



In Focus

What is the CAA's economic regulation role in new airport capacity?

October 2016

On 25 October, the Government announced its proposal to allow additional runway capacity to be developed at Heathrow Airport, subject to a consultation and going through parliamentary process. Here we explain the CAA's role in the process going forwards.

The CAA is the UK's independent aviation regulator, with responsibility for economic regulation, airspace policy, safety regulation and consumer protection.

We will lead the economic regulation of new airport capacity. We understand the vital importance of our role and will, along with others, aim to ensure that the airport delivers any new runway in an economic, efficient and timely manner.

Our duties are set out in the Civil Aviation Act 2012 (the "Act"). Our primary duty is to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services. Passengers and air cargo owners are therefore at the heart of our decisions.

The role of economic regulation

Under the Act, in 2014 we granted Heathrow Airport Ltd (Heathrow) a licence which allows them to levy charges for their services up to certain limits and subject to service quality standards, also set by us. We have strong powers to compel compliance with the licence through enforcement orders and to exact penalties for breaches. The principal purpose of this economic regulation is to protect consumers from the adverse effects of companies with substantial market power.

The legislation defining the breadth of our powers and responsibilities is similar to that governing other UK independent economic regulators. Over the past 30 years, independent economic regulation has provided a stable and consistent framework which has encouraged new businesses to enter markets, compete and invest billions of pounds in new infrastructure. This has encouraged Heathrow to invest around £11 billion in infrastructure projects since 2003/4, improving the quality of service and facilities offered to passengers.

The CAA's economic regulation of new airport capacity

We currently set a price cap on Heathrow's airport charges under a traditional Regulatory Asset Base (RAB) model on a 5-year cycle. Broadly speaking, the cap on airport charges is calculated with reference to the amount of investment, an estimated fair return on that investment (based on the risks involved) and the level of efficiently incurred operating expenses. A single till approach is used, where the commercial and other revenues are then deducted from the total revenue requirement.

With a new runway under design and construction, we will continue to regulate the existing operations at the airport. This will be done through periodic reviews of its licence, monitoring the effective operation of the airport, as well as regulating the costs and delivery of the new runway.

Any new runway will be privately financed by the airport's investors and paid for by airlines through airport charges which then has a knock-on impact on the ticket prices of consumers flying with those airlines. As with our work on existing operations, we will regulate the construction of the new runway in the interest of passengers and cargo owners and in accordance with all our statutory duties. We will expect Heathrow and the airlines operating at the airport to encourage productive engagement and discussions which support the ongoing development of the scheme.

The nature of this project, however, is unprecedented in terms of its economic regulation. The expansion of Heathrow will be a global first: no other major airport expansion of such scale and complexity has been financed by private capital. We are giving very careful consideration to how we will regulate the airport to ensure that the new runway is delivered efficiently, with regard to both financing and construction costs.



Scrutiny of the cost and design of new airport capacity

Expansion must deliver good value for money for the consumers who will pay for it and we note the aim of Government to see airport charges at Heathrow maintained as close as possible to their current level.

It is therefore crucial that the aviation community scrutinise the design of the runway, to help us ensure that it is cost efficient. In the normal course of Heathrow's 5-year regulatory cycle, we undertake a process called constructive engagement, where we harness the unique and strong position of the airlines to help drive efficient airport design and delivery. In the period following the Government announcement, we will facilitate intensive discussions between the airport and airlines on the cost and design of the scheme.

Consultation(s) on economic regulation

We have already published a number of policy documents identifying distinct categories of cost and broad principles for how Heathrow can recover its planning and construction costs. Our current plans are to publish a series of consultation documents through 2017 in which we will seek to build and expand on our regulatory principles.

We recognise the need for certainty and progress, but we must be diligent in our approach. We recently ran an initial consultation on the regulatory treatment of planning costs. We intend to publish our final proposals in November 2016. This will reduce the uncertainty faced by Heathrow and its investors and encourage investment to proceed in a timely way. Securing planning permission is a sizeable and complex task, and Heathrow is likely to incur a significant amount of expenditure years before additional capacity becomes operational.

Subsequent consultations will set out our views on other elements of the economic regulation framework, including:

- the overall timetable for the regulatory process;
- the long-term nature of capacity expansion and any implications for the length and structure of the regulatory price control cycle;
- risk allocation and the implications for the allowed return on capital;
- views on pre-funding;
- the treatment of surface access costs; and
- compensation to local communities (e.g. in relation to noise and blight).

Many of our decisions on these issues will require changes to the licence when implemented. These changes are subject to appeal, permitting Heathrow and the airlines an opportunity to challenge our decision making within the framework.

The settlement for expansion will be subject to equal rights of appeal from airlines and the airport. We will therefore fulfil our obligation to act in a balanced way and be scrutinised accordingly.

This document focusses on the economic regulation of new capacity. We will also publish further information on airspace and environmental factors in which we have a role to play.

