

The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: final proposals

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.

Final proposals

- 3.12 We propose to define the date of the Government policy decision on the location of new runway capacity as 25 October 2016. This determines the main boundary between Category A and Category B costs.
- 3.13 Category B costs are capacity expansion costs that are, in general, incurred by HAL after a Government policy decision on the location of new capacity (25 October 2016) and are associated with seeking planning permission. Categories of Category B costs include:
- planning advice and consultants for master planning;
 - environmental and sustainability advisory and consultancy;
 - legal and professional advice;
 - architectural, structural and engineering design;
 - surveys on land, surface access and the environmental;
 - public consultations for the DCO processes;
 - preparation of material for the Government's NPS; and
 - costs incurred by the IFS.
- 3.14 The list above is not exhaustive and, at this stage, should be used as guidance.
- 3.15 A governance group comprised of HAL, the airline representatives and the IFS should be set up to monitor spend on Category B costs. The IFS will take views from airlines and HAL and advise the CAA on a quarterly basis on whether we should consider any spend to be inefficient.
- 3.16 The CAA will make the final decision on whether any costs should not be treated as Category B or classed as inefficient in the same way as we judge the efficiency of construction spend for capex projects undertaken in Q6.

Definition of Category A and C costs

- 3.17 Our final proposals on Category A costs remains the same as our initial proposals and our March 2015 policy.⁸ We have said in our initial proposals that most Category A costs will not be recoverable, but some costs could be re-categorised as Category B if a strong and clear case is made by HAL that the information submitted for the planning process is not materially different to that submitted to the Airports Commission. Given that the design has already changed somewhat to the scheme prepared for the Airports Commission and is expected to change further in the coming months as a result of airport-airline engagement, we do not expect any Category A costs to be reclassified as Category B costs and it would be on a very exceptional basis for us to do so. Stakeholder views and our response is outlined in Appendix B.
- 3.18 We continue to define Category C costs as construction costs incurred by HAL. We will consider the merits of developing a specific policy on pre-planning construction costs, which would be on an accelerated timetable and before the overall approach to the economic regulation of Category C costs is devised. Pre-planning construction costs cover preliminary works, enabling construction, property relocations, land acquisition, blight and hardship. Stakeholder views and our response is outlined in Appendix B.

⁸ Category A costs are defined as Airports Commission-related and associated lobbying costs incurred by an airport operator or Heathrow Hub Limited. These are costs that we consider will, in general, be incurred before a Government policy decision on the location of capacity expansion is made.

Chapter 4

Recovery mechanism for eligible costs

Recovery of the first £10 million incurred in each year

Initial proposals

- 4.1 We said that Category B costs up to £10 million per year should be automatically recoverable in the year they are expected to be incurred. A similar £10 million threshold had already been included in the licence for GAL as part of the Q6 settlement and we have said since our first consultation in March 2015 that we would propose a similar arrangement for HAL.
- 4.2 We therefore proposed to undertake a licence modification to allow HAL to recover up to £10 million of Category B costs each year if Heathrow was selected as the preferred location for new runway capacity.

Stakeholder responses

- 4.3 GAL supported our proposal that costs up to £10 million per year should be automatically recovered in the year they are expected to be incurred.
- 4.4 HAL considered the rationale for the £10 million threshold was simply that it was already in the GAL licence. HAL did not view the value of the threshold to be particularly well founded, but it would ensure a fast start and, in the round, was a reasonable compromise.
- 4.5 Many responses from airlines and airline industry bodies argued that there should be no pass through of £10 million into airport charges, as this would mean “pre-funding”, and users should only pay for additional capacity when it comes into operation.
- 4.6 LACC/AOC argued that the CAA should re-launch the consultation reflecting an option that does not include any pre-funding of planning costs. It also suggested that further analysis and a series of workshops be

used to evaluate different options. Moreover, it questioned the justification of having the £10 million provision in the GAL licence.

- 4.7 IAG did not consider that any costs should be automatically recoverable, as either operator would re-categorise the costs it thought were least efficient. IAG also argued that there was no obvious reason to align the HAL and GAL licences as there were already differences in economic regulation between the two airports.
- 4.8 VAA argued that the chosen airport was already highly incentivised to work on planning as soon as possible after a decision, and supported our decision not to increase the threshold. However, VAA looked for further clarity on why removing the allowance would not be in line with the promotion of efficiency.
- 4.9 easyJet did not support the £10 million per year allowance, but accepted that it is built into the regulatory settlement.

Our views

- 4.10 Stakeholders stressed the need for all costs (including the £10 million per year) to be justifiable and subject to an efficiency test. We agree with these stakeholders and made this efficiency point in our initial proposals.⁹
- 4.11 Following this feedback, we clarify in our final proposals that the £10 million per year will be subject to confirmation by the IFS that the relevant costs are Category B costs and that they have been efficiently incurred.¹⁰
- 4.12 Stakeholders questioned the 'automatic' recovery of any costs. Our use of the 'automatic' phrase in our initial proposals meant that the recovery did not require any further agreement by either the airlines or the CAA. However, it did not mean that the first £10 million of Category B costs would not need to be subject to an efficiency test.

⁹ [CAP 1435](#). Paragraph 1.13.

¹⁰ If HAL's efficient spend in any one year is less than £10 million, but £10 million has already been passed through into airport charges, then an adjustment would need to be made to airport charges or the RAB in later years.

- 4.13 HAL has confirmed that, in order to comply with the consultation requirements in the Airport Charges Regulations,¹¹ it would recover the £10 million incurred in 2016 and 2017 through the K factor in the Price Control Condition in its Licence and the £10 million incurred in 2018 and 2019 through airport charges in the year in which they were incurred.
- 4.14 We do not consider that the threshold itself will have a detrimental impact on efficiency, as all costs are subject to an efficiency test and, in any case, Category B costs are expected to be significantly higher than £10 million a year.
- 4.15 We do not support LACC/AOC's request to re-launch the consultation and set up a series of workshops. We think it would be a better use of time and resources to now focus on Category C costs, which represent approximately 98% of scheme costs. The CAA commits to an open and engaging process for the consideration of these costs, including workshops.¹²

Final proposals

- 4.16 We propose that up to £10 million per year of 'efficient' Category B costs can be recovered in the form of higher airport charges either in the year they are expected to be incurred, or two years later for 2016 and 2017 through the per passenger correction factor (K_i) in the Price Control Condition in the licence. We are consulting separately on a licence modification to implement this proposal.¹³

¹¹ See www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Competition-policy/Airport-charges-regulations/.

¹² We have now undertaken two consultations (initial and final proposals) on planning costs. We also consulted extensively while developing our policy on the economic regulation of new runway capacity in May 2015 (CAP 1279). Our May 2015 policy encouraged airlines and the airport operator to engage in commercial discussions and in February 2016 we specifically encouraged discussions between HAL/GAL and airlines on the treatment of Category B costs.

¹³ CAA, Notice of proposed modification to Heathrow Airport Limited's Economic Licence to allow for an annual recovery of £10 million of Category B costs for runway expansion, November 2016, available here: www.caa.co.uk/CAP1470.

Capitalisation of costs above £10 million per year and clearly identified in the airport RAB

Initial proposals

- 4.17 We said that Category B costs above £10 million per year should be capitalised and rolled up into a separate pRAB. These Category B costs would not be entirely borne by existing users but spread out over both existing and future users.
- 4.18 We stated that a separate pRAB would allow for a more transparent reporting of the costs of the planning process and allows risk-sharing to be applied to incentivise cost efficiency and to encourage the airport operator to secure planning permission.

Stakeholder responses

- 4.19 GAL supported our proposal that costs above £10 million per year should be capitalised and rolled into a separate pRAB.
- 4.20 HAL agreed that planning costs should be clearly understood from a transparency perspective, but considered a separate pRAB to be overly complex, creating the impression of investments not being included in the RAB and the potential for additional financing costs. HAL suggested a simpler approach would be to keep Category B costs as a line item in the existing RAB.
- 4.21 The LACC/AOC supported the concept of a pRAB, but had major reservations on regarding the CAA's assumption that planning permission can be treated as an asset which attracts cost recovery.
- 4.22 IAG agreed with the concept of a separate account for Category B costs, but disagreed with the proposed treatment, specifically that planning permission was not an asset and the pRAB was therefore not an appropriate mechanism for recovering Category B costs.

Our views

- 4.23 We note the general support for some sort of RAB approach to the recovery of Category B costs, albeit with disagreement from IAG and

concerns from other airlines on the specific recovery assumptions we proposed (which are discussed in other sections).

- 4.24 We are in favour of a RAB approach as the most appropriate mechanism for the recovery of Category B costs as we consider it to be well understood by stakeholders and investors, and also means that future airlines and future passengers who use the airport after the runway opens bear the majority of the burden of Category B costs. The alternative to a RAB approach is to treat Category B costs as operating expenditure and immediately recover these via airport charges. However this will involve an instant and substantial rise in airport charges which we believe is not in the interests of passengers and does not adequately balance the interests of existing and future users.
- 4.25 We accept HAL's argument that a single line item in the existing RAB is more appropriate than the wholly separate pRAB we outlined in our initial proposals. It will avoid the complexity of having two RABs (airport and planning). This revision still allows us to meet our objective of Category B costs being clearly identified and subject to risk-sharing arrangements.

Final proposals

- 4.26 We propose that Category B costs above £10 million should be capitalised and rolled up into HAL's existing RAB. The costs in this RAB will need to be identified clearly and transparently, as they will need separate treatment (depreciation, return etc.) to other capital projects, as well as being subject to a risk-sharing mechanism.

Cost recovery when planning permission is secured

Initial proposals

- 4.27 We said that cost recovery (both the allowed WACC return and depreciation) should only start when the asset (planning permission) comes into use, that is when the result of the planning application is known. Returns earned before this time will be tracked in the RAB, rather than added to airport charges.

Stakeholder responses

- 4.28 GAL agreed with our initial proposal that cost recovery (both the WACC return and depreciation) should start only when the result of the planning application is known.
- 4.29 HAL disagreed with a move to an assets in operation (AIO) approach, arguing that it does not align with how it is currently remunerated and financed. It argued instead for the current assets in the course of construction (AICC) approach.
- 4.30 LACC/AOC argued that recovery of costs for planning purposes should not commence until the new runway is constructed and in service when passengers will receive the benefits. Furthermore, that planning permission should be viewed from the user perspective and cost recovery should therefore start only once the asset is built.
- 4.31 IAG believed that cost recovery should start when capacity becomes available, arguing that there was an intertemporal consumption problem between current and future users which could be resolved by making sure that only future users bear the cost of capacity expansion.
- 4.32 VAA welcomed our initial proposal that cost recovery only commences once the asset comes into use. At the same time, they questioned whether this furthers the interests of present users who may not accrue any benefit from using future capacity.
- 4.33 Star Alliance said that Heathrow should not be able to recover planning costs until the assets are in use and providing benefit to consumers. ABTA said planning costs should not be recovered until the new runway is constructed. Thomas Cook Airlines said that 'prefinancing' of airport expansion would place an unfair burden on today's passengers and should be recovered after the new infrastructure is in service.
- 4.34 easyJet believed that planning costs could only be recovered once the new capacity was being operated, but recognised the CAA's view that the purpose of the planning costs was to acquire planning permission and that therefore this was the service that passengers are receiving.

Our views

- 4.35 We acknowledge the different positions taken on when Category B costs should start to be recoverable. HAL proposed the AICC approach whereas the airlines consider that cost recovery should start only when new capacity comes into use (rather than when planning permission comes into use) and that current users should not pay for infrastructure they may not get the benefit from. We consider that our proposal significantly reduces the extent to which charges are paid by current users, without unduly impacting on the financeability of the planning stage of the new runway project.
- 4.36 As well as financeability issues, the debate on scarcity rents is also relevant. It is argued that existing airlines at Heathrow benefit from 'scarcity rents' from constrained runway capacity (albeit the evidence of the benefit is mixed¹⁴). In a competitive unregulated market, an airport would increase its charges to ration the capacity or to fund the investment needed to expand runway capacity.
- 4.37 Some airlines argued that planning permission was not an asset. We accept that this is debatable and there is no firm precedent. Our view is that if we did not treat planning permission as an asset, then we would need to treat Category B costs as opex (instead of capex). This would imply that costs should be recovered when they were incurred, which airlines were strongly against.

Final proposals

- 4.38 Our final proposal is that cost recovery (via depreciation and the WACC return) should only start when the result of the planning application and the DCO process is known.¹⁵ Returns earned before this time will be tracked in the RAB, rather than immediately added to airport charges.

¹⁴ SEO Economic Research (2014) Scarcity rents and airport charges.
www.gov.uk/government/publications/airports-commission-final-report-strategic-fit.

¹⁵ In practical terms, recovery of costs will start in the accounting year after the result of the planning process is known.

Cost recovery spread over 15 years and irrespective of the outcome of the planning process

Initial proposals

- 4.39 We said that costs in the pRAB should be recovered over a 10 year depreciation period under the scenario that the DCO is granted. This was based on the likely construction period and the length of time between planning permission and the latest target date for operation of 2030.
- 4.40 In the case where the DCO is not granted, we raised the option of Category B costs being recovered over a shorter period to avoid 'stranded costs' sitting in the pRAB for a prolonged period of time.

Stakeholder responses

- 4.41 GAL agreed with our initial proposal that cost recovery via depreciation should take place over 10 years where a DCO was successful and over 3-4 years if the DCO was not successful.
- 4.42 HAL considered that 10 years was the appropriate timeframe for depreciation regardless of the outcome of the planning process, as this ensured a smooth charging profile in the interests of users.
- 4.43 LACC/AOC and easyJet argued that depreciation should be aligned to the life of the asset, such as terminals and runways. IAG argued that costs should be charged back to users over a suitably long period of time and considerably longer than 10 years.
- 4.44 Where the DCO is not successful, most airlines questioned whether any costs should be recovered and that HAL/GAL should bear all of the costs for planning activities. VAA were concerned that, under the planning failure scenario, the recovery of costs over a shorter period would result in even higher charges for a constrained pool of users.

Our views

- 4.45 In the case where the DCO is granted, we note the support of cost recovery over 10 years by GAL and HAL, but that the airlines preference is for a recovery period of much longer than 10 years.

- 4.46 Standard regulatory practice is to match the depreciation period with the asset life. However, as pointed out in our initial proposals, it is not entirely certain what the asset life would be for a quasi-intangible asset such as planning permission, especially for a high profile and large infrastructure project.
- 4.47 We maintain that our estimate of 10 years is reasonable. We pointed out in our initial proposals that planning permission will have the most value from the date it is secured (e.g. 2020/21) and the latest time by when the Airports Commission said the runway should be operational (2030). However, given the uncertainty over the asset life, we are content to extend the depreciation period from 10 to 15 years, to reflect the strong views from many of the airlines that this period is too short.
- 4.48 Extending the depreciation period will attribute more of the costs of the planning process to future users of the airport, reducing the amount of Category B costs which are recovered before the new runway is open, which was a major concern from airlines in their responses. Approximately, two-thirds of the Category B costs above £10 million per annum would be recovered after the runway has opened, with the other third recovered after planning permission and before the runway opens.¹⁶
- 4.49 Where the DCO is not granted, GAL was the only respondent in favour of a shorter period of time for cost recovery, while HAL argued for a 10 year period in line with our initial proposals. Our main argument for having a shorter period was largely for the benefit for stakeholders. It would make future airport charges more transparent and cost reflective, as stranded Category B costs would not remain in the RAB and impact on airport charges for many years to come. As airlines seem to be more concerned about higher charges over a short period of time than stranded planning costs, we propose that Category B costs are written off over the same 15 year depreciation period under the scenario of the DCO not being granted.

¹⁶ This is a simple illustration. If planning permission is granted in 2021, then cost recovery will take place from 2022 to 2036. If the runway opens in 2026, then 10 years of the 15 year period of cost recovery will occur while the runway is open (i.e. two-thirds on a NPV neutral basis).

Final proposals

- 4.50 Our final proposal is that Category B costs should be recovered over a 15 year period and regardless of the outcome of the DCO process.

Adjustment for the time value of money (to ensure NPV neutrality)

Initial proposals

- 4.51 We said that the airport operator should earn a return on any Category B costs that are added to the pRAB. This return should be calculated using the WACC at the level determined in the Q6 settlement (i.e. 5.7% for GAL and 5.35% for HAL¹⁷).

Stakeholder responses

- 4.52 GAL and HAL agreed with our initial proposal that Category B costs should earn a return, so that net present value neutrality was maintained. HAL emphasised that costs should be treated in the same way as any other project undertaken in Q6.
- 4.53 Similarly, easyJet said that the accumulation of financing costs during the planning cost accrual period, determined by the cost of capital was a sensible approach.
- 4.54 LACC/AOC said that if a WACC should be attached to the pRAB, then it should do no more than cover HAL's direct financing costs and not earn an additional 5% reward. Similarly, VAA said that no return should be added to costs in the case where the DCO was not granted.
- 4.55 IAG took a different view to others and argued that Category B costs should be treated like research and development (R&D), which should not attract a return and should be charged back in nominal terms.

Our views

- 4.56 We note the strong views from airlines that the airport operator should not earn a return on the Category B costs accrued in the RAB. We consider

¹⁷ On a pre-tax real basis.

that we should reflect investors' time value of money and ensure net present value neutrality. This has been one of our key principles from previous reviews.

- 4.57 If we did not apply this time value of money principle, then we would be asking HAL to make uneconomic decisions as a pound is worth much less in 15 years than it is today. We consider HAL's investment incentives would be harmed in such circumstances and there could also be unintended consequences on how the strength of regulated companies such as HAL are perceived by the financial community.

Final proposals

- 4.58 Our final proposals remains unchanged, with HAL able to earn the WACC return on any Category B costs that are added to the RAB, with the WACC at the level determined in the Q6 settlement.
- 4.59 The WACC return will be applied to the Category B costs in the RAB irrespective of whether the DCO is successful or not.

Chapter 5

Risk-sharing arrangements

The principles of a risk-sharing arrangement

Initial proposals

- 5.1 We said that the principle behind the introduction of a risk-sharing mechanism was to ensure that both GAL/HAL and the airlines bear some risk in the event that planning permission was not granted, was rescinded or was withdrawn.
- 5.2 We considered that risk-sharing means that stakeholders will be incentivised to be part of the process and to help ensure that Category B costs are minimised as much as possible. HAL will also be encouraged to engage positively with local communities and other stakeholders to maintain support for expansion and efficiency. We also said that airlines should bear some of the planning risks, as they would stand to benefit from expansion.

Stakeholder responses

- 5.3 HAL and GAL both welcomed the principle of a risk-sharing mechanism, but questioned whether the balance of risk-reward was set at the right level. HAL questioned the asymmetric nature of the mechanism and proposed 120/80 whereas GAL proposed 110/85 and the preservation of the asymmetric principle.
- 5.4 LACC/AOC argued that airport operator should not be rewarded for performing its core function and that airlines should not be held accountable for risks associated with failure, as they have no control over planning and political risks.
- 5.5 Similarly, ABTA argued that the risk-sharing principle was flawed as airlines should not be held accountable for planning risks as they have no control on them whatsoever. Star Alliance believed that planning risks are beyond airlines' control and should be borne in entirety by HAL.

- 5.6 easyJet supported the concept of risk-sharing, and considered that it is in the interests of passengers for the airport operator to be exposed to the costs of a failure to secure planning.
- 5.7 IAG considered that the airlines' involvement in the planning process is at the discretion of HAL/GAL, who are the only parties in a position to bear planning risk. In addition, airlines do not need to bear planning risk (which would be uncontrollable for them) to have an incentive to be part of the process.
- 5.8 VAA welcomed the risk allocation mechanism, but is concerned that the level of risk apportioned to the airport is not enough, and argued that the airport operator is in the most appropriate position to bear the risk of planning failure. VAA made the point that our statement that 'airlines stand to benefit' from expansion does not apply to all airlines.

Our views

- 5.9 We maintain the view that all stakeholders should face a reasonable level of risk to provide an incentive to support and ensure cost efficiency. As a result, we changed from the approach adopted for Heathrow Terminal 5 and the (aborted) second runway at Stansted, where airport investors were given 100% protection from the risk of 'stranded' Category B costs. HAL now faces a risk of not being able to recover 15% of Category B costs.
- 5.10 We acknowledge that the proposed risk-sharing arrangement is a new policy, but the new runway is also unprecedented in terms of economic regulation. The reward part of the risk-sharing mechanism encourages HAL to secure planning approval and the prospect of under-recovery encourages HAL to keep Category B costs as low as possible. Airlines are also incentivised. They are encouraged to help HAL to keep Category B costs low, but also to facilitate the planning application process as they benefit from new runway capacity, albeit that future and current airlines do not experience the same cost benefit incentive.
- 5.11 We are not persuaded by the argument that airlines should not face planning risk as they have no control over planning and political risks. We

accept the argument that airlines do not have direct control over planning risk, but we maintain the position that airlines have a very important influencing role. We have always championed the role that the airlines play in the economic regulation of HAL, from scrutinising HAL's business plan during Constructive Engagement to scrutinising capital expenditure in real time. We have asked HAL to develop and present to the airlines and the CAA a set of proposals for how HAL will secure productive engagement over the next year.¹⁸

- 5.12 An alternative to risk-sharing would be to set a fixed budget for planning costs for each year or for a multi-year period, with a sharing mechanism for cost over-run or under spend. This would be similar in effect to raising the level of the £10 million threshold. However, we are not persuaded by the merits of this alternative approach. The degree of uncertainty around the length and scale of the planning process means it is not possible to make a credible estimate on the size of the fixed budget or cap at this stage. Furthermore, we did not receive any stakeholders responses which argued for a fixed budget approach.

Final proposals

- 5.13 Our final proposal is that Category B costs should be subject to a risk-sharing mechanism, as set out in our initial proposals. We consider that risk-sharing will help to minimise costs, encourage stakeholders to monitor the project and encourage stakeholders to seek a positive outcome from the planning process.

Design of the risk-sharing mechanism

Initial proposals

- 5.14 We said that a 105/85 risk-sharing mechanism should be put in place for Category B costs incurred above £10 million per annum.

¹⁸ We have set out our expectation on HAL's engagement with the airlines in the following letter: www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294981598 (PDF).

Stakeholder responses

- 5.15 GAL argued that under the proposal, it will face material risk of not able to recover costs that are necessary to support the runway development. GAL suggested the risk parameters should be 110/85, which will preserve the asymmetry of risk, maintain stakeholders' exposure if DCO not granted, reward GAL appropriately for taking risks over 2013 to 2020 and allow charges to rise faster to aid financeability. GAL also considered that property-related costs, if allowed in Category B, should not attach a premium, because such costs are largely driven by GAL's commitments to local communities and/or by compulsory purchase legislation.
- 5.16 HAL argued for a 120/80 proposal which they stated would provide the appropriate incentives to all parties and is a fair balance of risk. HAL considered that a symmetric risk-reward profile is important particularly when the CAA does not allow for the recovery of Category A costs. It disagreed with CAA's comment that "the airport operator will be able to generate additional value as a result of planning permission being secured". HAL also argued that this is because their ability to generate value from a positive planning decision cannot be considered in isolation and the statement is also not consistent with how the current regulatory framework works.
- 5.17 LACC/AOC argued that the passenger has no influence regarding the outcome of the planning consent and should not bear the risks. Consequently, the CAA's desire for airlines to accept 85% of the risks lacks credibility. They argued that if Government policy changes, the Government itself should be best placed to bear the risk, followed by HAL. Furthermore, the fact that HAL is a regulated monopoly does not insulate its shareholders from reasonable commercial risk.
- 5.18 IAG considered that Category B costs should be treated like R&D costs, should not attract a return, should be charged back to users in nominal (rather than real) terms and over a considerably longer period than 10 years. If DCO is not granted, no recovery should be allowed, because competitive businesses write off such costs.

- 5.19 VAA considered that there should be no additional return should planning permission be secured. This is because 'supernormal returns' is not seen in competitive markets, the costs already attract a return via the WACC apportioned to the pRAB, and HAL/GAL can generate additional return as a result of the planning permission and expansion. It also considered that the financial detriment should be much greater than 15% to encourage HAL/GAL to engage proactively with local communities and other stakeholders.
- 5.20 easyJet approved of an asymmetric risk-sharing profile, as this reflects the outcomes that would be seen in a competitive market. However, allowing the airport to recover 85% of a failed application remains excessively generous for the airport and removes the incentive on the airport to judge whether a planning application has a viable chance of success. If the airport has little confidence that approval will be granted and needs to be almost fully insured against failure, then the value of the application has to be questioned. The CAA, in setting the cost of capital in future, needs to be careful to avoid rewarding the airport twice for bearing the risk of planning failure.
- 5.21 ABTA believed that presenting a fully evidenced request for planning permission is HAL/GAL's core activity, so airlines should not be asked to accept 85% of that risk.

Our views

- 5.22 We consider that GAL's proposed 10% and HAL's proposed 20% over-recovery in the case where the DCO is granted is excessive and not in passengers' interests. HAL's proposal suggests that the chance of achieving planning permission is the same as not achieving planning permission which we judge to be too pessimistic.
- 5.23 GAL and HAL also appear to suggest that the over-recovery should be large enough to (at least in part) compensate Category A costs. We disagree with this view. The proposed additional return is put in place solely to compensate the airport operator for its exposure to planning cost

risk. The premium is not intended to recover Category A costs or serve any other purposes.

- 5.24 We are not persuaded by HAL's argument that a fair balance of risk and reward is one which is captured by a symmetric risk-reward profile. Symmetry implies that we would need to judge planning success to be equally as likely as planning failure, otherwise investment in the planning process would either be too attractive for HAL or would harm HAL's investment incentives. We therefore consider that symmetry is too pessimistic an assessment on the chance of planning success, albeit that we accept that it is difficult to estimate the likelihood of success with any more precision.
- 5.25 We acknowledge the airlines' concerns that a 15% financial detriment is not sufficient for the airport to encourage HAL/GAL to engage with stakeholders. Many of the airlines have argued that they should not face any planning risk, with IAG proposing a 100% financial detriment for the airport operator. We are against introducing such a detriment as it would significantly increase HAL's risk during the planning phase and would have a consequent increase on the cost of capital. As a result, airport charges would rise at the start of the next regulatory period and then feed indirectly into higher passenger fares, which in our view is not in the interests of passengers. We consider that our proposal is a balanced proposition and is significantly more favourable to airlines than previous regulatory treatments where the airport operator faced no financial detriment (e.g. Heathrow Terminal 5 and the aborted Stansted runway).
- 5.26 We have thought about how to introduce IAG's proposal to treat Category B costs like R&D costs. We concluded that an airport operator is much different from a company which typically gets involved in R&D (which is likely not to be subject to economic regulation). HAL only has one substantial expansion project, whereas a pharmaceutical company investing in research and development for example would be able to pool risk over a portfolio of projects. Moreover, the airport's ability to earn supernormal returns from a successful R&D product (securing planning consent in this case) will be heavily constrained by the fact that the airport

is very likely to continue to be subject to economic regulation by the CAA and hence its charges will probably be capped. This is a critical distinction to R&D in a more competitive non-regulated counterfactual and we therefore concluded that a R&D approach does not appear to be appropriate.

Final proposals

5.27 Our final proposal is that a 105/85 risk-sharing mechanism should be put in place for Category B costs incurred above £10 million per annum.

Different scenarios around the reasons for planning failure

Initial proposals

5.28 We said that it would be difficult, in practice, to identify clearly the potential reason for the failure of the DCO process, which is a complex process involving multiple stakeholders. We therefore propose to apply a simple approach to risk-sharing, namely two scenarios of either success or failure.

5.29 We also set out a scenario where the airport operator unilaterally withdraws from the planning process, reserving the right to decide that GAL/HAL will be able to recover less than 85% of the Category B costs incurred.

Stakeholder responses

5.30 HAL welcomed the CAA's decision to simplify the number of scenarios into success or failure of planning consent, as this offers regulatory predictability and avoids subjective debates as to stakeholders' merits or faults.

5.31 However, HAL set out significant concerns regarding the CAA's comments about an airport operator unilaterally withdrawing from the planning process. HAL argued that this could override the objectivity and certainty generated by defining two outcome based scenarios, reduce the deliverability of the project if investors perceive that the regulatory

framework is highly subjective, trigger a higher cost of financing, and foster a culture of allocating fault and blame between the airlines, the airport and the CAA.

- 5.32 VAA argued that users should not bear any Category B costs if the airport operator unilaterally withdraws from the planning process. easyJet argued that without a clear statement from the CAA on the conditions for cost recovery lower than 85%, it seems unlikely to have a significant impact on incentives. ABTA suggested that if the planning process is subject to political factors then the CAA should determine equitable risk-sharing.

Our views

- 5.33 We note the general agreement that it is sensible to reduce the number of scenarios to two (success or failure). We agree with stakeholders and do not propose to change from our position of defining two scenarios.
- 5.34 While acknowledging HAL's comments, we maintain the view that in order to protect passengers from undesirable outcomes it is necessary for the CAA to have a policy that if there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process, then we reserve the right to decide that HAL will be able to recover less than 85% of the Category B costs incurred. We consider that passengers should not pay for planning failure which is a direct consequence of HAL's actions.
- 5.35 We note easyJet's view that we need to state the conditions for cost recovery to be lower than 85%. We consider that it is sufficient at this stage to say that the evidence needs to be clear and compelling, otherwise we may create perverse incentives for either HAL or the airlines.

Final proposals

- 5.36 Our final proposal is to apply a simple approach to the risk-sharing scenarios, namely either success or failure.
- 5.37 We reserve the right to decide that HAL will be able to recover less than 85% of Category B costs, if there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process.

Chapter 6

Promoting efficiency and transparency

Creation of a planning IFS at Heathrow

Initial proposals

- 6.1 We said that a planning-focused IFS should be set up at Gatwick or Heathrow with an objective to scrutinise and advise on the Category B costs incurred in the planning process. The IFS should be appointed jointly by GAL/HAL and the airline community in an open and competitive process, with oversight by the CAA.

Stakeholder responses

- 6.2 GAL agreed with the establishment of a specific planning IFS and considered that the IFS should provide forward guidance on proposed expenditure as well as backward-looking approval of expenditure incurred.
- 6.3 HAL supported the use of the current IFS, arguing that this is a more efficient and simple approach compared with setting up a new and separate planning-focused IFS, provided that the current IFS is deemed to have the right expertise.
- 6.4 LACC/AOC supported the concept of the IFS but stressed the importance of airline engagement. It also considered that the scope of IFS activities should be widened to include solution options analysis and cost minimisation for the selected scheme. Furthermore, the CAA should consider the governance arrangements for the design phase.
- 6.5 VAA supported the creation of a new IFS at Gatwick and an enhancement to the role of the IFS at Heathrow. IAG also remarked that an IFS has had a positive impact on airport/airline discussions at Heathrow and that this could be further improved by the IFS reporting directly to airlines or the CAA.

Our views

- 6.6 We note the widespread support for the IFS process to scrutinise Category B costs and the various proposed enhancements to the IFS mechanism. In developing the scope of the planning IFS, we will engage with stakeholders to capture the lessons learned for the Q6 capital governance arrangement at Heathrow. We agree that expanding the remit of the current IFS at Heathrow to include Category B costs could be more efficient than setting up a separate IFS.
- 6.7 We agree with the LACC/AOC on the need to assess all design options and choices for cost minimisation and that cost certainty increases when the airline experts engage in the master planning stage. We consider that the scope of the IFS should initially be focused on the efficiency of planning costs. However, we are open to the scope of the IFS being widened at a later date to cover scheme design and cost minimisation if the airlines and airport operator sees this of benefit. In the first instance, we consider design issues should be tackled through a much wider and comprehensive engagement process. We have been asked to advise the Government on how effectively HAL has engaged with the airline community on the design of the scheme.¹⁹

Final proposals

- 6.8 Our final proposals on the IFS are largely unchanged from our initial proposals. The IFS will provide an ongoing assessment of the reasonableness of Category B costs incurred. It will be an independent view on cost efficiency and aim to drive good behaviours. Activities undertaken include providing:
- real time advice to HAL on the planning process and scrutinising costs in real time;
 - advice to the CAA in case there are disagreements on the definition of Category B costs;

¹⁹ This work will be conducted under section 16 of the Civil Aviation Act 1982 and outlined in the following letter: <http://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294981598> (PDF).

- periodic reports to HAL, the airlines and the CAA. These would be at key decision points in the planning process and typically every 3 months; and
 - verification of the need and efficiency of the Category B costs incurred.
- 6.9 The IFS will also provide advice on the processes being followed, the assumptions being made and the overall appreciation of the risks being managed.
- 6.10 The IFS should be appointed jointly by HAL and the airlines. In the first instance, we propose that the remit of the current IFS is expanded rather than a new IFS created.

Transparency around planning materials produced

Initial proposals

- 6.11 We said that GAL/HAL should make relevant materials and reports prepared for the planning process available to the airline community, the CAA and relevant stakeholders as early as practicable.
- 6.12 We were keen that GAL/HAL and the airlines engage collaboratively on the design of the scheme. We emphasised that strong engagement by the airlines is a necessary condition for delivering a final design and cost for the new runway that is in the interests of users.

Stakeholder responses

- 6.13 GAL agreed that any materials produced by the airport operator for the planning process should be made available to stakeholders, and argued that there should be clear processes established at the outset for the handling of confidential information.
- 6.14 HAL undertook to share with stakeholders as much material as practicably and legally possible as part of (but not limited to) the high quality consultation that will need to be undertaken before the planning application is submitted.

- 6.15 IAG argued that as users are charged Category B costs, materials related to the process (reports, opinions) should be transparently made available to current and future users. If HAL/GAL wants to keep any materials confidential, the costs should not be charged to end users and not charged to the pRAB. Moreover, the CAA needs to implement concrete rules to set out how HAL/GAL and airlines should share responsibility for the design of new capacity and do more than just encourage engagement.
- 6.16 VAA welcomed the CAA's encouragement to engage in the design of the process. It also stressed the importance of timely reporting to the IFS.

Our views

- 6.17 We note the broad consensus of sharing information related to the planning process in a timely fashion. We agree that there is merit for stakeholders to agree in advance the rules of handling confidential information.
- 6.18 We agree that it is important for stakeholders to take part in the design of new capacity and are encouraged by the eagerness of stakeholders to engage. As mentioned earlier, we expect HAL to undertake a thorough and meaningful process of strategic engagement with the airline community over the options for the detailed design of the scheme.²⁰

Final proposals

- 6.19 Our final proposals are unchanged from our initial proposals. HAL should make materials and reports prepared for the planning process available to the airline community, the CAA and relevant stakeholders as early as practicable. Stakeholders should agree in advance the rules around the timing of when information should be shared and how to handle confidential information.

²⁰ See the following letter: <http://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294981598> (PDF).

Appendix A

Our duties

Our general duty

- A.1 The Civil Aviation Act 2012 (the Act) gives the CAA a number of general duties, including a primary duty to carry out our functions under Part 1 of the Act in a manner we consider will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.
- A.2 Under the Act, users of air transport services are defined as present and future passengers and those with a right in property carried by the service i.e. cargo owners. We must also have regard to the general principles of regulation to ensure that our regulatory activities are transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.

Stakeholder views

- A.3 GAL supported the CAA's analysis of the relationship between its statutory duties and their application, particularly the CAA's conclusion that it should maintain incentives to invest.
- A.4 IAG emphasised that HAL is already highly incentivised to invest in scarce new capacity, as evidenced by their engagement with the Airports Commission. It argues that the ability to finance an investment does not mean that it should be able to earn additional returns.
- A.5 VAA said that it was vital that the CAA's primary duty should guide all interventions and mechanisms.
- A.6 Other stakeholders did not directly make any substantive comments on either our statutory duties or our interpretation of our duties in relation to Category B costs.

A.7 Many stakeholders did, however, make indirect comments about our duties by arguing that specific policies should be modified to align with our duties. For example, HAL urged the CAA to reconsider our policy on HAL unilaterally withdrawing from the planning process to align it with our duties.²¹ Thomas Cook Airlines also said that ‘prefinancing’ of airport expansion would place an unfair burden on today’s passengers and in contradiction of the CAA’s primary duty. We have responded to issues of policy like these in the relevant chapters.

Our response

- A.8 We acknowledge stakeholders’ views on the interpretation of our duties. In putting forward our final proposals, we have ensured that they are not only consistent with our primary duty to users but also take into account our other secondary duties.
- A.9 Our interpretation of our duties remains the same as set out in the initial proposals. We consider that new runway capacity is needed to prevent future consumers from experiencing higher airfares, reduced choice and lower service quality, which is directly in line with our primary duty to further the interests of users. In addition, we continue to consider we must have regard to a number of other duties including:
- “the need to ensure that the airport operator undertaking runway expansion is able to finance its provision of services” – we consider that it is important to maintain incentives to invest. Development of new runway capacity requires substantial private investment over an extended period of time. Although Category B costs are only a small proportion of the total costs of the project, our proposed treatment of Category B costs could send a positive signal to potential investors that their investment will attract a reasonable return given the risks of the project.
 - “the need to secure that all reasonable demands for airport operation services are met” – we consider that, given the current capacity

²¹ Paragraph 5.14 outlines a policy to safeguard users from a scenario where the airport operator unilaterally withdraws from the planning process.

constrained environment, securing the provision of new runway capacity is crucial to fulfil future demands for services. This is also consistent with our duty to future users.

- “the need to promote economy and efficiency on the part of the airport operator undertaking runway expansion” – we consider that it is important to protect users from unnecessarily high charges. We propose to achieve this by increasing transparency and strengthening incentives through a risk-sharing mechanism.

Appendix B

Category A and Category C costs

Category A costs

Initial proposals

B.1 We said that Category A costs should be defined as Airports Commission-related and associated lobbying costs and will, in general, be incurred before a Government policy decision. Furthermore, that the recovery of *most* Category A costs will not be permitted, but if a strong and clear case could be made that costs incurred before the Government policy decision were used for the subsequent planning process, then we will consider re-classification.²²

Stakeholder responses

- B.2 GAL considered that costs on developing plans (a subset of Category A costs) before a Government decision should be re-classified as Category B. These costs include technical design, planning, environmental and other advisory work. GAL argued that not allowing these costs will strand assets and harm incentives to investment. GAL proposed that the IFS could assess whether these costs are necessary and efficient.
- B.3 HAL considered that splitting costs into Category A and Category B is artificial and does not follow robust market or commercial logic. HAL argued that Category A costs are integral to the success of the project, without which it would not be possible for Heathrow to achieve a Government recommendation. HAL also considers that some Category A costs incurred before a government decision should be re-categorised as Category B. HAL does not expect to recover Category A costs if it does not receive Government support.

²² We specifically said that some costs could be re-categorised as Category B provided that GAL/HAL can make a strong and clear case (subject also to a *de minimis* threshold and an efficiency assessment) that information submitted for the DCO application is not materially different from that submitted to the Airports Commission.

B.4 LACC/AOC were concerned that there is no clear detailed criteria to determine what should not be considered as Category A costs. Similarly, IAG was concerned about the vagaries of the definition, which the airport operator could seek to exploit. VAA considered that all Category A costs should not be recoverable and is opposed to any re-categorisation of costs.

Our views

B.5 We note the opposing views on the exclusion of Category A costs from a recovery mechanism. GAL and HAL consider such costs should be recoverable as long as they are efficiently incurred, whereas the airlines argue that all Category A should not be recoverable.

B.6 We strongly believe that we should safeguard users from paying for costs incurred in the political lobbying and public relations process. Allowing these costs to be recovered would mean that consumers could be exposed to escalating costs as each promoter tries to out bid and out lobby each other through advertising and promotional activities. It would also leave consumers exposed to the risk that any of the long-list options considered by the Airports Commission would seek to recover their bid costs. More importantly, competitive tenders issued by public bodies and private companies almost always exclude the recovery of bid or proposal costs from all bidders, irrespective of whether they become the chosen provider or not.

B.7 We consider that our policy has not harmed any of the promoters' investment incentives. All three promoters continued to incur Category A costs after this policy was developed in July 2014 and finalised in March 2015.

Final proposals

B.8 Our final proposals remain the same as our initial proposals and our March 2015 policy.²³ Most Category A costs will not be recoverable, but some could be re-categorised as Category B if a strong and clear case is made by HAL that the information submitted for the planning process is not materially different to that submitted to the Airports Commission.

²³ Available here: www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/.

- B.9 We expect the design of the scheme to change significantly as a result of airport-airline engagement in the coming months. Information needed for the DCO planning process is therefore likely to be different to that submitted to the Airports Commission. We do not expect any Category A costs could be reclassified as Category B costs and it would therefore be on a very exceptional basis for us to do this.

Category C costs

Initial proposals

- B.10 We defined Category C costs as construction costs incurred by an airport operator. These costs will typically be incurred after planning permission is granted and up to entry-into-operation. We noted that there may be some significant expenditure on preliminary works or enabling construction (e.g. property relocations and land acquisition) before planning permission is given and termed these pre-construction costs.

Stakeholder responses

- B.11 HAL broadly agreed with the definition of Category C costs and acknowledged the CAA's recognition that there will need to be significant expenditure on preliminary works, early hardship mitigation or enabling construction. It stressed the importance for the CAA to clearly define blight and hardship and publish its initial proposals on these costs in earnest.
- B.12 GAL considered that the property support costs should be re-categorised as Category B costs. These include the Property Market Support Bond and the Home Owners Support Scheme which GAL argues are a necessary pre-condition to achieving planning permission.
- B.13 Airlines made strong arguments about the principles around recovery of Category C costs, such as not being recoverable until the time when the assets come into operation, rather than on the definition of Category C costs.
- B.14 Lakeside Energy from Waste Ltd pointed out that HAL's expansion proposal will necessitate a relocation of its facilities, which is a complicated process involving site acquisition, preparation, construction and commissioning. It

stated that significant amounts of work will need to be undertaken in advance of the grant of planning consent and that they would welcome early regulatory certainty.

Our views

- B.15 We note the significant magnitude of Category C costs could be incurred before a planning decision and the need to offer early regulatory certainty on their treatment.
- B.16 Pre-planning construction costs could cover preliminary works, enabling construction, property relocations, land acquisition, blight and hardship. These costs could be treated in a similar fashion to the way the costs of capital projects are handled in Q6.
- B.17 We are considering developing a policy on pre-planning construction costs as a separate Category C cost and on an accelerated timetable (i.e. before we propose the regulatory treatment of the majority of Category C costs which are incurred after planning permission is granted).

Final proposals

- B.18 We continue to define Category C as construction costs incurred by HAL, typically after planning permission is granted, in connection with implementation and construction of new capacity, up to entry-into-operation.
- B.19 We are considering developing a specific policy on pre-planning construction costs in advance of our overall approach to Category C costs.