

Recovery of costs associated with obtaining planning permission for new runway capacity: policy update

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Contents

Contents	3
Summary	4
Existing CAA policy on Category B costs	7
Eligible costs	9
Recovery mechanism for eligible costs	11
Promoting efficiency	13
Risk-sharing arrangements	15
Next steps	17

Chapter 1

Summary

- 1.1 This policy update¹ concerns the regulatory treatment of the costs associated with Heathrow Airport Limited (HAL) or Gatwick Airport Limited (GAL) obtaining planning permission, subject to the Government making a decision on the location for new runway capacity in the south-east of England. Specifically it concerns the arrangements for how these costs could be recovered from the charges the airport operators levy on users.

Background

- 1.2 The Government in December 2015 confirmed that:
- it agreed with the Airports Commission that the south-east needs more runway capacity by 2030;
 - it agreed with the Airports Commission's shortlist of three options² all of which it concluded were viable; and
 - the location decision for new runway capacity would be subject to further consideration on environmental impacts and the best possible mitigation measures. The Government indicated that this package of further work was expected to conclude over the summer of 2016.

The reasons why regulatory clarity is required

- 1.3 Provided that the Government also makes a location decision over the summer of 2016, the CAA expects that the chosen airport operator will immediately begin work on securing planning permission for constructing and opening the new runway capacity.
- 1.4 The task of securing planning permission is a sizeable and complex task. The airport operator may incur a significant amount of expenditure many years before construction starts. At this stage, the magnitude of planning costs is not

¹ This document provides a further update on our policy updates on new runway capacity issued in [March 2015](#) and [September 2015](#).

² Two at Heathrow and one at Gatwick.

known but, as a guide, could exceed £50 million per annum and take several years.

- 1.5 Clarity on the regulatory treatment of costs associated with planning (termed Category B costs³) will reduce uncertainty faced by the airport operator and its investors and encourage investment to proceed in a timely way. It will also reduce uncertainty faced by airlines in terms of how this category of costs might affect the airport charges they will pay. We consider that developing a clear framework for the treatment of these costs, in advance of developing a broader framework for the treatment of constriction costs, will further the interests of current and future users.
- 1.6 We consider that the Government's confirmation that new capacity is needed means that it is prudent at this time to invite contributions from the airport operators, their airline communities, and other interested parties, on the most appropriate arrangements for the recovery of these costs.

The process

- 1.7 As previously indicated in our September 2015 policy document, we consider that the airport operator and its airline customers should, in the first instance, look to agree appropriate risk-sharing agreements around the recovery of Category B costs. Allowing space for these commercial discussions could result in innovative solutions being developed that can be beneficial for users.
- 1.8 We suggest an initial 3-month window is given aside for these discussions. We strongly encourage both the airport operators and airlines to approach these discussions actively and in good faith with the aim of trying to seek agreement within the timeframe.
- 1.9 To aid this process, this document sets out some guidance on the type of issues that we would expect to be covered by these commercial discussions. For example, the definition of Category B costs; the mechanisms to secure that any expenditure is efficiently incurred; the way in which the costs should be recovered from airport charges; and how cancellation risk should be treated.
- 1.10 If we reach a view that the prospects of constructive discussions taking place, or continuing, are poor we would expect to engage directly with stakeholders with a view to developing our policy position for publication at that time. In particular, we would publish a consultation around May 2016 on our proposed treatment of Category B costs, including with respect to risk-sharing arrangements.

³ See Chapter 2 for definitions of Category A, B and C costs.

- 1.11 Following the consultation, and having assessed the evidence provided to us in response, we will publish our decision on Category B costs in the autumn of 2016 and propose to make a licence modification as appropriate.
- 1.12 In terms of the wider regulatory framework and the treatment of construction costs, we plan to publish a consultation on new runway capacity after a Government location decision. This will build on the principles-based policy we set out in March 2015 and set out the key issues we see as relevant for establishing the appropriate regulatory framework and the timetable over which we expect to move to a firm policy position.

CAA contact

- 1.13 If you would like to discuss any aspect of this document please contact Stephen Gifford (stephen.gifford@caa.co.uk).

Chapter 2

Existing CAA policy on Category B costs

- 2.1 In our March 2015 and September 2015 documents we distinguished three categories of expenditure related to new runway capacity:
- 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 the location of capacity expansion is made;
 - Category B costs: 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 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.
- 2.2 We set out two principles in relation to Category B:
- first, that we see planning as a cost that users can reasonably be expected to carry in full or in part; and
 - second, that the airport operator and their airline customers should, in the first instance, look to agree risk-sharing agreements for Category B costs dealing with the associated risks where planning approval is not successful.
- 2.3 We also defined two categories for the recovery of Category B costs:
- costs up to £10 million per annum will be automatically recoverable by an airport operator; and
 - costs over £10 million per annum may be recovered by an airport operator, subject to them being efficient and there being risk-sharing arrangements in place. Risk-sharing agreements may cover, for example, the risk that

planning costs are larger than expected and the risk that planning permission is not granted.

- 2.4 In the event that the Government supports a new runway at Gatwick, GAL's commitments in its licence already permit it to recover planning costs of up to £10 million incurred in any one charging year. If Heathrow is selected, then Category B expenditure up to £10 million per annum will also be allowed to be automatically added to annual charges during the Q6 period. The approach or formula by which this can occur will need to be developed and a licence modification process undertaken.
- 2.5 The £10 million per annum threshold that we have set is not a cap but it is intentionally lower than the amount we expect to be incurred by an airport operator in order to create a strong incentive for it to reach an agreement with its airlines on risk-sharing. Should agreement not be possible, and the CAA needs to make a policy statement itself, we said we would be guided by principles such as:
- the party best placed to manage each risk should manage the associated costs;
 - a sufficient level of risk needs to be allocated to each party to ensure sufficient engagement in, and ongoing support for, the project; and
 - risk-sharing arrangements should be as comprehensive as possible.
- 2.6 Any risk-sharing agreement will also need to bear in mind the CAA's overall objective to develop an effective, fair and proportionate regulatory approach to safeguard the interests of users of air transport services.

Chapter 3

Eligible costs

Definition of eligible costs

- 3.1 There must be a clear definition and scope of the eligible costs for inclusion as Category B costs. The costs of securing planning permission will typically include spending on:⁴
- planning consultants;
 - master planning;
 - legal advice; and
 - environmental audits.
- 3.2 It might also be sensible to include blight compensation measures within the definition of Category B as these costs are closely aligned to the planning process.
- 3.3 Eligible costs need to be itemised in detail with their links to the planning application clearly evidenced. They must also be efficient (see Chapter 5).

Costs incurred before a Government decision on location (Category A costs)

- 3.4 Category A costs relate to Airports Commission-related and associated lobbying costs incurred by an airport operator or HHL. These are costs that we consider will, in general, be incurred before a Government policy decision on capacity expansion is made. In other words, although the Airports Commission process has concluded, the Government has not yet made a decision on the location of new runway capacity. Any costs currently being incurred by airport operators are therefore, defined as Category A costs.
- 3.5 The recovery of *most* Category A costs will not be permitted. We do not consider that lobbying costs (including publicity costs) to influence Government policy are part of the costs of constructing new capacity, nor are they part of the

⁴ The definition cannot include costs that have been allowed for in the airport operators' current regulatory price limits.

planning process. We consider that these costs should be borne by the relevant airport operator. We understand that the airport operators were expecting the Category A costs to cease with a Government decision in December 2015, but this position will now continue until at least summer 2016. We will not be changing our policy for Category A costs, as if we allowed Category A costs to now be recovered across both airports for three short-listed schemes, users would be bearing duplicated costs and there would be less incentive to keep these costs manageable.

Construction (Category C) costs incurred after a Government decision but before planning permission is secured

- 3.6 Whilst the bulk of construction costs (Category C) will not be incurred until after planning permission is given, there may be some small but significant expenditure on preliminary works or enabling construction (e.g. specific property relocations). Category C expenditure that must be incurred before planning permission is given could therefore be brought within the scope of our autumn policy statement if an interested party can make a strong and detailed case that doing so would be in users' interests. Any recovery of costs such as land acquisition costs would need a mechanism to determine the net costs faced by the airport operator.

Chapter 4

Recovery mechanism for eligible costs

- 4.1 There needs to be a clear way of recovering eligible Category B costs from airport charges to users. Two broad potential options are set out below, although there may be other methods. We would be interested in proposals that stakeholders may have in this regard, particularly in relation to the contracts and commitments regime at Gatwick.

Capitalisation/slow money

- 4.2 The airport operators and airlines could adopt the current capital expenditure (capex) governance mechanisms at Heathrow or similar at Gatwick. Under this approach, Category B costs would be treated as capex and added to the Regulatory Asset Base (RAB) for Heathrow or through modifying the CAA's view of the fair price for Gatwick. The airport operator would be remunerated through airport charges over a time period consistent with the depreciation period adopted. This airport operator would earn an allowed return on this expenditure.
- 4.3 As an illustrative example, a capitalisation of £160 million (£40 million a year for four years) in real terms would result in an increase in airport charges in the first year of recovery of about 16 pence per passenger per Heathrow and would be equivalent to 36 pence at Gatwick.⁵ This is equivalent to a 0.7% increase in average airport charges at Heathrow and 3.8% at Gatwick.

Pay as you go/fast money

- 4.4 Eligible costs could be treated in the same way as operating expenditure (opex) and recovered through a specific addition to airport charges over the next few years. This could be done by allowing the airport operator to pass through these costs via a levy in addition to the maximum allowable yield specified in its price control licence condition in the case of Heathrow or through modifying the CAA's view of the fair price in the case of Gatwick. The costs would be recovered at a much faster rate than under the capitalisation approach.
- 4.5 As an illustrative example, a recovery of say £40 million of eligible costs in one year is the equivalent to about 54 pence per passenger at Heathrow and £1.18

⁵ Assuming a weighted average cost of capital of 5.35% in real terms, a depreciation period of 50 years (straight line), 74 million passengers per year for Heathrow and 34 million passengers for Gatwick.

at Gatwick.⁶ This is equivalent to a 2.4% increase in average airport charges at Heathrow and 12.4% at Gatwick

- 4.6 The airport operator would not receive a return on this expenditure as it would be treated as a revenue item. At the end of the planning process, airport charges would be less than they would otherwise be, as no further Category B costs would be incurred.

⁶ Assuming the same passengers numbers as above.

Chapter 5

Promoting efficiency

- 5.1 We are keen to ensure that there is an appropriate and proportionate mechanism in place to encourage efficient expenditure by the chosen airport operator, without introducing unnecessary delay into the timetable. Specifically this mechanism would relate to expenditure in excess of the £10 million per year threshold. Five broad options are discussed below. They are not mutually exclusive and we would welcome views on these and potential alternatives.

Use of an Independent Fund Surveyor

- 5.2 At Heathrow, an Independent Fund Surveyor (IFS), jointly commissioned by HAL and the airline community, has been set up to offer advice on capital planning and efficiency. A similar arrangement could be deployed on assessing Category B cost efficiency. The IFS could undertake periodic (3, 6, or 12-month reports) or take an active role in scrutinising Category B costs in real time and decide on whether efficiency criteria have been met.

'Two-tier' capex budget

- 5.3 Under this method, expenditure would be defined as 'core' or 'development'. Each quarter/year on successful completion of a Gateway type review or similar governance process the expenditure would move into the 'core' programme and be eligible as recoverable costs.

Establishing a fixed budget before money is spent

- 5.4 The CAA could work with the airport operator and airlines with a view to establish a reasonable estimate of eligible costs and then fix this amount for the planning period. In effect this would raise the £10 million per year threshold but turn it into a firm limit. A risk-sharing mechanism for cost over-runs/under-spends could be introduced.

Efficiency reviews after money is spent

- 5.5 Under this approach the CAA would undertake a proportionate review after the costs have been incurred with a view to reaching a judgement on whether the expenditure was efficient.

Annual or multi-year budgets

- 5.6 An issue to consider is whether the budget should be an annual or multi-year budget. A multi-period budget would allow flexibility across different years regardless of which year the expenditure is incurred.

Chapter 6

Risk-sharing arrangements

6.1 We need to consider the treatment of Category B costs already incurred by the airport operator in the event that the new runway expansion does *not* proceed (after the Government location decision) to planning approval. As indicated in our March 2015 publication, our policy objective is to 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.⁷

6.2 There are at least three different scenarios that might be considered. In each of these scenarios where the runway project does not proceed, Category B costs already incurred may need to be written off. Any risk-sharing allocation would probably need to specify the proportion of costs (say X%) which would be passed to airlines and the proportion (say 1-X%) covered by the airport operator/shareholders.

Scenario 1 - Planning permission is not granted or is later rescinded or lapses, due to factors outside of the airport operator's control, such as unforeseen difficulties in the planning process, severe worsening economic prospects or other significant incidents that cause traffic to collapse.

6.3 Under scenario 1, where the failure to obtain/loss of planning consent happens due to factors outside of the airport operator's control, there may be a strong case for the majority if not all charges to be recovered from users, as the airport operator will have entered into the planning process in good faith. That said, the ability to recover these costs could be undermined if the reason for the project not proceeding was a collapse in traffic.

Scenario 2 - Planning permission is not granted or rescinded, as a direct result of action by the airport operator or the airport operator is deemed the responsible party.

6.4 Under scenario 2, where the airport operator is found responsible by the CAA for the runway not proceeding, then it might be reasonable for the airport operator to bear the cost risk. This would also help to safeguard users' interests by

⁷ Equally we may need to think about an appropriate and commensurate level of reward for the airport operator if we are expecting it to bear a significant share of sunk cost risk.

ensuring that users will not be required to bear all of the risk if the airport operator unilaterally makes a decision not to proceed with capacity expansion.

Scenario 3 - Government changes its policy on new runway capacity or wider Government policy changes undermine the business case.

- 6.5 Scenario 3 could be outside the control of either the airport operator or airlines and revolves around Government political and policy risk. In our March 2015 document, we outlined that this is an area where Government has a role to play in managing this risk. On the other hand, it might be argued that in this scenario the airport operator and airlines also have a role to play by doing everything they can to reassure local communities and Government about the case for runway expansion. The CAA is interested in views on how this risk should be addressed when it comes to the regulatory treatment of costs incurred before any change of Government policy.

Chapter 7

Next steps

- 7.1 Over the next 3 months, we are looking to the airport operators and airlines to deepen their discussions on risk-sharing arrangements. We understand that HAL and GAL have already had some preliminary engagement with airlines on these issues. We strongly encourage both the airport operators and airlines to approach these discussions actively and in good faith with the aim of trying to seek agreement within this timeframe.
- 7.2 If no (or limited) progress has been made on risk-sharing arrangements by early April 2016, (or, indeed, earlier, if it is clear from what stakeholders are telling us that progress cannot and will not be made), then we will request that feedback, information and updates from the airport operators and airlines is provided to the CAA on the progress made. It may be that agreement has been reached on some elements of the policy, but it has not been possible to reach a comprehensive agreement. This information should be sent by 29 April 2016 to economicregulation@caa.co.uk.
- 7.3 We would then publish a consultation in May 2016 on the proposed treatment of Category B costs, including with respect to risk-sharing arrangements. Following the consultation, we will publish our decision on Category B costs and are aiming to do this in the autumn of 2016.
- 7.4 Our timetable assumes a clear and unambiguous Government decision in favour of a new runway capacity at a specific location has been made before we publish our decision. Any decision made could be back dated to allow for recovery of any Category B costs already incurred.