



Notice in relation to a modification of Heathrow Airport Limited's Licence made under section 22 (6) of the Civil Aviation Act 2012: Modification to Condition C1 to allow for an annual recovery of £10 million of Category B costs for a new northwest runway

1. On 13 February 2014, the Civil Aviation Authority (CAA) granted a licence to Heathrow Airport Limited (HAL) pursuant to section 15 of the Civil Aviation Act 2012 (the Act) (the Licence).
2. Condition C1 of the licence relates to the price control formulae which came into effect on 1 April 2014 and lasts until 31 December 2018 (known as "Q6").
3. Pursuant to section 22(1)(a) of the Act, the CAA may modify a licence condition.
4. In accordance with section 22(2) of the Act, the CAA consulted on proposed modifications to Condition C1 on 8 November 2016¹ (CAP 1470), the CAA proposed the inclusion of a new condition in Condition C1 of HAL's licence that would allow HAL to recover up to £10 million a year of Category B planning costs incurred by it for airport expansion for the remaining years of the Q6 price control period. The CAA proposed that these costs would be subject to review by an Independent Fund Surveyor (IFS) who would advise the CAA on whether the costs had been incurred efficiently and so should be allowed. The CAA noted that, due to the consultation requirements of the Airport Charges Regulations, HAL is planning to recover the costs incurred in 2016 and 2018 in 2018, and the costs incurred in 2017 and 2019 in 2019.
5. The consultation closed on 6 December 2016. We received four representations to the consultation. These were from HAL, the AOC representing the airline community, IAG and Virgin Atlantic Airways. HAL broadly supported the proposal whilst the airlines were opposed and requested certain further information.

¹ CAP 1470 – Notice of proposed modification to Heathrow Airport Limited's economic licence to allow for an annual recovery of £10 million of Category B costs for runway expansion. <http://www.caa.co.uk/CAP1470>

6. The CAA has carefully considered the views of the consultees and has decided to modify the conditions as proposed. The licence modification is set out in the Appendix to this notice.
7. The modification will take effect on 1 February 2017.

Reasons for and effect of the proposed modifications

8. The CAA is making these modifications because it is in the interests of consumers that HAL has reasonable funding for planning and design costs to allow vital new capacity to be planned and developed in the best way practicable. Further, in these early stages of the planning process, whilst the funding principles and economic regulation policies are still being developed and as HAL is seeking longer term funding for the project, it is both important and reasonable that it has clarity on recovery of some of its immediate costs in order to finance its provision of airport operation services. Making these allowances should also send an appropriate signal to investors that will support the airport operator in continuing to raise finance. Nonetheless, we have considered the representations to the consultation carefully and consider that we can alleviate the airlines' concerns regarding setting precedents for other expansion costs and the governance. Further details of this are set out below.
9. Overall, we consider that making this modification is consistent with our duties in section 1 of the Act to further the interests of users of air transport services and to secure that HAL is able to finance its provision of airport operation services, because it will facilitate the start of the expansion project.
10. The effect of the modifications will be to allow HAL to recover up to £10 million per year of the Category B planning costs that it incurs in Q6 from 25 October 2016, the date of the government's announcement of support for a third runway at Heathrow, subject to the CAA agreeing that those costs were incurred efficiently.

Representations in response to the consultation

11. HAL broadly supported the proposal but noted that the proposed condition did not properly take into account our recent consultation in which we proposed to extend the duration of Q6 by one year. HAL suggested a change to the proposed condition to refer to the 'five subsequent years' instead of 'four subsequent years' of the current control period.
12. The AOC, IAG and Virgin (the airlines) were all opposed to the proposal on a number of grounds. They repeated their views from earlier consultations on the treatment of Category

B costs that they are opposed to the principle of pre-funding of any expansion costs, which they do not believe is in the interests of current users or that they should be treated as an asset. They see this proposed condition as setting a precedent for our future decisions, particularly given our decision to extend the consultation on the rest of the Category B planning costs (CAP1469²) to 6 January.

13. The airlines also questioned the need for the condition as they did not consider that HAL needed an incentive to begin the expansion project and they did not accept that consistency with the GAL licence was an adequate reason for including it in the HAL licence. They argued that the situation now is very different to that in 2014, when there was uncertainty over the location of a new runway, and the circumstances which led the CAA to allow GAL's £10 million pass through are no longer relevant today. They also noted that HAL and GAL are under very different regulatory regimes so a 'one size fits all' approach is not necessarily appropriate and sought more evidence as to why the treatment of costs should be the same for both airports. They were unclear why £10 million was the appropriate amount for this pass through, other than consistency with the GAL licence.
14. The airlines also questioned how the condition would work in practice, in particular how the process would work for deciding whether the costs were efficiently incurred and whether there would be rules around which costs could be passed through under the £10 million allowance and which would have to be dealt with under any alternative mechanism for the rest of the Category B planning costs. They asked for greater transparency and explanation on this.
15. Finally the airlines asked whether the £10 million would be *pro rata* for 2016 as the announcement on the location of the runway was not made until October 2016.

CAA response to the representations

This condition does not set a precedent on pre-funding

16. We do not see this licence condition for costs below the £10 million threshold as setting a precedent for the treatment of any other expansion costs and we will make a final decision on our policy on the timing for the recovery of Category B planning costs over the £10 million threshold following the consultation in CAP 1469. We note that the treatment of costs up to the £10 million threshold is significantly different to those proposed for the treatment of costs above it; for example, costs below the £10 million threshold will be

² CAP 1469: The recovery of costs associated with obtaining planning permission for a new north west third runway at Heathrow Airport: Final proposals <http://www.caa.co.uk/CAP1469>.

treated as opex and will be recovered in their entirety within Q6 whilst we are proposing that costs above the threshold would be considered capex and added to the RAB on a risk sharing basis.

17. We will develop our thinking on the timing for the recovery of Category C (construction) costs in accordance with our duties and we consider that this new provision does not set a precedent for these future decisions. We will consult further on these matters in due course.

Enabling a quick start and regulatory certainty

18. We agree that HAL has an incentive to expand and to make a start in order to meet the government's planning timetable, but only if it considers it has a reasonable prospect of recovering efficiently incurred costs. In these early stages of the planning process, whilst the funding principles and economic regulation policies are still being developed and as HAL is seeking longer term funding for the project, it is both important and reasonable that it has clarity on recovery of some of its immediate costs, provided that the recovery of these costs will not be overly burdensome on current users.
19. Our view is that amending the licence to allow the recovery of up to £10 million per year of category B costs should also send an appropriate signal to investors that will support the airport operator in continuing to raise finance, given that we have consistently said that we will implement the £10 million threshold in HAL's licence. Our intention to modify the HAL licence to allow cost recovery of £10 million per year was signalled in a number of consultations and policy updates³, but we did not seek to make this modification at an earlier date because of the continuing delays in the government's announcement on the location of the new runway.

Consistency with GAL

20. We agree with the airlines that the frameworks within which GAL and HAL operate are different and that there is no requirement for a one size fits all approach. We did not mirror the GAL licence to include this provision in the HAL licence when it was granted because it was not clear at the time how it would work within HAL's regulatory framework although we

³ CAP 1221 (October 2014), CAP1279 (March 2015), CAP1332 (September 2015), CAP 1372 (February 2016), CAP1435 (July 2016), CAP1469 (November 2016) and CAP1470 (November 2016) can all be found at <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/>

said in our notice granting the licence⁴ that we would consider this in more detail as we developed our policies on the recovery of runway costs.

21. We consider that the principle of allowing some flexibility in the recovery of some costs in the early stages of the planning process holds true as much for HAL as for GAL. It would be fair and equitable treatment and is consistent with our duty under section 1 of the Act to have regard to the need for HAL to be able to fund its obligations.

Reasons for settling on £10 million and whether it should be pro rata for 2016

22. We considered for GAL that £10 million was a reasonable amount to give GAL some flexibility in recovering some of its costs quickly without putting too great a burden on current passengers. We considered whether to increase the amount for HAL as the scale of its project is much bigger than GAL's but decided against this for two reasons: that there was not enough information on how much greater the Category B planning costs would be for HAL than they would have been for GAL; and we considered that £10 million remained a reasonable limit for a pass through of initial planning costs.
23. We do not agree with the airlines that the costs for 2016 should be *pro rata* because the government announcement was delayed until October 2016. This is because significant planning costs may be incurred immediately after the government announcement and the licence modification contains additional protections for consumers and airlines by providing mechanisms to ensure that any pass-through of costs is further limited to actual costs that have been efficiently.

Draft policy guidance on Category B costs

24. The new licence condition requires HAL to have regard to any policy guidance that may be issued by the CAA, following consultation, in relation to the recovery of the Category B planning costs. In order to give airlines the further information they sought on the processes and rules governing this pass through we set out our draft policy guidance below.

Category B Planning costs

25. We consider that the Category B planning costs (both above and below the £10 million threshold) will include:

⁴ Economic regulation at Heathrow from April 2014 – Notice granting the licence (February 2014) can be found at: <http://www.caa.co.uk/cap1151>

- planning advice and consultants for master planning;
- environmental and sustainability advisory and consultancy;
- legal and professional advice;
- architectural, structural and engineering design;
- surveys on land, surface access and the environmental;
- public consultations for the Development Consent Order processes;
- preparation of material for the Government's National Policy Statement; and
- costs incurred by the IFS.

Efficient costs, governance and the role of the IFS

26. We will require a clear governance structure to be set up to ensure that Category B planning costs incurred up to the £10 million threshold can only be recovered if they are deemed by the CAA to be efficient. The CAA will make the decision on whether costs are efficient, acting on the advice of the IFS.
27. HAL will be required to develop a governance protocol under Condition F1 of the licence, based on the process set out in paragraph 28 below, for agreement with the airline community by 1 April 2017. If agreement cannot be reached, the matter should be referred to the CAA to make a determination under Condition F1.7, which the CAA would make by 1 July 2017. This governance protocol for the pass through of £10 million of Category B planning costs could be extended and, where necessary, amended to fit any final policy decision on the Category B planning costs above the £10 million threshold.
28. As stated above, we will appoint an IFS to review costs and provide us with an ongoing assessment of the efficiency of the £10 million Category B costs incurred. For costs up to £10 million to be deemed efficient by the CAA, the following ex-ante and ex-post procedures must be followed starting from the date this condition comes into force:
- HAL must produce a 12 month indicative budget within a reasonable time in advance of each new regulatory year to allow for ex-ante scrutiny by the IFS and the CAA. The 2016 expenditure and 2017 indicative budget should be made available to the CAA and airlines by 1 February 2017;
 - Planning costs incurred each quarter will be scrutinised ex-post by the IFS;
 - The IFS will advise the CAA whether any of these costs should be disallowed;

- The CAA will make the final decision on any recommendations by the IFS in relation to these costs for 2016 and 2017 costs at the end of 2017; and
- HAL must record the expenditure on planning costs on a monthly basis, with any items over £100k itemised individually.

HAL's proposed amendment to the modification.

29. We agree with HAL that the proposed modification does require an amendment to take account of our proposal to extend Q6 by one year (Q6+1)⁵ by modifying Condition C1.2 to read "five subsequent relevant Regulatory Years" instead of "four subsequent relevant Regulatory Years". We consider that this amendment does not differ significantly from the modification proposed. We did not include this in the proposed condition in CAP 1470 in error, but it was clear from the consultation that this condition was intended to have effect until 31 December 2019. In addition, this modification has now already been made in the modification notice⁶ published alongside this notice in relation to our decision on Q6+1.



Richard Moriarty

Director, Consumers and Markets Group

21 December 2016

⁵ Formal notice to extend the current price control in Heathrow Airport's economic licence by one year (Oct 2016) can be found at: <http://www.caa.co.uk/CAP1459>.

⁶ Notice in relation to a modification of Heathrow Airport Limited's Licence made under section 22 (6) of the Civil Aviation Act 2012: extension of the Q6 price control by 1 year to 31 December 2019. <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/>

Appendix: Modification to Condition C1 of the Heathrow Airport Economic Licence

C1.2 On each occasion on which the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in each of the ~~four~~ **five** subsequent relevant Regulatory Years **starting on beginning with** 1 January 2015 **and ending on 31 December 2019**, the Licensee shall fix those charges at the levels best calculated to secure that, in each relevant Regulatory Year, total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the amount set in accordance with the formula below:

$$M_t = (1 + RPI_{t-1} + X + B_{t-2})Y_{t-1} + \frac{D_t}{Q_t} - \frac{T_t}{Q_t} + \frac{A_t}{Q_t} + \frac{BR_t}{Q_t} - K_t$$

Where:

- M_t is the maximum revenue yield per passenger using the Airport in Regulatory Year t expressed in pounds, where;
- RPI_{t-1} is the percentage change (positive or negative) in the Office for National Statistics (ONS) CHAW Retail Price Index between April in year $t-1$ and the immediately preceding April;
- $X = -1.5\%$;
- B_{t-2} is the bonus factor in Regulatory Year t , based on the Licensee's performance in $t-2$, as defined in condition C1.8;
- Y_{t-1} is the revenue yield per passenger in Regulatory Period or Regulatory Year $t-1$ defined in condition C1.3;
- D_t is the cumulative development capex adjustment in Regulatory Year t defined in condition C1.9;
- T_t is the capital 'trigger' factor in Regulatory Year t defined in condition C1.7;
- Q_t is passengers using the Airport in Regulatory Year t ;
- A_t is the cost pass-through for runway expansion in Regulatory Year t defined in condition C1.12;
- BR_t is the business rate revaluation factor in Regulatory Year t defined in condition C1.11; and

- K_t is the per passenger correction factor in Regulatory Year t defined in condition C1.5.

NEW:

A_t : pass-through of Category B costs (planning costs) for runway expansion

C1.12 A_t is the cost pass-through adjustment of up to £10 million in each Regulatory Year to allow for the recovery of the reasonable costs (capital and operating) of applying for planning permission for a third runway and associated infrastructure (Category B costs) since the Government announcement of its decision on 25 October 2016 to support the development of a third runway at the Airport. These Category B costs must, in the CAA's view, have been efficiently incurred. This adjustment shall have regard to any policy guidance that may be issued by the CAA, following consultation, in relation to the recovery of these Category B costs.

If: $t = 2016, 2017, 2018$ or 2019

Then: $A_t =$ eligible and efficient Category B costs up to £10,000,000

Otherwise: $A_t = 0$

Definitions

C1.123 In this Condition C.1:

