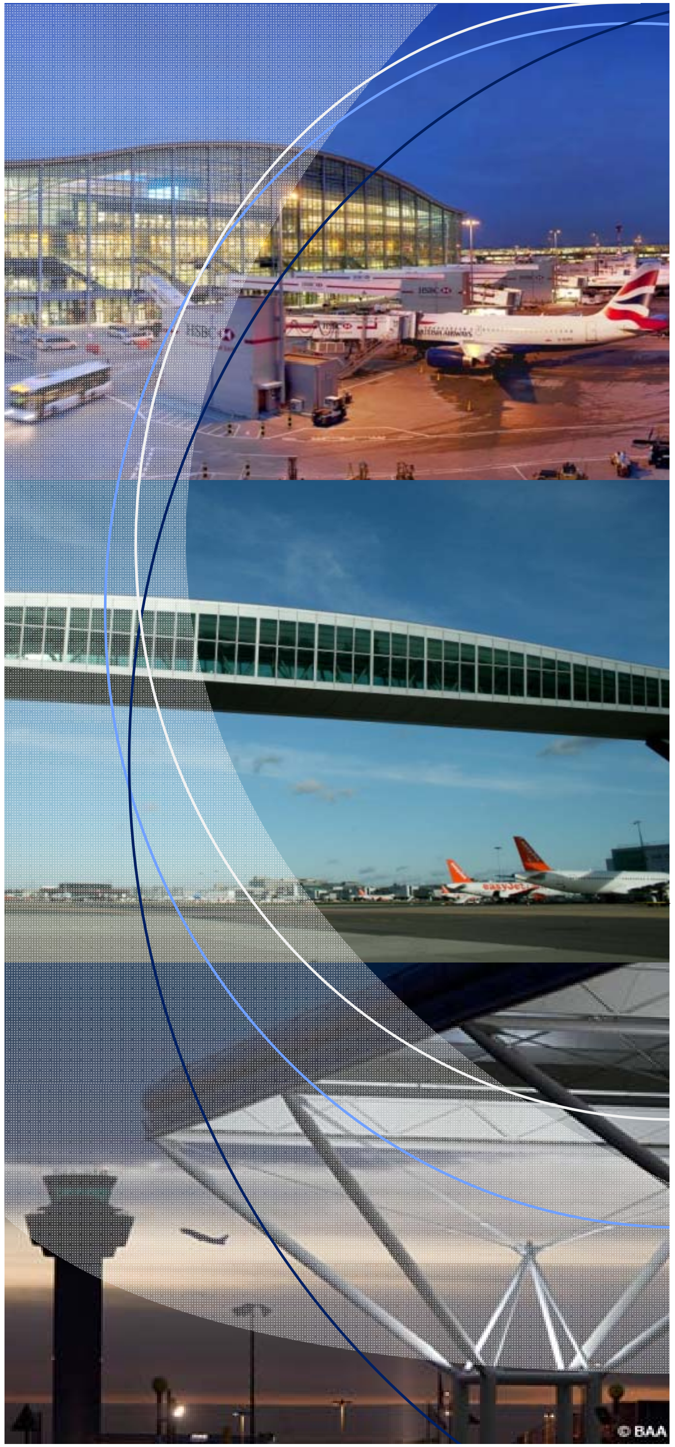

Civil Aviation Authority

Regulatory and financing issues associated with aviation capacity expansion

Stakeholder workshop
Wednesday 14 May 2014

Agenda

14:00 – 14:15 (10 mins)	Welcome, objectives and scope
14:15 – 15:15 (60 mins)	Financial issues, precedents and risks
15:15 – 15:30 (15 mins)	Break
15:30 – 16:30 (60 mins)	Recovery of costs
16:30 – 16.50 (20 mins)	Other issues
16:50 – 17:00 (10 mins)	Next steps

Objectives & scope

- Start a discussion:
  - Identify the issues at play
  - Recognise that any future regulation may be dependent on finding SMP

- Capacity expansion options considered at this stage:
  - A runway at Heathrow, north west of the existing airport (H3), proposed by Heathrow Airport Limited
  - A westward extension of the northern runway at Heathrow (HH), proposed by Heathrow Hub Limited
  - A second runway at Gatwick (G2), to the south of the existing airport, proposed by Gatwick Airport Limited

Process

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- This is the first step in the CAA's process

14 May	Stakeholder workshop
May to July	Incorporating stakeholders' initial views into CAA thinking
Mid-July	Publication of consultation paper
Mid-July to September	Public consultation
September to November	Consolidating stakeholders' views
End-November	Publication of policy statement

- We will revisit this timetable in the event that the Airports Commission decides to include an inner Thames estuary option in the shortlist in September

Financial issues, precedents and risk

- HAL and GAL have complex financial arrangements
- Given the size and risk of any potential expansion the financing of it may be different to that which is currently used. The CAA may therefore have to change the assumptions it makes with respect to financing
- There are precedents that the CAA may be able to draw on to inform how it may wish to treat costs
- At the broadest level there are two possible approaches to financing any expansion – debt and/or equity. There are different benefits/costs with each of these approaches (see slide 13). While the appropriate financing structure is up to individual businesses to decide, we recognise that any decision we take may affect their decisions

Precedents: Airports & Utilities

- UK airports sector (slide 7):
  - Subsidisation of the construction and initial operation of Stansted by Heathrow and Gatwick through the system approach of price controls from 1991
  - Construction of Heathrow's Terminal 5 in Q4
  - Project for the sustainable development of Heathrow (PSDH) in Q5
- Utilities (slide 8):
  - Thames Tideway
  - Northern Ireland gas networks
  - GB offshore electricity transmission
- Discussion points:
  - Are there lessons that can be learnt from these?
  - Does the transfer of risk to users reduce the risk and cost?

Case studies of precedents: Airports

- Stansted: System approach in Q1 & Q2
  - Price controls at Heathrow and Gatwick subsidised the development of Stansted (when all owned by BAA)
- Terminal 5 in Q4: Expenditure added to the RAB
  - To moderate the increase in prices during Q4, the CC in its Q4 report decided to defer £300 million of revenue to Q5. The price profile was set to ensure that BAA and the airlines would be indifferent, in net present value terms, to the delay of the expenditure
  - To incentivise BAA to open Terminal 5 on time and to reduce the cashflow benefit that it received from delaying completion, capex triggers on individual components of the project were set. After a three month grace period, BAA's revenues were reduced by the amount of the rate of return it would have received had the project been delivered on time
- PSDH in Q5: CAA allowed c.£538 million of early costs into Heathrow's RAB
  - Cost added, but explicitly acknowledging that it reserved the right to reconsider the treatment of expenditure during Q6 and beyond
  - As a result, existing customers were to fund the expenditure, even though neither they nor subsequent customers were to benefit from the significant capacity expansion that it was supposed to facilitate

Case studies of precedents: Utilities

- Thames Tideway: Delivered by licensed Infrastructure Provider (IP)
  - The Government identified four reasons why an IP may be appropriate:
    - Scale risk: size of the project in the context of the whole of Thames Water's business
    - Construction risk: nature of the project's construction works in the context of the works usually undertaken by the incumbent undertaker
    - Management risk: type and scale of management resource necessary to manage the project compared to resources necessary to manage the rest of the incumbent undertaker's business
    - Regulatory risk: arising from the duration of the project in the context of the usual duration of capital works in the incumbent undertaker's business
- NI gas network: Investors given a reasonable rate of return over 40 years.
  - WACC fixed for the first 20 years and losses rolled into the RAB. However, demand assumptions were not realised and had to be revised, and customers bore a higher share of the volume risk than initially anticipated
- GB offshore electricity transmission: Licence-based regime
  - A nonexclusive system where an offshore owner licence is granted to any party that can satisfy relevant application criteria. This system allow these parties to complete with other for the right to build, own and operate offshore transmission connections

Treatment options

- Potential financing options for any potential new runway:
  - Same RAB: Adopt the CAA's treatment of capex that it uses for HAL and used to use for GAL
  - Separate RAB / a different category in the same RAB: Development of new capacity may have a different risk profile comparing with the existing assets
  - Special purpose vehicle
  - Pass through of efficient costs (immediately or at a later stage)
  - Other?
- Discussion points
  - What are the advantages and disadvantages of these options?
    - Increased transparency
    - Increased 'financeability'
    - Better grouping of projects with similar risks and therefore more appropriate WACC(s)?
  - What are the implications of these options to economic regulation?

Treatment options: Discussion points

- Could the CAA treat different stages of the project differently (ie certain stages of construction may be riskier than others)?
- How should any potential Government support be factored into any decisions (eg negative capex, other?)
- In the event of a RAB based approach, how long should different aspects be set:
  - Set the WACC for 5, 10, 20 years (or other)
  - Set prices every 5, 7, 10, 20 years (or other)
  - Revisit demand forecasts every 5, 7, 10, 20 years (or other)
  - Other?
- What are the costs and benefits of these potential options?

Risk (1)

- While the CAA's duties do not explicitly mention allocation of risk, this has a bearing on it duties:
  - Duty to further customers' interests
  - Duty to promote competition
  - Duty to secure that each holder of a licence can finance its activities
  - Duty to promote efficiency
- How can the regulatory system best mitigate, attribute or remunerate risks (financing, construction, cost, demand, regulatory and political) to:
  - Passengers
  - Actual and potential investors
  - Airline and cargo operators
  - Airport operators?
- Should risk be allocated to those parties that are best able to manage it?

Risk (2)

- If risk is perceived as too high, should the CAA look to try and address this by:
  - Allocating the political and regulatory risks to customers of the regulated airport
  - Suggesting that the sunk costs of any airport expansion for which support is withdrawn be assumed by the Government
  - Requiring the regulated airport to assume the sunk costs of airport expansion?

- What are the benefits/costs of these options?
- Are there other options that the CAA should consider?

Appetite for debt and equity

	Advantages	Disadvantages
Debt financing	Retains control and ownership of the project	A fixed (often very long) length of time for loan repayment
	Tax deductible interest repayment	A high level of debt may cause cashflow problems and make future equity financing difficult
	Loans can be short term or long term	
Equity financing	Investors often take a long term view	May require higher returns than bank loans
	No need to channel profits into loan repayment	Equity investors may demand control and ownership
	More cashflow available	Takes time and effort to identify the right investors

Inter-generational issues and risk

- The CAA's duties give it considerable latitude to consider such issues
- Contextual issues:
  - Years/decades between capacity approval and capacity coming into use
  - DfT forecasts suggest passenger demand will increase to the year 2030 and to the year 2050. Opportunities may therefore present for current and future airlines
  - Increasing blurring between FCCs and LCCs
- Discussion points:
  - Should FSCs (and their customers) pay more for an airport that is built to meet FSC requirements rather than LCC requirement in this or subsequent generations?
  - Which generation will be better suited to pay for any costs associated with any runway expansion?
  - Will the next generations of airlines and passengers be
    - Richer than the current generation and, perhaps more importantly, would they, if alive now, be willing to pay for a new runway?
    - Poorer and unwilling to pay for a new runway, if alive?
    - Be equally rich/poor, and would be willing to share the cost of a new runway (equally), if alive?

Inter-generational issues: Regulatory approaches

- Assets in the course of construction (pre-funding)
- Assets in operation
- Profiling of revenue
- Discussion points:
  - What are the costs and benefits from these different approaches?
  - Are there alternative approaches that the CAA should consider?

Slots and risk

- Slots at airports must be distributed in a fair and non-discriminatory way. The allocation of new slots can facilitate competition
- Allocation of new slots:
  - Up to 50% of the new capacity being available to ‘new entrants’, with the remaining 50% being available to new requests by incumbents.
  - If the 50% available to new entrants is not fully subscribed, the slots are available to new flights by incumbents
- Discussion points:
  - Does the current allocation process affect potential willingness of stakeholders to contribute to any capacity expansion?
  - Should the CAA consider who has contributed to airport expansion costs in setting any price caps, particularly where agreements between key stakeholders have not been reached?
  - While the CAA has no authority to compel an airport operator on potential discounts to charges, should there be some recognition of any contributions to final charges that may be levied?
  - Are there other options that could be used to recognise an incumbent's potential contribution relative to a new entrant (where there is pre-funding)?

Break

Recovery of costs

- The Q6 documents highlighted how some costs may be recovered but these costs could be the tip of the iceberg
- Principles the CAA could use to help it determine how it should costs to be recovered:
  - Selectivity: given its primary statutory duty to further passengers' interests, the CAA will attempt to incentivise airports to develop in ways that are of most benefit to passengers
  - Efficiency: given its statutory duty to promote efficiency and economy on the part of licence holders, the CAA will allow the recovery only of costs which are efficiently incurred
  - Risk: the CAA will look to ensure that statutory requirements do not impose so much risk as to undermine its financeability
  - Manageability in practice, for the CAA, airport operators and airlines
- Are these principles reasonable?

A role for Constructive Engagement?

- Should Constructive Engagement be used as part of the process associated with additional capacity going forward?
- Can the principles and approach outlined in the CAA's mandate for constructive engagement be modified so it is fit for purpose (see slide 20)?
- If such an approach was adopted, would the type of information the CAA has outlined on the next slide be sufficient?
- Is there scope to go beyond Constructive Engagement to contracts?

Potential approach?

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Accountability	A clear and agreed governance framework setting out the expected accountabilities.
	This includes the CAA giving a clear, upfront mandate to the parties.
Transparency	Information provided for CE should be relevant and timely.
	The scope of CE should be widened to include discussion on all items relevant to proposed new runway capacity, including operational expenditure and commercial revenues.
Collaboration	All parties should participate constructively and in good faith. Airlines should be involved fully in the development of plans for airport expansion.
	CE should not be seen as a zero-sum game and should allow opportunities for outcomes such as "gain sharing" between airports and airlines.
"No surprises"	Trust is undermined if either side suspects the other is simply playing games.
	To avoid airlines raising concerns over airports exploiting information asymmetry, the airport should operate on the basis of "no surprises" and should agree when they will provide updates to key data and information.
	All parties should work on the presumption that data submitted to the CAA after formal deadlines will not generally be taken into account, especially if it could have been generated at an earlier date and has not been shared with other parties.
Dispute resolution	The parties should agree clear and efficient dispute resolution procedures.
	The CAA does not wish to replace or interfere with the existing dispute resolution mechanisms at each airport.
	The parties may also engage an independent facilitator and the CAA is happy to work with such a person.
Role of the CAA	Although CE should not be regulator-led, where appropriate, the CAA will step-in.

Possible cost recovery options in Q6

1. Only allowing a pass through of a certain level of costs(e.g. £10 million) each year (as is currently the case for GAL), with a requirement for CE for amounts greater than the set level
2. Setting a cap:
   - (a) setting a cap, linked to agreed timings, on specific costs that could be passed through
   - (b) setting a cap (greater than that current allowed in any licence) on specific costs that could be passed through
3. Only allowing the amount outlined in a licence to be passed through, with any other efficient costs to be recouped in Q7 (assuming continued economic regulation)
4. Only allowing the costs outlined in the relevant licence to be recovered in Q6, with all other costs to be carried by a special purpose vehicle
5. HAL buying Heathrow Hub Limited's new runway capacity concept (HH) and the CAA allowing all/some/none of those costs to be recovered

Possible cost recovery options beyond Q6

1. No review of airport operator plans (as proposals considered by the Airports Commission and Government) and automatic pass through of costs
2. High level review of airport operator plans considered by the Airports Commission and Government
3. Detailed CAA review of detailed airport operator plans
4. Ex-post assessment of what the efficient costs should have been

Options 1 - 4 are built assuming:

– SMP continues to be present and the CAA's duties remain unchanged
– The Government agrees that expansion can occur and the plans submitted to the Airport Commission are taken forward.

Possible cost recovery options beyond Q6

- For all the possible options (in Q6 and beyond), what are the advantages, disadvantages of these options?
- Are there other options that the CAA should be considering?

Competition and market power

- Market power may change as a result of any new capacity and the CAA may decide (or may be requested) to undertake a new MPD
- When may there be sufficient certainty for the CAA to undertake a new MPD?
- When would be appropriate for the CAA to consider a MPD in advance of a potential material change in circumstances? Would there be benefits/costs in this?
- What do you consider would be the implications if an existing airport operator does not end up operating the new capacity?

The CAA's statutory duties

- The duties of the regulator are the main influence on how we behave
- Consumers are at the heart of the CAA's work - putting consumers at the heart of things is the UK norm. This approach has delivered dividends
- We look to effectively engage with stakeholders in a transparent manner
- A different regulatory focus - for example, pro-investment - could have quite different outcomes
- Discussion points:
  - While the CAA is happy with the Act, do stakeholders consider that changes need to made to better facilitate investment, including that associated with additional runway capacity?

Other issues

- The CAA is looking at a range of issues associated with additional runway capacity. What value to stakeholders place on a coordinated approach to the various issues?
- Any other issue(s)?

Thank you

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