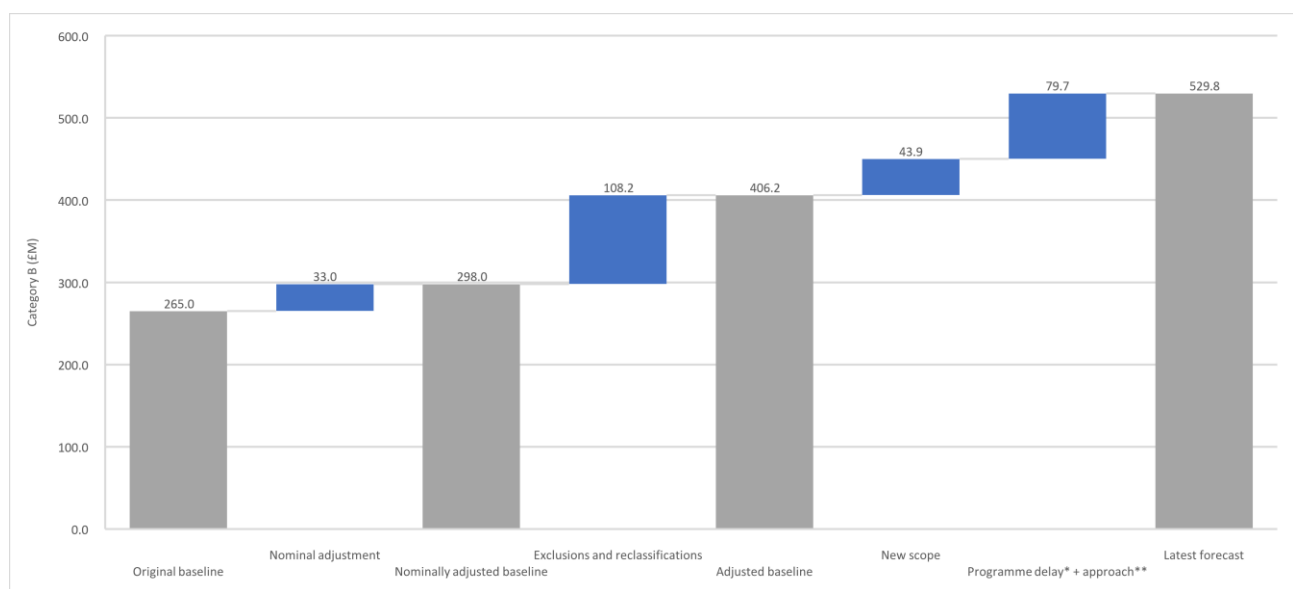
"Efficiency is not necessarily about achieving the lowest cost; rather it is about delivering the right outcomes and making informed and robust decisions on scope, cost, time and risk. In this context, costs are considered to be efficiently incurred when:

- i. The programme which they are attributable to has been set up to succeed in the early planning stages;
- ii. Performance and progress are meaningfully measured to enable management intervention; and
- iii. An environment is created which proactively identifies opportunities to improve."

1.11 We understand the main driver of the cost increase to be related to HAL not having developed a sufficiently mature understanding of the scope of work necessary to support the relatively complex planning process when it made its original Category B cost estimate. As shown in Figure 3, based on HAL's presentation to the airport/airline Cost and Benefit Working Group in December 2018, HAL has explained the changes in its estimates of costs in the following terms:

- the cost of new scope not established at the time of the original estimate, for example additional consenting activity, including an additional consultation, increased geographical spread requiring more ground investigation works and improved understanding of stakeholder requirements;
- costs classified as early Category C at the time of the original estimate which have since been reclassified as Category B, such as ground investigations, land referencing and certain staff costs; and
- cost items relating to the original scope but excluded from the original estimate, such as additional operating costs, airspace design costs and the costs of dealing with consultation responses.

Figure 3: Category B costs movement from original estimate



Source: HAL, Based on Cost and Benefit Working Group presentation, December 2018

* These delays relate to the 2017 General Election and Aviation National Policy Statement

** This change in approach refers to top-down verses bottom-up

- 1.12 The IPCR has reviewed HAL's Category B costs for 2016 and 2017 (as discussed further in Appendix B) with a view to ensuring that costs have been correctly classified as Category B costs and not double counted in terms of costs already allowed for in HAL's main price control. The IPCR has also considered whether there was a clear and consistent baseline, whether established and appropriate governance processes were in place, whether progress and performance was clearly and consistently reported and whether information provided was relevant, complete and timely.
- 1.13 In each of these areas, the IPCR review highlighted concerns. Stakeholders have also said that this work was not sufficiently wide ranging and there could have been greater focus on whether costs were necessary and represented value for money. Nonetheless, it is also important to bear in mind that HAL was at the start of the planning process in 2016 and 2017 and needed to create momentum to help secure timely delivery and develop an engagement process with airlines that would allow for the exploration of a full range of options.
- 1.14 At the end of May 2019, HAL shared with us a report prepared for it by consultants, Steer. HAL had asked Steer to consider whether the December 2018 (nominal) £530 million Category B cost estimate is "reasonable" and "justified" and consistent with that which might be expected for a project of this scale and complexity.
- 1.15 Steer's approach was to use a combination of:
- "top down" benchmarking, drawing on a range of other large UK infrastructure projects which have either been through, or are going through, the DCO process; and
 - a "bottom up" assessment of whether the types and levels of costs included in the estimate seem appropriate.
- 1.16 While we understand that HAL has shared the Steer report with airline stakeholders, it should publish this report so that all stakeholders can comment on the robustness of the evidence on efficiency.
- 1.17 In summary, there is only limited evidence on the efficiency of HAL's Category B costs and we have observed the near doubling of HAL's estimates of these costs.

These factors strongly suggest that it is appropriate for us to carry out a review of our existing policy in respect Category B costs.

Future treatment of Category B costs

1.18 Overall, we consider that our main policy aim should remain one of ensuring that HAL is able to recover only those Category B costs which:

- fall within the definition of Category B costs which we have developed (including seeking to ensure that there is no double counting of other activities that HAL would be undertaking absent expansion);
- have been efficiently incurred; and
- are consistent with the regulatory incentive arrangements for these costs.

1.19 The cost escalation which we have observed suggests that greater reliance on regulatory incentives for cost efficiency as part of our future Category B policy would be desirable. However, for planning costs there are substantial difficulties in developing effective incentives, including how to:

- benchmark planning costs (due to the limited number of genuinely comparable projects);
- identify and measure the efficiency of spending by reference to deliverables arising from that spending (even though much Category B spending will contribute indirectly to the likelihood of a successful DCO application); and
- avoid creating unintended and adverse consequences: for example, a gain sharing mechanism to encourage efficiency could unintentionally reward HAL for simply reallocating costs.

1.20 Bearing the above in mind, we propose to develop a revised Category B cost policy that focuses on strengthening the existing governance arrangements and, where it is proportionate and reasonable to do so, strengthening the existing regulatory incentives. Our proposals in relation to these matters are described below and summarised in Figure 4.

Strengthening existing governance arrangements

1.21 Stronger and more robust governance of Category B costs is a high priority if these costs are to be correctly allocated and efficiently incurred. HAL should be able to:

- show that it has a good understanding of these costs by clearly and transparently identifying costs, cost drivers and deliverables;
- anticipate and budget for these costs transparently and robustly;
- identify and quantify any risks to meeting its budget and deploy appropriate risk management strategies to minimise any unnecessary cost increases;
- provide evidence that it is incurring costs efficiently; and
- engage regularly with stakeholders on all of the above.

1.22 HAL's approach to governance in 2016 and 2017 did not meet the above objectives and requirements although, as we have noted above, HAL was starting a difficult programme and it is expected that governance arrangements will evolve and improve over time. More recently, HAL has started to improve its approach to governance and has provided greater transparency of its cost estimates. Nonetheless, it needs to make substantial further progress on these matters if it is to win the confidence of stakeholders.

1.23 Our proposed approach to the future governance of Category B costs has three main elements:

- i) strengthening reporting requirements: HAL will be required to commit to a governance process that delivers the objectives set out in paragraph 1.21 above. At this stage our intention is that this will also include sharing with us and the airlines, at quarterly intervals¹⁷, an updated forecast for Category B costs including (a) actual spending to date; and (b) the amount it expects to spend on a month by month basis until the DCO process is complete. We will discuss

¹⁷ We understand that quarterly reporting was established by Ofwat in relation to 'development costs' (which are broadly analogous to Category B costs) incurred by Thames Water on the Thames Tideway Tunnel.

further the detail of these arrangements with HAL and airlines to ensure that the final arrangements are proportionate and robust.

We expect HAL to accompany its forecasts with a detailed commentary which describes what costs are included on a month by month basis, what are the expected deliverables and outputs associated with this spending, and how the cost categories are consistent with our definition of Category B costs and to identify what risks exist to meeting this budget and how HAL intends to mitigate these risks.

- ii) establishing recovery cap: the CAA will establish a new recovery cap by assessing HAL's overall revised budget (currently about £500 million) for reasonableness (including building on the findings of HAL's Steer report and other evidence including the findings of the IFS and IPCR reviews). At regular intervals and at the same time as it updates its Category B budget, HAL should explicitly consider and report on whether it is likely to breach this recovery cap. If it considers that a breach is likely, it will need to seek stakeholder approval for spending in excess of the cap through its existing approach to engaging stakeholders as specified in its governance protocol with disputes being determined by the CAA. Unless airlines agree to the spending proposed by HAL, or, in the event of a dispute, the CAA considers that such spending is appropriate, no costs above the new recovery cap will be recoverable.
- iii) increasing cost scrutiny: we aim to improve our scrutiny of Category B costs, although we recognise that in a new and relatively novel programme such as capacity expansion this assessment remains relatively difficult. We will do this through (a) our approach to setting the recovery cap discussed above, (b) and through the work of the IPCR in continuing to scrutinise Category B costs and making recommendations to CAA as to whether they both fall within the definition of Category B costs and are reasonably efficient. We will consider further whether these scrutiny arrangements could reasonably be strengthened and/or whether there is further work we could reasonably complete on the efficiency of Category B costs.

Strengthening existing regulatory incentives

- 1.24 Regulatory incentives have the potential to play an important role in ensuring that HAL only seeks to incur costs on an efficient basis. Targeted and effective incentives should seek to reward HAL for efficiency and penalise it for inefficiency, while avoiding incentives for perverse or inefficient behaviour.
- 1.25 In the light of the recent escalation of HAL's costs estimates and the limited evidence as to the efficiency of these costs, it is appropriate to review the incentive arrangements for these costs to make sure that consumers interests are properly protected and that HAL can continue to recover its efficiently incurred costs.
- 1.26 Since our policy was established in February 2017, further information has emerged both on the overall level of Category B costs and on HAL's cost of capital. We consider the implications of this additional information below for the incentive arrangements that should apply to HAL's Category B planning costs.
- i) Recovery mechanism:
- a. The existing regulatory arrangements roll forward those Category B costs that are to be capitalised and added to HAL's RAB at the cost of capital associated with the price arrangements that are currently in force. This means that for costs incurred in 2016 to 2018 costs will have been allowed a return at the Q6 price control real cost of capital of 5.35%. As noted above, since the publication of the February 2017 policy statement that set out this approach further information is available both on the level of Category B costs and HAL's cost of capital. The CAA is also developing further analysis to inform the estimate of the cost of capital for the period of capacity expansion.
 - b. Given that the increase in HAL's estimates of Category B costs has triggered our review of the regulatory treatment of these costs, it is appropriate to take account of this new information on the cost of capital. Nonetheless, it is also important to maintain the stability of the regulatory framework and not to act retrospectively, as this might increase uncertainty and raise HAL's cost of finance. This suggests

allowing a 5.35% real return on Category B costs for the period 2016 to 2019 (for costs up to a maximum of £265m), but reconsidering the cost of capital for spending above this level and for the period 2020 to 2021 (i.e. the point in time when we anticipate that the position becomes clear on planning consent). Once added to the RAB, these costs will be treated consistently with the other items in HAL's RAB and in due course remunerated at the same cost of capital as used to set HAL's next main price control.

- c. There are arguments in favour of retaining a real cost of capital of 5.35% for the period 2020 and 2021. It would promote regulatory stability and reflect a relatively high level of return that might compensate for risks associated with capacity expansion. Another approach would be to apply the cost of capital we develop for the next main H7 price control review. The arguments for this approach would be strongest if the risks associated with the Category B expenditure were similar to those for costs that will be incurred after the grant of the DCO. This approach could also avoid setting multiple different costs of capital. However, using a cost of capital that has not yet been calculated, and would not be confirmed until 2021, would reduce transparency and could increase uncertainty as well as arguably having an element of retrospectivity. It is also important to note that if the DCO was not granted, the CAA may not set a cost of capital that corresponded to the period covering expansion.
- d. On the other hand, we are not setting full efficiency incentives that would involve a target level and automatic cost sharing incentives around this target for Category B planning.¹⁸ This means that, in practice, the risks for the period 2020 to 2021 may be more like those of HAL's "business as usual activities" rather than the period of capacity expansion. While there are additional risks linked to the possibility that HAL not be granted DCO consent, these are dealt with below under the discussion of the incentive gain share mechanism.

¹⁸ The difficulties of this approach are noted above at paragraph 1.19.

Bearing this in mind, another option for allowing for financing costs over 2020 and 2021 would be to use a cost of capital that is consistent with our estimates of the financing costs for HAL's business as usual activities. For instance, a mid-point from the range of 3.2% to 4.2%¹⁹ based on PwC's February 2019 cost of capital report²⁰ (which we have uplifted to account for 17% rate of corporation tax and using embedded debt costs of 1.8% as proposed in PwC's December 2017 report²¹) would be 3.7%. Using 1.2% for embedded debt costs would give a real cost of capital of 3.4%. This reflects the more recent estimate which we have available and is broadly consistent with our approach to estimating the WACC for NERL and included in our February 2019 Draft Reference Period 3 ("RP3") performance plan proposals for the regulation of NATS (En Route) plc;²². We welcome views on the approach to the estimate of the cost of capital.

- e. We will finalise our estimate of the cost of capital to use for the roll forward of HAL's Category B costs for the period up to the government's decision on its DCO application in September or October 2019, following consideration of responses to this consultation.
- f. If HAL were to propose spending beyond the new recovery cap (as discussed in the governance section above) and airlines were to agree, or in the event of a dispute the CAA were to consider that such spending is appropriate, this could be financed at our estimate of HAL's current cost of debt. In its December 2017 report, PwC estimated HAL's current real cost of debt in the range of 1.7% to 1.8%

¹⁹ This does not include the impact of expansion, which we are considering for the cost of capital in H7. If this broad proposal is accepted, then we would seek to specify an exact figure within this range.

²⁰ See PwC report which report presents an updated WACC estimate for HAL in the 'as-is' case for the H7 price control, [Estimating the Cost of Capital for H7 - response to stakeholder views](#)

²¹ We recognise PwC estimated a lower RPI-deflated embedded cost of debt of 1.2% in its February 2019 report. HAL has responded that it considers PwC has understated its embedded cost of debt. The CAA will be considering PwC's approach and HAL's response during 2019, and at this stage we have taken the conservative approach of using the higher 1.8% cost of embedded debt from PwC's December 2017 report.

²² See Paragraphs 71.6 to 7.21 of Draft Reference Period 3 performance plan proposals, '[Draft RP3 proposals](#)'