Economic regulation of new runway capacity – a draft policy

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Executive Summary

Duties

1. The Civil Aviation Act 2012 (the Act) sets out the CAA's duties in relation to economic regulation, including any required for new runway capacity. Our primary duty is to ensure that decisions are taken in the best interest of users (passengers and cargo carriers). In carrying out these duties, we are required to act in a reasonable and proportionate manner.

Principles

2. On the recovery of the main construction and implementation costs of runway expansion, we consider we can best meet our duties at this time by setting out a broad framework of applicable regulatory principles rather than by specifying a detailed regulatory regime.

3. The following principles will underpin our future regulatory decisions in relation to new runway capacity:

   - Risk should be allocated to those parties who can best manage it. This approach is most likely to protect users' interests (that is, the interests of passengers and those with a beneficial interest in freight), by producing the lowest expected out-turn cost (as incentives to manage the cost are maintained) and by revealing information about parties' valuation of risk.
   - Commercial negotiations should be encouraged. If a commercial agreement to underpin expansion is possible, it could incentivise efficiency, ensure that risks are borne by those best able to manage them, reveal information about parties' valuation of risk, and avoid any unnecessary regulatory intervention.
   - Capacity can be paid for both before and after it opens. Whether pre-funding arises through the natural operation of a market or through regulatory intervention, some measure of pre-funding may be in users' interests.

Price control structures

4. Where we consider that regulatory intervention is required, we have a range of regulatory tools at our disposal. In selecting the most appropriate tool, we will adopt the least intrusive measure while also ensuring that users' interests are effectively protected.

5. If a Regulatory Asset Base (RAB) based approach is adopted, our current thinking is:

- We are sceptical as to the benefits of a split RAB arrangement as the commercial and operational risks of a new runway seem to be integrated with those of the rest of the airport. However, if a Special Purpose Vehicle to fund investment can be created (whose risks are genuinely ring-fenced), we are open to considering such an arrangement.
- We currently see no reason to move away from our past practice of allowing unanticipated, efficiently incurred capacity expansion capital expenditure (capex) to be added to a RAB at the end of a control period, including the full financing costs.
- We expect to allow efficiently incurred capacity expansion operational expenditure (project opex) to be capitalised. This means that we will treat project opex in the same way that we treat capacity expansion capex. (This is of course, subject to our proposed approach to the recovery of costs, which is outlined below.)
- We will consider sculpting depreciation to match costs to growing demand. However, as this approach is likely to increase risk and the cost of capital, we will need to ensure that it does not have a detrimental effect on users.
- We are open to extending the duration of price controls, or to fixing some elements over multiple control periods.

Scrutiny of costs

6. We propose to scrutinise the efficiency of any capacity expansion capex. This scrutiny will take place in two phases:

- After the Government decides where expansion can proceed, but before the planning application is lodged with the Planning Inspectorate (or before a hybrid bill process is completed). At this stage, we will review the efficiency of the proposed design of the capacity expansion proposal.
- Where cost-recovery through regulation is allowed, an *ex post* scrutiny of the efficiency of the build (e.g. procurement, benchmarking of costs) will be undertaken.

Recovery of costs

7. We see costs falling into three categories:

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

- Category B costs: capacity expansion costs that are incurred by an airport operator after a Government policy decision and are associated with seeking planning permission.
- Category C costs: those costs incurred by an airport operator in connection with implementation and construction of new capacity, up to entry-into-operation.

8. In Category A, no recovery of costs will be permitted. We do not consider costs associated with an airport operator's submissions to the Airports Commission, and associated political lobbying, as part of the costs of constructing new capacity, nor as part of the planning process. We consider that Category A costs should be borne by the relevant proposer (airport operator or HHL).

9. We see Category B costs as part of the costs of constructing new capacity, costs which users can reasonably be expected to carry (in full or in part). However, we aim to avoid users' bearing the whole risk of these costs in the event that planning approval is not granted, is rescinded or is withdrawn, as occurred with Stansted Airport Limited's second runway project. Our approach will therefore be:

- costs up to £10m per year will be automatically recoverable by an airport operator; and
- costs over £10m per year will be subject to an efficiency review. These costs may be recovered by an airport operator, subject to them being efficient and there being risk sharing arrangements in place that mean such charges are returned to airlines in the event that planning permission is not granted or is rescinded.

10. These arrangements will also apply if the Government allows a HHL capacity expansion option to go forward. This means that:

- the costs HHL has incurred in submitting material to the Airports Commission and any associated political lobbying will not be recoverable from users; and
- if Heathrow Airport Limited (HAL) buys the relevant intellectual property from HHL, this cost will not be recoverable. HAL will not be able to recover this cost as it would, in effect, be compensating HHL for Category A costs. In addition, we consider that an efficient operator in HAL's circumstances should have taken steps to avoid the need for it to purchase a third party's concept that was directly related to its core business.

Market power

11. Our current thinking is that there would not be any benefit in undertaking a market power assessment until much closer to, or even after, the opening of any new capacity. We are unconvinced that an earlier market power assessment would provide greater regulatory certainty.

Chapter 1

Introduction

1.1 This consultation document outlines our proposed regulatory policy on capacity expansion at Heathrow or Gatwick.[1] It builds on our June 2014 discussion paper and May 2014 workshop.[2]

1.2 This document is structured as follows:

- First, it reviews our duties (chapter 2);
- It then discusses how we intend to treat different categories of costs:
  - Category A costs, those costs incurred by an airport operator or Heathrow Hub Limited (HHL) for work in support of the Airports Commission ('the Commission') and any associated political lobbying, before a Government policy decision on capacity expansion is made;
  - Category B costs, those costs incurred by an airport operator, after a Government policy decision, that are associated with seeking planning permission; and
  - Category C costs, those costs incurred by an airport operator for the implementation and construction of new capacity, up to entry-into-operation;
- Category C costs are likely to be the most material and are therefore considered first (chapter 3). Given current levels of uncertainty, our proposed policy is based on regulatory principles rather than a detailed regulatory regime;

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1 The Airports Commission was set up to examine the need for additional UK airport capacity and will recommend to Government how this can be met in the short, medium and long term. Both Heathrow and Gatwick have been identified by the Airports Commission as possible locations for capacity expansion in the South East of England. Information on the role of the Commission is available at: https://www.gov.uk/government/organisations/airports-commission (accessed 22 October 2014).

2 See: http://www.caa.co.uk/docs/78/CAP1195_capacity_expansion_discussion_paper.pdf and http://www.caa.co.uk/docs/589/CAA%20Workshop%2014%20May%202014.pdf.

- Our current thinking on aspects of price control design are addressed in chapter 4 (notwithstanding the principles outlined in chapter 3);
- Our proposed treatments of costs that fall into Categories A and B is addressed in chapter 5;
- How and when we will scrutinise capacity expansion costs to ensure they are efficient is discussed in chapter 6; and
- Chapter 7 concludes by explaining why we consider that there would not be any benefit in undertaking a market power assessment (MPA) until much closer to, or even after, the opening of any new capacity.

1.3 Comments on this draft policy are due by 5 pm **19 December 2014** and can be emailed to airportregulation@caa.co.uk. We cannot commit to take into account submissions after this date.

1.4 Submissions received in response to this consultation will be published on our website. If there are parts of your submission that you consider confidential, please mark them clearly as such. Please note that we have powers and duties with respect to information disclosure that can be found in section 59 of, and Schedule 6 to, the Act and in the Freedom of Information Act 2000.

1.5 If you would like to discuss any aspect of this document, please contact Stephen Gifford (stephen.gifford@caa.co.uk) or Ian McNicol (ian.mcnicol@caa.co.uk).

1.6 Following consideration of stakeholders' views on this consultation, we intend to produce our final policy in the first quarter of 2015.

Chapter 2

The CAA's duties

Introduction

2.1 The Civil Aviation Act 2012 (the Act) outlines the issues to which we must have regard when coming to our decisions (see appendix A). Specifically, section (1) (1) – (3) of the Act states:

1. *The CAA must carry out its functions under this Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.*
2. *The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.*
3. *In performing its duties under subsections (1) and (2) the CAA must have regard to—*

    a) *the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted,*

    b) *the need to secure that all reasonable demands for airport operation services are met,*

    c) *the need to promote economy and efficiency on the part of each holder of a licence under this Chapter in its provision of airport operation services at the airport to which the licence relates,*

    d) *the need to secure that each holder of a licence under this Chapter is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport ("associated facilities") and aircraft using that airport,*

e) any guidance issued to the CAA by the Secretary of State for the purposes of this Chapter,

f) any international obligation of the United Kingdom notified to the CAA by the Secretary of State for the purposes of this Chapter, and

g) the principles in subsection (4).

2.2 Section 69 (1) of the Act defines user as:

"user", in relation to an air transport service, means a person who

a) is a passenger carried by the service, or

b) has a right in property carried by the service.

2.3 We also have concurrent powers with the Competition and Markets Authority (CMA) to enforce UK and European Community law on competition prohibitions in relation to the provision of the supply of airport operation services and air traffic services.[3] We are required to consider whether it would be more appropriate to use these powers before we take enforcement action against an airport operator and an air traffic services provider for breach of a licence condition. We may not take such licence enforcement action to the extent that we consider it would be more appropriate to proceed under the competition prohibitions.

2.4 Many of our regulatory objectives are consistent with the aims of competition law, which seeks to improve choice, quality and value for aviation consumers. However, when acting under our competition powers we can only take into account our sectoral objectives where the CMA would be able to have regard to those same matters when exercising its competition law functions. So some matters, for example environmental effects and financeability, may not therefore be relevant considerations when we apply our competition law powers.

[3] The CAA's concurrent competition powers for airport operation services and air traffic services, CAP 1016, available at: http://www.caa.co.uk/docs/33/CAP%201016.pdf.

Passengers are at the heart of the CAA's decisions

2.5 Our primary duty under the Act is to users, which includes passengers. We must also, where appropriate, promote airport competition. 'Users' implicitly includes future users as well as present users. The Act states that where conflicts between user interests arise, we must act to protect those interests as we think best.[4]

2.6 To inform our view of users' interests, we consider information from a range of sources, including from:

- the CAA Consumer Panel;
- passenger surveys;
- airline-airport operator negotiations; and
- rigorous consultation processes.

2.7 Established in October 2012, the CAA Consumer Panel acts (with internal independence) as a 'critical friend', scrutinising and challenging all our work. The principal aim of the Consumer Panel is to be a champion for the interests of consumers and the members of the Consumer Panel have a broad range of skills and experience in this area. Collectively, the Consumer Panel has a deep understanding of the regulatory environment both through the development of policy in the consumer interest, and through practical experience of how business best operates within a regulatory framework.[5]

2.8 Passenger research helps us understand passengers' airport experience and better understand passengers' priorities, requirements and expectations in terms of services provided at airports. This research can be undertaken by us or through different providers. For

[4] See Section (1) (5) of the Act.

[5] The key activities of the CAA Consumer Panel are: (1) to help us understand and to take account of the interests of consumers in policy development and decisions; (2) to undertake new targeted research and to gather intelligence to understand the aviation consumer experience; (3) to provide feedback from a consumer perspective on the effectiveness of our policies and practices; (4) to help us develop our approach to consumer engagement; (5) to challenge us on behalf of aviation consumers, as appropriate; and (6) to maintain an overview of developments in the aviation market from a passenger perspective and developments affecting consumers in other markets. See: '*The CAA Consumer Panel*', available at: http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90.

example, we undertook passenger research to inform our proposals for economic regulation of airports for the period from April 2014.

2.9 Rigorous consultation processes, combined with an 'open-door' policy, also ensures that we obtain a wide range of views from stakeholders on the issues that we need to consider. In particular, by outlining why certain decisions are being considered (and why others are not), we look to be proportionate, transparent, accountable, consistent and targeted in our regulatory approach.

2.10 While we have to apply judgement when coming to our regulatory decisions, our evidence based approach ensures that our decisions can withstand scrutiny and can be tested if there are challenges, including through the CMA and/or the Competition Appeals Tribunal.

2.11 We have regularly emphasised that the interests of airlines and those of passengers often overlap. This means that we often look to airlines to protect their own interests, and rely on this as also protecting user interests. This approach has helped us to deliver on our objectives.

2.12 We therefore consider that market or commercial agreements involving airlines have the potential to facilitate better outcomes for passengers, including with respect to price, service quality and new product/service development.

2.13 However, airline interests do not always align with those of users. This can be due to reasons such as:

- market power, including potentially a lack of competition in the airline sector;
- the cost of meeting the needs of certain user groups can outweigh the costs to airlines; and
- airlines focusing more than passengers on the present rather than the future.

2.14 This means that commercial agreements between airport operators and airlines do not guarantee that users' interests are protected. We therefore review such agreements when making regulatory decisions. Where commercial agreements are not sufficient to protect users' interests, we will not rely on them as the best way to deliver our duties, and will act in other ways. Where agreements are not in the passengers' interests, we may intervene to ensure that passengers

are adequately protected. For instance, we enforce competition law and the Airport Charges Regulations which, among other things, prohibit undue discrimination by airport operators.

2.15 Our ability to rely on commercial agreements is also restricted as commercial agreements between airport operators and airlines may not be possible.

Intervention should be proportionate

2.16 Consistent with the principles of good regulation and our duties under the Act, regulation to protect passenger outcomes should only occur where a market or commercial solution is not possible and where there is substantial market power (SMP).

2.17 Where intervention is required, this should be proportionate.[6] Regulation that is proportionate minimises burdens while being effective in delivering benefits for passengers, businesses and society. Effective regulation should not be seen as a burden as it can make markets work better and can bring benefits, including reduced prices, improved quality, more choice and innovation.[7]

2.18 Where intervention is required, we have a range of regulatory options and, consistent with our duties, our initial preference will be to intervene in a proportionate, light-handed way (e.g. monitoring). However, the better regulation duty is subsidiary to our duty to protect users' interests, and we will give primary weight to ensuring our actions are effective in protecting those interests.

The interests of users

2.19 In delivering on our duties to users, and promoting competition, we must have regard to a range of factors. Set out below is a range of factors we consider most relevant to the consideration of users' interests where capacity expansion is concerned.

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6 Other factors that we need to consider when determining the appropriate regulatory intervention are transparency, accountability, and consistency – see section (1) (4) of the Act.

7 '*Better Regulation*', available at: https://www.gov.uk/government/collections/better-regulation (accessed 22 October 2014).

2.20 Financeability. This duty implies that when we act, we do so in a manner that does not undermine the ability of the airport operator to raise finance. This does not necessarily mean that the regulatory regime should be tailored pre-dominantly to facilitate the raising of capital. Rather, it means we should consider the financeability duty alongside our other duties.

2.21 Reasonable demands. The scarcity of runway capacity has seriously damaging implications for passengers. We should look to carry out our functions in a way that facilitates the construction of new capacity. We expect that, after the Commission reports, only one capacity expansion project will have a reasonable likelihood of gaining planning permission in the medium term. Our duty means that we should act in a way that promotes the construction of such a project, so long as that remains overall in users' best interests.

2.22 Economy and efficiency. We should seek to ensure that the costs of new runway capacity represent good value for money. Our approach to achieving this needs us to take account of uncertainty and risk. This means that:

- incentives must be created to keep costs low;
- we should recognise our own lack of certainty about the future, and avoid where possible taking 'big bets'; and
- risk should be explicitly recognised and managed. Risk has a price, and there is often a choice between users carrying a risk (which reduces the price but increases the impacts if the downside of risks crystallises) and users paying others to carry a risk.

2.23 Environment. This important principle is fundamental to the planning process for new capacity. It also applies within our economic regulation functions insofar as we must ensure that environmental protection built in by the planning process is not frustrated.

2.24 Proportionality and targeting – see earlier discussion.

2.25 The following chapters set out the approach we propose to take to protect these interests and satisfy our other duties.

Chapter 3

Treatment of Category C costs – principles

Introduction

3.1 This chapter addresses the main costs of building new capacity – Category C costs: those costs incurred in connection with implementation and construction, up to entry-into-operation.

3.2 Our regulatory policy on this matter is set out in terms of principles. We consider this approach (rather than setting out a more detailed design for a regulatory regime), will best protect users for several reasons:

- All parties, including us, still have major uncertainties about what expansion will be permitted, and the market context in which expansion will occur. A detailed design published now may well turn out to be wrong and would need to be changed. Therefore, any apparent certainty would be illusory and could be misleading.
- We hope that uncertainty will be dispelled in part by stakeholders focusing their analysis on the fundamentals of expansion. However, if we published a detailed regulatory design now, there is a risk that effort would be diverted into analysing how best to profit from our decisions.
- Uncertainty can be dispelled if stakeholders are given incentives to reveal their true preferences. Publishing a detailed design now would not obviously create such incentives, and may stifle them.

3.3 We have identified three principles that we currently consider should underpin our future regulatory decisions (so as to protect the user interests identified in chapter 2):

- Principle 1: Risk should be allocated to those who can manage it best;
- Principle 2: Commercial negotiations should be encouraged; and
- Principle 3: Capacity can be paid for both before and after it opens.

Principle 1: Risk should be allocated to those who can manage it best

3.4 Risk means uncertainty as to outcome. At this stage, the uncertainties around airport expansion are considerable (e.g. planning risk, procurement risk, construction risk, regulatory risk, political risk, demand risk).

3.5 Risk relates to cost in two ways:

- it reflects the fact that the out-turn cost is unknown. The party that 'holds' the risk (i.e. will benefit if the out-turn is better than expected or suffer if it is worse than expected) has an incentive to make the out-turn as low as possible; and
- risk has a price. Investors price this risk in a relatively transparent way, expecting greater returns for greater risks. Making users carry risk without being paid for it is equivalent to taxing them or charging them more.

3.6 There is no 'true' price of risk – parties will price risk depending on their risk appetite and their view of prospective out-turn. That is, the price of risk will ultimately depend on opinion. Market negotiations can allow parties to reveal the price they place on risks.

3.7 Reducing risk for one stakeholder (or group of stakeholders) can also mean increasing it for others. For example, most proposals for reducing an airport operator's level of exposure to passenger demand risk imply passing that risk on to airlines and, indirectly, to passengers. We will therefore carefully consider such effects in any decision that involves the allocation of risk.

3.8 As a broad regulatory principle, we consider that risk should be attributed to those who can best manage it. Such an approach will ensure that:

- final out-turn cost is minimised. This is because the party with the strongest incentive to reduce costs is also the one with the ability to do so. This is particularly important in the case of civil engineering projects, where large cost over-runs are not uncommon;

- perceived fairness will be strongest. The party that controls the risk can benefit or suffer from its own decisions, rather than those of others; and
- information about the price of risk is likely to be revealed. This is because the risk-holder may act to 'lay off' the risk to parties with a different view of the risk, for instance through insurance or procurement. However, it will only do this if it can find a party with a different idea of the price (perhaps because this party has even stronger capabilities to manage out-turn costs). The price of the transaction will reveal information about the two parties' estimate of the risk.

3.9 We will, in general, only pass risks downstream to users where there is a strong justification. This might be where:

- users are best-placed to manage the risk, or no other party is better placed. However, it is not clear that this applies to any of the likely categories of risk under consideration. Even political and regulatory risk is capable of being shaped through policy debate or lobbying, activities that market players are better able to undertake than ordinary users; and
- this is overall in users' interests – for instance, because such an allocation is strictly necessary to get new capacity built.

3.10 We do not accept the view that risk should be allocated to the party with the lowest cost of capital. Our reasons for this view are explained in the following paragraphs.

3.11 The normal market mechanism is understood as follows. A party with a low cost of capital can raise funds cheaply because it is seen, overall, as a good risk. A borrowing company can generally be seen as a bundle of different projects with different risks; but lenders assess it as a package (unless there are strong reasons to believe some risks are ring-fenced) and attribute a weighted average. If a substantial new risk (higher-cost than the previous average) is brought into the bundle, then the weighted average will increase.

3.12 Given this model, and assuming the investment market runs efficiently, it makes no difference for users whether the risk of new capacity is paid for through an airport operator's or an airline's balance sheets. In either case, the weighted average cost of capital (WACC) of the risk-bearer will be adjusted to reflect the new risk, and the combination of the two (airport WACC plus airline WACC) will come to the same whichever balance sheet bears the risk.

3.13 The exception to this principle would be if the risks associated with the runway were uncorrelated with the other risks of an airline or airport operator. In that case, a portfolio benefit could be identified that would reduce the overall cost of capital. However, as the underlying drivers of risk associated with new capacity appear to be closely linked to the risks of the rest of the airport, we give more weight to the value of effective management of risk factors.

Principle 2: Commercial negotiations should be encouraged

3.14 The airline sector is generally competitive and incentives therefore exist for airlines to seek the best deal through negotiation with airport operators. As noted above, we consider that airline and users' interests are often, although not always, aligned and we therefore consider that airline-airport operator negotiations could deliver more user benefits than regulation.

3.15 There are several reasons why airline-airport operator negotiations could deliver more user benefits than regulation:

- Limits to the regulator's knowledge. Relative to a regulatory consultation, commercial negotiations have the potential to elicit more truthful information from participants about their opinion and appetite for risk.
- The dynamism and volatility of the aviation sector, which places a premium on flexibility over time. Regulatory processes cannot be too flexible, since highly flexible also means unpredictable, which can have negative implications for cost of capital and the willingness of investors and other companies to participate. In contrast, contracts may offer more scope for parties to re-negotiate and therefore make flexibility more consistent with commercial risk-management.

- The variety of user needs and preferences, which means the optimal outcome is not 'one size for all' but a complex mix of price and quality factors. As the resources of a regulator are often limited, it is likely to be less effective at addressing this variability, compared to the continual optimisation that can be achieved by a market.

3.16 While Heathrow Airport Limited (HAL) and Gatwick Airport Limited (GAL) are not operating in perfectly competitive markets, even in the presence of SMP there is scope for commercial agreements to be struck that would not necessarily involve an abuse of SMP or a distortion of competition.

3.17 Where commercial agreements are struck we will review them to make sure that no further action is necessary to deliver on our statutory duties. We will also review the compliance of commercial agreements with other statutes that fall to us to enforce, notably competition law and the Airport Charges Directive.

3.18 However desirable, commercial agreements on capacity expansion may not be possible. Reasons why a commercial agreement may not be reached include:

- different risk appetites;
- participants taking too short-term a view. (No criticism is intended by this comment, it is simply a matter of the strategic choices taken by shareholders and company boards);
- market power, whether this means an airport operator exercising its SMP in negotiations, or airlines seeking to exercise countervailing buyer power. In either case, the counter-party may prefer to seek a regulated outcome; and
- in general, airlines and/or airport operator may consider that a more favourable outcome could be achieved through regulation.

3.19 It is also not clear what form a commercial contract could take. The simplest such contract might be to pre-sell the right to use the new capacity. However, the Slot Regulation[8] (and associated UK implementing regulations[9]) prevent airlines from pre-buying capacity at an airport (see appendix D). Indeed, the Slot Regulation facilitates new entrants obtaining capacity, and might therefore discourage the incumbent airlines from supporting expansion at all. The Slot Regulation also creates grandfather rights on slots, and airlines with a legacy position at a particular airport may not face the full cost of congestion.

3.20 What is possible, however, is the usual type of contract already signed between airlines and airport operators, which sets the price at which slots can be used (rather than selling the slot itself). Typically, such prices are set as part of a deal that covers the number of passengers or flights that an airline will bring to an airport, quality factors, retail revenues, marketing support provided by the airport operator, as well as other elements.

3.21 Such contracts could be the vehicle by which an airline commits to bring demand and revenue to a new runway, which may be the crucial factor that enables new capacity to be financed. However, whether this is feasible or not may depend on whether airlines consider that any achievable price discount would give them effective access to slots once the new capacity was open. (They might believe this because they foresee that capacity would not, in fact, need to be rationed; or even if it were, they might foresee a non-contracted airline winning a slot, but deciding not to use it because the price was too high, so it would be recycled to the contracted airline.)

3.22 Airline attitudes on this matter are currently unclear, and we consider that an extended period of negotiation will be necessary to confirm whether such contracts are a viable basis for financing and constructing new capacity. The success of such negotiations will also depend on whether an airport operator considers airlines as reliable counter-parties to such long-term arrangements, and this also is unclear.

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8 Regulation EEC 95/93 as amended.

9 The Airport Slot Allocation Regulations 2006.

3.23 These challenges notwithstanding, both HAL and GAL have indicated a willingness to explore commercial arrangements to support capacity expansion. As we see scope for passenger benefits to accrue from the successful completion of such negotiations, we are willing to give stakeholders space for these negotiations to occur.

3.24 However, we recognise that the uncertainty of waiting to see if commercial deals are possible will need to be contained. Therefore, we will conduct a review around six months after a Government policy decision on capacity expansion to determine if airlines, airport operators and investors have confidence that a market or commercial approach could support capacity expansion.[10] Following this review, we will determine the best way forward.

Principle 3: Capacity can be paid for both before and after it opens

3.25 We consider that payments for new capacity can be made before or after it is open for use. There are two main reasons for this:

- front-loading[11] is likely to reduce the overall costs of a project unless the mechanism by which it is achieved undermines incentives to minimise these costs; and
- it is consistent with the working of a competitive market, which seems to be a reasonable basis against which to design regulation.

[10] There are a number of different stages where the Government will have to make decisions on capacity expansion, although this is somewhat dependent on what process the Government adopts to facilitate the development of any new capacity. We have assumed that two main Government decisions will be required: (1) a Government policy decision on if and where new capacity can proceed – this is the stage referred to in this paragraph; and (2) a Government planning decision following the Planning Inspectorate's decision (although this could also take the form of Parliament passing an hybrid Bill). This assumption is, however, subject to some uncertainty.

[11] In this document, the terms front-loading, pre-funding and pre-financing are used interchangeably.

Front-loading is likely to reduce the overall cost of the project

3.26 We consider that capacity being paid for before it is delivered may be good for users.

- Front-loading revenues can help ensure that there are sufficient cash flows to meet the upfront design and construction costs involved in a large infrastructure project such as capacity expansion. This can reduce the risk of project failure and hence can reduce the cost of finance that an airport operator may reasonably incur in undertaking this project.
- Front-loading can also bring forward the point where investment is paid back, and so it can reduce the project's exposure to demand risk later in its life. Again, this can reduce the price-of-risk that users may have to pay.
- Front-loading can help to smooth increases in charges that users may ultimately face. That is, rather than having a significant step change in charges at the point when new capacity becomes operational, pre-funding can spread the costs over users, which results in a smaller step change. Minimising the size of the uplift in airport charges in any given year means fewer passengers are likely to be priced off (to the extent that any are priced off by the cost of airport capacity), and also should provide relatively more certainty to users

3.27 There are nevertheless grounds to be cautious about whether front-loading will be in users' interests. While in many cases users who will have paid for the expansion will be the same as those that use it, this many not be the case. Given the dynamism of aviation, the services provided using capacity may be quite different twenty or thirty years hence than those provided when a runway opens, and hence the users might not be naturally seen as the heirs of those who provided pre-funding. Also, a later generation of users may choose not to use the capacity at all – to fly less, or from elsewhere. So pre-funding can raise inter-generational concerns and implies that, individually or collectively, users are carrying demand risk. The benefits from pre-funding need to be at least large enough to compensate users for this demand risk. We would only implement pre-funding if we were satisfied that we could reasonably consider this to be the case.

3.28 Moreover, we will consider whether concerns about pre-funding could be mitigated. For instance, we are open to sculpting depreciation where required to help address this issue. Sculpting depreciation could ensure that those who use the new capacity will bear more of the cost. This is, however, a complex issue that is discussed in more detail in chapter 4.

Consistency with the working of a competitive market

3.29 We also consider that for prices to rise before new capacity opened is a pattern that might be seen in a competitive market. This is therefore a pattern that may be appropriate as an outcome of regulation.

3.30 In a simple supply and demand model of a competitive market, if capacity were insufficient to meet demand, prices would rise until demand had been priced off such that available supply or capacity could serve that demand. If a market participant had the ability to expand, creating new capacity with a lower unit cost than current 'scarcity prices', then it would have an incentive to build this capacity, so long as the perceived value of future gains exceeded the perceived costs. The effect of this expansion of supply would be to enable more demand to be served, reducing prices to a new market-clearing point. The extent to which prices fall depends on the gradient of the demand curve.

3.31 In practice, in many markets this process happens in small increments, such that investment is made along with demand growth and prices do not rise, and/or participants plan and invest ahead of demand growth.

3.32 If expansion was likely to arrive in a large 'lump', however, prices might rise significantly before a new investment was made. Where the cost of the new 'lump' was relatively low, and it led to a large price effect – large enough to swamp any price effects that might arise from smaller expansion projects – then the latter might not be built. However, where the price resulting from the expansion is expected to be quite high, smaller expansion projects may well be viable.

3.33 In the real world, competing businesses seek to expand. They are able to expand where current revenues and profitability sustain the expansion, so higher prices as result of scarcity may contribute to ability to invest. However, their willingness to expand will depend on expectations of prices after the expansion, as well as of demand and of the actions of competitors.

3.34 Our preliminary conclusions on this issue are:

- In a competitive market, price rises can be a signal for increasing output/investment, and to some extent these higher prices could pay for any capacity expansion. Some respondents to our earlier consultation argued that 'in a competitive market, one is not expected to pay for a product before receiving it'. However, this argument seems to be invalid, as it does not take into the account the way higher prices in a tight market can signal (and effectively contribute towards) capacity expansion that is inherently 'lumpy'.
- Where there are capacity constraints, the upward pressure on prices towards the market clearing level will encourage capacity expansion across the sector (i.e. across all the airports in the relevant market rather than just one airport). These expansion projects may not collectively be sufficient to fully meet demand, but nevertheless could contribute to reducing market power (once the various investments have been made) and reducing prices by increasing supply.
- Price rises can apply across a market. However, to the extent that airports are serving different markets (product or geographic), higher prices at 'airport A' will not lead to price rises at 'airport B'.

Determining appropriate prices

3.35 Where there are conditions that prevent competitive airport markets occurring (such as differentiated markets, SMP and/or barriers to expansion through Government policy), determining appropriate prices can be challenging. However, even in these circumstances, the broad principle that where there is scarcity of airport capacity, prices would rise before any new capacity came on-line, seems to be a fair assumption.

3.36 In the current control period (Q6), prices at HAL and GAL were prevented from rising. One of the reasons for this was that higher prices would not trigger new capacity investment, as it was blocked by other factors.

- In the case of Gatwick, we concluded that GAL's prices were in line with the range of prices that could reasonably reflect the competitive price. We did not accept GAL's view that the competitive price was well above current regulated prices. We noted that GAL's view suggests that in the absence of regulation prices at Gatwick would rise. However, this is inconsistent with the latest evidence in relation to the recent deals proposed by GAL offering discounts to the airlines on their airport charges.[12]
- In the case of Heathrow, we considered HAL's prices by evaluating evidence from a range of sources, including evidence from airlines, other airport operators and from benchmarking. We concluded that there was evidence that HAL's approach to pricing reflected SMP. We also noted that, given excess demand and capacity constraints within the London area, it is likely that the current regulated price at HAL is below the market clearing price. In the absence of regulation, given the current capacity constraints and that HAL is the only operator in the relevant market, the market clearing price would most likely be far above competitive levels (potentially at levels close to the price that would be set by a dominant operator).[13]

[12] CAA, Appendix G: Evidence and analysis on indicators of market power, CAP 1134, available at: http://www.caa.co.uk/docs/78/GAL%20CAP%201134%20Appendix%20G-%20Evidence%20and%20analysis%20on%20indicators%20of%20market%20power%20(Non%20Con).pdf.

[13] CAA, Appendix F: Evidence and analysis on indicators of market power, CAP 1133, available at: http://www.caa.co.uk/docs/78/HAL%20CAP%201133%20Appendix%20F%20-Evidence%20and%20analysis%20on%20indicators%20of%20market%20power%20(Non%20Con).pdf.

3.37 If expansion becomes unblocked, we consider that it may be appropriate to allow airport prices to rise to levels higher than the current 'cost-plus' approach. However, this will only apply where the market clearing price is higher than the regulated price. These higher prices would, however, only apply at the expanding airport and those in the same relevant market.[14] (Of course, to the extent that those other airports are not economically regulated, we have little or no influence over their pricing.)

3.38 At this stage, we are not taking a firm view as to the appropriate mechanism by which prices could start to rise before any new capacity comes on-line. Potential mechanisms by which prices could start to rise include:

- the effect of commercial contracts that provide for pre-funding;
- us taking a different approach to general price controls, such that prices were allowed to rise towards a clearing price; or
- us making specific provision for expansion in capital plans, where these are part of setting price controls.

[14] In recent market power determinations, where relevant markets were defined, we noted that capacity constraints and high access prices prevented airlines at Gatwick successfully switching to Heathrow. As a result of any significant increase of capacity at Heathrow, there may therefore be greater scope for airlines to switch from Gatwick to Heathrow, which could affect the competitive constraints faced by GAL. (Our market definition for HAL was that we considered that there was one market in which HAL operated, that being the provision of airport operation services for full service carriers and associated feeder traffic market that is limited to Heathrow.) Our Q6 decision on the appropriate form of regulation introduced licence backed commitments for GAL and the evidence used to inform this decision suggested that prices at Gatwick were appropriate (notwithstanding GAL considering that the market clearing price was much higher). What all this means is that in the event that GAL is allowed to increase capacity (and assuming market definitions remain unchanged), it may be appropriate to allow prices to increase at Gatwick if it could be demonstrated that the market clearing price was higher than the regulated price. Under this scenario, HAL (which would not be expanding capacity and operates in a different market), would not be permitted to increases its prices above the cost-plus approach currently in place.

3.39 However, to the extent that we are determining prices, we do not consider that prices should not be allowed to reach the market clearing price that would be achieved in the absence of regulation. Such a price might be very high, so taking full account of it could create substantial volatility that is not in the long-term interests of users. Moreover, the analysis is subject to significant uncertainty and depends to some extent on decisions taken by the CAA as regulator. (For instance, when setting prices it is important to recognise that treatment of depreciation will have a significant effect on prices faced by airlines – see chapter 4 for more information.)

3.40 While we are open to allowing prices to rise above the appropriate 'cost-plus' price where capacity expansion has been unblocked, we recognise that the application of Principle 2 (see earlier in this chapter) may negate the need for us to be involved in as intrusive a manner as we may have been in the past.

Chapter 4

Current thinking on some aspects of price control structures

Introduction

4.1 This chapter explores our current thinking on price control structures and considers:

- regulatory options;
- current thinking on RAB-based regulation; and
- the duration of a price control.

4.2 The information outlined in this chapter should be taken as our current thinking rather than a definite position.

Regulatory options

4.3 It follows from the principles in chapter 3 that a commercial settlement should be encouraged, subject to the outcomes being in users' interests. Such a commercial settlement could conceivably mean that no regulatory intervention would be required.

4.4 The tests for whether regulation is applicable at all are set out in section 6 of the Act (the market power test). This section states:

> *(1) The market power test is met in relation to an airport area if tests A to C are met by or in relation to the relevant operator.*
>
> *(2) For the purposes of tests A to C "the relevant operator" means the person who is the operator of the airport area at the time the test is applied.*
>
> *(3) Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate (but see subsections (6) and (7)).*

(4) Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power.

(5) Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

4.5 So, for example, a commercial agreement could:

- provide evidence that an airport operator has no market power; or
- establish, even though an airport operator has market power, that the benefits of regulation are less than the adverse effects, since the scope to abuse market power has been substantially contracted away. (Or contractually mitigated to such an extent that competition law is a sufficient remedy.)

4.6 Otherwise, a commercial settlement might allow for only high-level regulation to be applied.

4.7 Where regulatory intervention is applied, it should be proportionate and we would define the form of regulation by considering the range of options available.

4.8 Given the proportionality objective, we have a preference towards light-handed interventions (e.g. monitoring), with more interventionist approaches (e.g. licence backed commitments) further down the ranking.

4.9 The main regulatory options available to us (from a lighter to a more interventionist approach) include:

- monitoring (which can be light-handed, such as occurs in some Australian airports, or progressively more intrusive);
- commercial arrangements, compliance with which was enforced by a licence (such as that currently applied to GAL). These could be multi-lateral or bi-lateral or both; and
- RAB-based regulation (such as that currently applied to HAL).

4.10 We explored the potential for monitoring in the Stansted Airport Limited (STAL) Initial Proposals[15] but there are numerous alternative ways such an approach could be developed.

4.11 Similarly, there are a number of ways by which commercial arrangements supported by a licence could be developed. However, the licence backed commitments approach adopted at GAL, if it proves successful over time, could provide a useful framework for us to build on.

4.12 With respect to RAB-based regulation, there are a number of different approaches that could be adopted and these are discussed in more detail below.

Current thinking on RAB-based regulation

4.13 Where a RAB-based approach is applied to an airport operator that is undertaking or has undertaken capacity expansion, our current thinking is that:

- There is limited value in a split-RAB approach or a separate RAB for the new runway. While it is feasible for multiple RABs to be used, there would be strong linkages between the risk profiles of the runway and the rest of the airport, and hence of the capital that would fund the different RABs. This is likely to result in the market taking a 'blended' view of the risk that the airport as a whole is facing. Thus, the same funding costs would be incurred in the multiple RABs. If the primary aims of using multiple RABs were to better manage risk (usually reflected in the cost of gaining finance), this suggests little would be gained from using multiple RABs.
- It may nevertheless be possible to construct a Special Purpose Vehicle whose risks were substantively de-coupled (genuinely ring-fenced) from those of the rest of the airport. As many of the risks of a new runway are intertwined with those of the rest of the airport, we are unclear if investors would back such a proposition. However, we are open to considering such an arrangement.

[15] CAA, Economic Regulation at Stansted from April 2014: Initial Proposals, CAP 1030, available at: http://www.caa.co.uk/cap1030.

- It has been our practice that unanticipated, efficiently incurred capacity expansion capital expenditure (capex) should be added to a RAB at the end of a control period, including the full financing costs (the WACC of the current control period). We understand that this is different from the approach in other sectors, where unanticipated capex is not allowed to be added to a RAB, and reflects the volatility of aviation. We currently see no reason to move away from this approach.
- Efficiently incurred capacity expansion operational expenditure (project opex) should be capitalised. This means that we will treat project opex in the same way we treat capacity expansion capex.[16]
- Sculpting depreciation may be appropriate – this means that the recovery of costs by the airport operator could be delayed so as to reflect growing demand levels/utilisation levels. This can help avoid a step increase in charges when new capacity opens and can create a strong incentive for an airport operator to fully utilise the capacity that it has available. However, compared with applying straight line depreciation, this approach may increase airport operator risk (included with respect to stranded assets) and increase the cost of capital. We will, therefore, need to carefully consider the merits of such an approach following development of a detailed plan, and consideration of market conditions, to ensure that it does not have a detrimental effect on users.

4.14 There is little that we can say at this time on the appropriate WACC. However, our current thinking is that the WACC should appropriately reflect the conditions that we expect the airport operator to face over the duration of a price control (see below).

The duration of a price control

4.15 Under the Airports Act 1986, we were required to set price caps for five years. However, the Act provides new flexibility around the duration of price control periods. For example, the Q6 price cap for HAL was set for four years and nine months, while GAL has licence backed commitments that last seven years.

[16] This is subject to any provisions that we have outlined, including with respect to costs incurred as a result of the Commission process.

4.16 We consider that there are merits in setting a longer price control given the scale of the capital investment required to build a new runway. Alternatively, some elements of the control could be 'locked in' for a longer period (i.e. across multiple control periods) through a CAA policy statement.

4.17 One of the benefits of such an approach would be a reduction in regulatory risk. By providing assurance that we do not intend to reconsider our regulatory approach for a longer period of time, airport operators/airlines may be exposed to lower financing risks and lower costs of capital than would otherwise have been the case.

4.18 A longer price control may also:

- give airport operators a clear financial stake in controlling their costs over a longer time horizon;
- change the way airport operators plan their activities, anticipate customer needs and innovate; and
- reduce administrative and regulatory burdens of the price control regime.

4.19 However, there are a number of potential drawbacks of longer price controls:

- the regulatory regime is likely to be less adaptable, making it difficult to makes changes to what airport operators are required to deliver and to improve the regulatory arrangements over time; and
- forecasting over a longer timeframe increases the risks that airport operators either find themselves unable to finance their activities or earn what could be perceived as 'windfall profits'.

4.20 Notwithstanding these limitations, we consider there are merits in setting a longer price control in the case of a major new capital project such as a new runway. That said, the assessment of the relative costs and benefits of a longer price control will require consideration of applicable circumstances, for instance, the state of the UK economy and financial markets, which are not known at this time. Therefore, it is too early to make a decision on the appropriate duration of any price control.

Chapter 5

Cost recovery of Category A and B costs

Introduction

5.1 This chapter sets out our current thinking on how we will treat costs in Categories A and B:

- Category A costs are all costs incurred by an airport operator or HHL in seeking to influence the Commission, and associated lobbying. These costs will, in general, be incurred before a Government policy decision on capacity expansion is made.
- Category B costs are capacity expansion costs incurred by an airport operator after a Government policy decision and are associated with seeking planning permission.

5.2 These costs have in common the fact that they relate to a project that might not happen. We are keen to ensure that passengers should not bear the full risk of a project in the event that planning approval is not granted (or is rescinded or is withdrawn), as occurred with STAL's second runway project.

Category A costs

5.3 We consider that all costs associated with an airport operator's or HHL's submissions to the Commission, together with any associated lobbying costs, should be borne by the proposer.[17]

5.4 We do not see a capacity expansion proposer's submissions to the Commission as part of the planning process, even if one of the proposer's proposals is permitted to go forward by the Government. The Commission has no statutory role in planning. Moreover, unlike in a planning context, there is no legal mechanism for proposers to be held to their forecasts. Indeed, we anticipate that the 'winning'

[17] We currently consider that lobbying costs would include (but are not limited to) the costs involved in developing and implementing advertising campaigns, the cost of any strategy experts employed to assist with their campaign, and the costs associated with engaging (lobbying) Councils, Ministers and Members of Parliament.

proposal may well evolve after the Commission's final report, and as set out in chapter 6, we will undertake our own review of the selected design. For these reasons, in general, we do not consider that proposals to the Commission can be considered as preparation for the planning process.

5.5 Our proposed approach to treatment of Category A costs aims to ensure that:

- all short-listed proposers are treated equally (including HHL, the only non-airport operator that has a capacity expansion proposal that has been short-listed by the Commission);
- users do not carry costs that shareholders have willingly incurred, for reasons of their own commercial strategy, without any promise of compensation; and
- users do not carry costs that have been incurred as part of a political strategy to convince stakeholders about the merits of a particular proposal, rather than in delivering capacity.

Category B costs

5.6 Category B costs are capacity expansion costs incurred by an airport operator after a Government policy decision and are associated with seeking planning permission. We expect that these costs could be much more substantial than Category A costs.

5.7 Category B does not include development of proposals to the Commission. However, it may include costs for further development or modification of work done for the Commission where this is necessary to prepare the proposed scheme for a planning application.

5.8 As Category B costs will be incurred after a Government policy decision on whether to allow capacity expansion to occur, we consider they can be seen as part of the costs of building more capacity. For this reason, users can reasonably be expected to carry some or all of these costs.

5.9 We are keen to maintain strong incentives to keep costs as low as possible. The simplest way to create such incentives is to set a fixed allowance of cost that the airport operator can recover. If the airport operator reasonably incurs less than this, we will allow it to retain the under-spend.

5.10 For both HAL and GAL, where there is a material change in circumstances, we have discretion to reopen a price control to ensure that the price controls better reflects the changed circumstances. However, our preference is to avoid re-opening price controls unless absolutely necessary.

GAL's recovery of Category A and B costs

5.11 In the event that the Government supports the development of a second runway at Gatwick, GAL's commitments in its licence permit GAL to recover the reasonable capital, operating and financing costs of up to £10m incurred in any one charging year for the purposes of applying for planning permission for a second runway and for the subsequent development of the runway and associated airport infrastructure. Recovery of these costs is subject to GAL following any policy guidance issued by us in relation to the recovery of costs.

5.12 Under its licence, if GAL wants to recover costs above the £10m threshold in a charging year, it must inform us in writing, setting out its reasons and justification in accordance with any guidance issued by us. In addition, recovery of its expenditure will be subject to the process governing modification of licences set out in sections 22 to 30 of the Act.[18]

5.13 Assuming that the appropriate procedures (as outlined above) are followed (and that the Government supports the development of a second runway at Gatwick), this means that reasonable planning costs (Category B costs) can be passed through to airlines.[19] This holds whether or not these costs are smaller or greater than £10m per year.

5.14 We consider that it would be unreasonable for any of our guidance on cost recovery to prevent recovery. However, for the recovery of sums over £10m per year, we can, through the licence modification process, introduce further conditions that must be complied with for cost recovery to proceed.

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18 See Appendix B for more information.

19 This includes planning costs even if these are incurred before a Government decision. However, as set out above, we consider that submissions to the Commission, which is not a planning body, cannot be considered as preparation for the planning process.

5.15 The CAA's guidance, as referred to C1.10 of GAL's licence (see appendix C), is outlined below.

5.16 The recovery of reasonable planning (Category B) costs, equal to or less than £10m per year, should exclude all Category A costs, notwithstanding that information gained from Category A expenditure may (in part or in full) be subsequently used for planning purposes (Category B costs). For the avoidance of doubt, costs associated with lobbying for a particular proposal will be considered Category A costs and will have to borne by GAL (and not users). In addition, once costs have been incurred for Category A costs, we will not allow those costs to be re-categorised as a Category B cost if the information is subsequently used for planning purposes. That is, following the cost being incurred (or 'sunk') by GAL, we will consider that the cost of using that information for another purpose is £0.

5.17 To ensure that such costs are not borne by users, GAL will need to be able to provide evidence on the scope, nature and extent of Category A and Category B costs. Where GAL is seeking to recover a Category B cost that represents work that draws on an input that is a Category A cost, it will only be the residual cost (Category B cost minus Category A cost) that will be considered. The onus will be on GAL to clearly demonstrate why a cost should be categorised as B and not A.

5.18 Assuming that the planning costs of £10m per year or less are incurred, GAL's licence allows these costs to be automatically passed through to airlines following the completion of the work of the Commission and after the Government has indicated that capacity expansion at Gatwick can proceed.[20] We consider that these costs can start to be passed through in the year following the Government's policy decision on where capacity expansion can occur. The process outlined in GAL's Conditions of Use (2014/15) illustrates how the recovery of these costs can occur.

[20] Government support can take a number of forms and it may be difficult for us to judge how the Government will articulate its response. Potential options include but are not limited to a policy statement/press releases or a National Policy Statement. We will carefully consider the available evidence to determine when we consider a Government decision on new capacity has been made. As part of this process, we would expect GAL to notify us, with supporting evidence, as to when it considers this milestone has been met.

5.19 Where GAL has been unable to secure a commercial arrangement on capacity expansion costs in excess of £10m per year there is (as noted above) a regulatory process that can facilitate it.

5.20 If GAL wishes to recover Category B costs over £10m in any given year, we will conduct an efficiency review of the proposed costs to ensure that they are reasonable (and can be passed through to airlines).[21] Inefficient costs may not be recovered from airlines or passengers.

5.21 We also consider that it is appropriate for GAL and the airlines to develop appropriate risk sharing arrangements where capacity expansion costs in excess of £10m per year result. This means that in the event that planning permission is not given, or is rescinded, there will be a mechanism by which airlines will be able to recover the charges that GAL has collected over the £10m per year permitted (or some proportion of them, by agreement). Where a commercial agreement on this risk sharing arrangement is not reached, we will determine what these risk sharing arrangements should be.

5.22 Any licence modification to enable the recovery of costs greater than £10m per year will include provisions that reflect the intent of this guidance, including that we will have efficiency reviews for sums over £10m in any year.

5.23 Where a commercial arrangement to cost recovery of costs in excess has been established, we will allow those agreements to remain (provided that they are in the interests of users and otherwise that is the course of action most consistent with the CAA's statutory duties).

HAL's recovery of Category A and B costs

5.24 For HAL in Q6, Category B expenditure up to £10m per year will be allowed to be added to annual charges. The approach (formula) by which this can occur will need to be developed but we may draw on the approach we have adopted for GAL.

[21] We currently consider that this review will feed into the licence modification process outlined in section 22 of the Act.

5.25 Consistent with the approach adopted for GAL, we will allow each year (assuming the Government allows a new runway at Heathrow) the first £10m of Category B costs to be passed through to airlines. However, where these costs exceed £10m in any year of Q6, we will review these costs to ensure that they are efficient.

5.26 Subject to such efficiency review, and consistent with the approach taken in respect of GAL, Category B costs over £10m per year can be recovered subject to risk sharing arrangements being established. This means that, absent any contractual provision, these sums must be returned to airlines if planning permission either is not granted or is rescinded.

5.27 We will make proposals to amend HAL's licence to give effect to these provisions. However, we would welcome provision being made for these matters in commercial negotiations and agreements. As is made clear earlier in this paper, we consider that commercial arrangements regarding capacity expansion could be good for users and may reduce the need for licence provisions on these matters.

5.28 We consider that our approach to both HAL and GAL fulfils our duties to users (see appendix A). It foresees users bearing the lion's share of planning costs, which are legitimately part of the total cost of delivering capacity expansion that will be beneficial to users. However, it should prevent them from having to carry the total planning costs of a project that does not get past planning approval or where any approval is rescinded.

HAL's recovery of costs where HHL is involved

5.29 If the Government determines that a HHL capacity expansion option should be developed (recognising that it is not an airport operator), our current thinking is that the approach outlined with respect to HAL (above) should, in general, apply.

5.30 As we consider that the bulk of HHL's costs will be Category A costs (as we understand that HHL intends to sell the intellectual property rights for its runway concept to HAL), we do not consider that users should carry these costs.

5.31 In buying HHL's concept, HAL will largely be compensating HHL for Category A costs and we do not consider it would be appropriate for those costs to be paid by HAL users (see earlier discussion). Allowing such costs to be recovered would also result in inequality of treatment between capacity expansion proposers. In addition, we would be likely to consider that an efficient operator in HAL's circumstances should have taken steps to avoid the need for it to purchase a third party's (HHL's) concept that was directly related to its core business. Either way, we consider that these costs should be borne by HAL, not users.

5.32 Any Category B costs that HAL subsequent incurs would be subject to the policy we have outlined for HAL (above).

Chapter 6

Scrutiny of design and costs

Introduction

6.1 This chapter outlines how we propose to scrutinise airport operator capacity expansion design and costs, through an *ex ante* and *ex post* review of the 'winning' proposal. Given the scale of the investment required to build new capacity, these reviews will protect users as regards the economy and efficiency of expansion.

6.2 Undertaking an *ex ante* and *ex post* review will help ensure:

- efficiency in the proposed design;
- only efficient costs are passed through to airlines; and
- the interests of users, including passengers, are protected.

6.3 We consider that stakeholder engagement and negotiations will be key components in any assessment. We encourage airlines and airport operators to actively engage so as to ensure that their views are reflected in any proposals. Records should be kept to illustrate this engagement as we may wish to view these as part of our assessment process.

Ex ante review

6.4 Building on analysis already undertaken by others, our current thinking is that we will undertake a detailed *ex ante* review of the proposed design of any capacity expansion proposal. This will occur after the Government decides where expansion can proceed but before the planning application is lodged with the Planning Inspectorate (or before the hybrid bill process).

6.5 Our proposed timing for the *ex ante* review recognises that we cannot ask for a ‘frozen’ design. However, we seek to ensure that we will be considering broadly the proposal that the airport operator intends to introduce into the planning process.

6.6 We recognise that the Planning Inspectorate may request material changes to the plans that an airport operator may have submitted (and which we will have considered). Where the Planning Inspectorate determines that submitted plans must be materially changed, we will consider re-opening our cost review. However, where any Planning Inspectorate changes are not as material, or for any other reason we do not re-open our review, then consideration of such changes will be rolled into any *ex post* review of costs (see below).

Ex post review

6.7 Assuming that a RAB-based approach is in place at the airport where capacity expansion occurs, we will complement our *ex ante* review with a detailed review of costs later, before they are added to a RAB.

6.8 This review will focus on how the project has been delivered: for instance, tendering, project management, benchmarking. It will be based on how well the work was undertaken, in the light of information that was available at the time (rather than with the benefit of hindsight).

6.9 The regulated airports and airlines will be familiar with this approach as, under our traditional RAB-based approach, the efficiency of a project has been assessed at the end of a regulatory control period before it has been added to a RAB.

6.10 The success, scope and level of commercial discussions an airport operator has had with airlines, including as part of any Constructive Engagement style processes, will be used by us to inform the scope and magnitude of our reviews. We will also consider the behaviour of participants in any engagement process.

6.11 Successful commercial negotiations could negate the need for us to undertake an *ex post* assessment, or at least greatly diminish the level of *ex post* reviewing that we will be required to undertake.

Chapter 7

Market power

Introduction

7.1 This chapter provides information on our current thinking on market power. In considering these issues we have assumed that the Act remains unchanged.

Market power

7.2 Our current thinking is that a market power assessment (MPA) should not occur until much closer to, or even after, the opening of any new capacity. We are unconvinced that an earlier MPA would provide greater regulatory certainty.

7.3 There is an argument that regulatory uncertainty and the cost of capital could be reduced if it was possible to do a MPA in advance of what might be a material change in circumstance. However, we are not persuaded by this argument as:

- An early, forward looking MPA would have to be based on assumptions of future market conditions. While all MPAs need to do this to some extent, forecasting expected market condition over such a time horizon is unlikely to be accurate.
- An early MPA would be subject to periodic review and would need to be changed if the evidence changed. Given we would have to state in the MPA that the decision would be kept under review and therefore subject to change, this would not provide much additional regulatory certainty.
- Practically, there is likely to be a shortage of robust evidence that we would be able to draw in coming to any decision. That is, while new runway capacity may result in airlines and airport operators changing their long-term business strategies and investment plans, there is unlikely to be substantive evidence in the market for many years after the government planning decision.

7.4 Given the above, an early and forward looking MPA is likely to be challenged at the Competition Appeals Tribunal. This would impose delays and potentially add additional risk to the capacity expansion process.

7.5 With respect to timing, an MPA can be undertaken at anytime between now and after any new capacity is in operation. However, we require sufficient evidence of a material change of circumstances to consider changing any previous finding of SMP.

APPENDIX A

CAA general duties – extract from the Act

CAA's general duty

1. *The CAA must carry out its functions under this Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.*
2. *The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.*
3. *In performing its duties under subsections (1) and (2) the CAA must have regard to—*
   a) *the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted,*
   b) *the need to secure that all reasonable demands for airport operation services are met,*
   c) *the need to promote economy and efficiency on the part of each holder of a licence under this Chapter in its provision of airport operation services at the airport to which the licence relates,*
   d) *the need to secure that each holder of a licence under this Chapter is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport ("associated facilities") and aircraft using that airport,*
   e) *any guidance issued to the CAA by the Secretary of State for the purposes of this Chapter,*
   f) *any international obligation of the United Kingdom notified to the CAA by the Secretary of State for the purposes of this Chapter, and*
   g) *the principles in subsection (4).*

4. *Those principles are that—*

   a) *regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and*

   b) *regulatory activities should be targeted only at cases in which action is needed.*

5. *If, in a particular case, the CAA considers that there is a conflict—*

   a) *between the interests of different classes of user of air transport services, or*

   b) *between the interests of users of air transport services in different matters mentioned in subsection (1), its duty under subsection (1) is to carry out the functions in a manner which it considers will further such of those interests as it thinks best.*

6. *For the purposes of subsection (3)(d) the environmental effects of the airport, associated facilities and aircraft include—*

   a) *substances, energy, noise, vibration or waste, including emissions, discharges and other releases into the environment,*

   b) *visual or other disturbance to the public,*

   c) *effects from works carried out at the airport or the associated facilities or to extend the airport or the associated facilities, and*

   d) *effects from services provided at the airport or the associated facilities.*

7. *Section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the carrying out by the CAA of its functions under this Chapter.*

APPENDIX B

Modifying licences – extract from the Act

22 Modifying licence conditions and licence area

1. The CAA may modify a licence by modifying—

a) the licence conditions, or

b) the area for which the licence is granted,

subject to section 23.

2. Before modifying a licence in reliance on this section, the CAA must—

a) publish a notice in relation to the proposed modification,

b) send a copy of the notice to the persons listed in subsection (3), and

c) consider any representations about the proposed modification that are made in the period specified in the notice (and not withdrawn).

3. Those persons are—

a) the holder of the licence, and

b) such bodies representing airport operators or providers of air transport services as the CAA considers appropriate.

4. The notice under subsection (2) must—

a) state that the CAA proposes to modify the licence,

b) specify the proposed modification,

c) give the CAA's reasons for the proposed modification,

d) state the effect of the proposed modification, and

e) specify a reasonable period for making representations.

5. If, after publishing the notice under subsection (2), the CAA decides not to modify the licence in reliance on this section, the CAA must—

a) publish a notice, giving its reasons, and

b) send a copy of the notice to the persons listed in subsection (3).

6. *If, after complying with subsections (2) to (4) in relation to a modification, the CAA decides to modify the licence in reliance on this section, the CAA must—*

   a) *publish a notice in relation to the modification, and*

   b) *send a copy of the notice to the persons listed in subsection (3).*

7. *The CAA is not to be treated as having complied with subsections (2) to (4) in relation to a modification of a licence if the modification differs significantly from the modification proposed in the notice under subsection (2).*

8. *The notice under subsection (6) must—*

   a) *specify the modification,*

   b) *specify the date from which the modification has effect (subject to paragraphs 7, 8 and 12 to 14 of Schedule 2),*

   c) *give the CAA's reasons for the modification,*

   d) *state the effect of the modification,*

   e) *state how it has taken account of any representations made in the period specified in the notice under subsection (2), and*

   f) *state the reason for any differences between the modifications and those set out in the notice given under subsection (2).*

9. *In the case of a modification of a licence condition, the date specified under subsection (8)(b) must fall after the end of the period of 6 weeks beginning with the day on which the notice under subsection (6) was published (subject to paragraph 21(2) of Schedule 2).*

APPENDIX C

GAL's licence – Part C: The commitment conditions

C1 Commitments

C1.1 The Commitments are conditions of this Licence and shall be set out in the Conditions of Use.

C1.2 Obligations placed on third parties in the Commitments shall not be treated as conditions of this Licence.

C1.3 In complying with this Condition C1 and the Commitments the Licensee shall, so far as reasonably practicable, do so in a manner designed to further the interests of passengers regarding the range, availability, continuity, cost and quality of airport operation services.

Modification of the Commitments

C1.4 The Licensee shall not modify the Commitments otherwise than in the circumstances set out in the modification provisions of the Commitments.

C1.5 The modifications that can be made under Condition C1.4 are modifications set out in the modification provisions of the Commitments at:

a) paragraph 6.1 of Schedule 2 to the Conditions of Use (price commitments);

b) paragraph 6.2 of Schedule 2 to the Conditions of Use (recovery of second runway costs in the price commitments) up to a total limit of £10 million in any one charging year;

c) paragraph 5 of Schedule 3 to the Conditions of Use (service commitments); and

d) the final paragraph in Schedule 3 Appendix I to the Conditions of Use (core service standards).

C1.6 Modifications can be made to the Commitments under Condition C1.4 at any time.

C1.7 Where the CAA makes any changes to the conditions of this licence under section 22 of the Act, the Licensee shall, as soon as reasonably practicable and subject to the outcome of any appeal to the Competition and Markets Authority under section 25 to 30 of the Act, make any necessary consequential changes to the Conditions of Use.

Recovery of second runway costs

C1.8 Where a provision in the Commitments at paragraph 6.2 of Schedule 2 to the Conditions of Use allows any amendments to the Indicative Gross Yield Profile to allow for the recovery of second runway costs, any such amendments necessary to recover expenditure by the Licensee above the £10 million in any one charging year allowed under Condition 1.5(b) shall be subject to the modification provisions under sections 22 to 30 of the Act.

C1.9 The CAA may, following consultation, issue guidance to the Licensee with regard to the recovery of second runway costs.

C1.10 Where the Licensee requires a modification to the Indicative Gross Yield Profile in accordance with Condition C1.8, it must inform the CAA in writing, setting out its reasons and justification for the modification in accordance with any guidance issued by the CAA under Condition C1.9.

Definitions

C1.11 In this Condition C1:

a) the Commitments means the contractual obligations given by the Licensee to providers of air transport services at Gatwick Airport and in the case of certain obligations also to other service providers of Gatwick Airport as contained in the following provisions of the Conditions of Use as agreed by the CAA and to be effective from the date this Licence comes into force and as amended from time to time under Conditions C1.4 to C1.7 namely:

(i) Condition 2.1.2 of the Conditions of Use (Applicability and Enforceability of Conditions of Use);
(ii) Condition 2.1.3 of the Conditions of Use (Variation);
(iii) Conditions 2.1.11-2.1.20 of the Conditions of Use (Dispute Resolution Procedure);
(iv) Condition 5 of the Conditions of Use (Price Commitment);
(v) Condition 6 of the Conditions of Use (Service Standard Commitment);
(vi) Condition 7 of the Conditions of Use (Continuity of Service Plan, Operational and Financial Resilience);
(vii) Condition 8 of the Conditions of Use (Investment and Consultation Commitment);
(viii) Condition 9 of the Conditions of Use (Financial Information Commitment);
(ix) Schedules 2, 3 and 4 to the Conditions of Use and associated appendices; and
(x) Annex to the Conditions of Use (the Gatwick Airport Core Service Standards Handbook);

b) the Conditions of Use means the Gatwick Airport Conditions of Use, published by the Licensee;

c) the Indicative Gross Yield Profile has the meaning set out in Paragraph 1.11 of Schedule 2 to the Conditions of Use; and

d) the recovery of second runway costs means the recovery of reasonable costs (capital, operating and financing) of applying for planning permission for a second runway and the subsequent development of the second runway and associated airport infrastructure.

APPENDIX D

European slot regulations

Introduction

D1 This chapter provides information on the European Union airport slot regulation[22] (the Slot Regulation) and our expectation that the Slot Regulation will not change in the short-term.

European slot regulations

D2 Slot allocation at UK airports is governed by the Slot Regulation and associated UK implementing regulations.[23] According to the Slot Regulation, a slot is a right to use a bundle of airport facilities (runway, stands, terminals) for landing or taking off at a specific date and time. The objective of slot allocation is to ensure the access of air carriers to congested airports follows the principles of neutrality, transparency and non-discrimination.

D3 Under the Slot Regulation, slots only exist at 'level 3 coordinated airports', which have insufficient capacity to meet actual or planned airline operations.

D4 Slots which are not subject to grandfather rights, including new slots created by new airport capacity, are placed in a 'slot pool'. New entrant airlines have priority for 50% of these slots. Put simply, this means that, at a coordinated airport that expands capacity, an incumbent airline may not be able to capture any of the expected benefits from up to half of the new capacity while its non-incumbent actual and/or potential airline competitors may.

D5 As noted in our recent discussion paper on capacity expansion, we continue to agree with the Commission's opinion that if the Slot Regulation rules could be modified to recognise an incumbent's potential contribution relative to a new entrant that this might be helpful in raising finance for the new capacity.

D6 We recognise that there are proposals to modify the Slot Regulation rules but that these remain only proposals.

D7 Based on the above, we have therefore, for the purposes of our analysis, assumed that the Slot Regulations remain unchanged.[24]

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22 Regulation EEC 95/93 as amended.

23 The Airport Slot Allocation Regulations 2006.

24 Further information on the Slot Regulation is available in chapter 8 of the capacity expansion discussion paper.

D8 Even accepting the implications of the Slot Regulations, we are keen to see if there is scope for commercial mechanisms that establish linkages between financing of the new capacity and the subsequent benefits of new slots and/or associated returns, possibly in the form of payment by those who secure new slots to those who contributed. As noted in chapter 3, we expect the airlines and airport operators to work together to determine if such commercial arrangements are possible.

APPENDIX E

Abbreviations

Abbreviations	
capex	capital expenditure
CMA	Competition and Markets Authority
GAL	Gatwick Airport Limited
HAL	Heathrow Airport Limited
HHL	Heathrow Hub Limited
MPA	market power assessment
opex	operational expenditure
Q6	the current (sixth) control period
RAB	Regulatory Asset Base
SMP	substantial market power
the Act	Civil Aviation Act 2012
the Commission	the Airports Commission
the Slot Regulation	the European Union airport slot regulation
WACC	weighted average cost of capital