

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

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Executive summary

1. Expanding Heathrow is a once in a generation opportunity for passengers, our airlines, our local community and the whole United Kingdom. New capacity will deliver economic benefits for the UK. New capacity will also enhance competition and choice for passengers and airlines in the South East. This is a huge opportunity in the best interest of passengers. In a competitive and fast moving global aviation market, pace, simplicity and robust commercial and regulatory approaches to foster investment are required to seize this opportunity to deliver expansion.
2. Heathrow Airport Limited (Heathrow) wholeheartedly supports the Civil Aviation Authority's (CAA) view that expanding Heathrow is fully aligned to its primary duty, and welcomes that the CAA has been a strong advocate for expanding capacity in the South East. The opportunity to expand Heathrow is a reality now. Expanding Heathrow will only be successful if envisaged and delivered as a joint effort, with the CAA, the airport, airlines and local community shaping plans throughout the process. Although stakeholders will not always be aligned regarding commercial and regulatory considerations, we all must remain focused on the bigger opportunity presented. As a community we will need to move with purpose, pace and clarity to foster growth and investment to enable expansion.
3. We welcome the CAA's response to the Government announcement on new capacity. We note that the CAA has already modified Heathrow's licence to allow automatic recovery of £10m of Category B costs and we look forward to the CAA converting its final proposal on Category B costs into a policy decision early in 2017 reflecting the changes suggested by Heathrow in this response.
4. We agree with the general principle of risk-sharing arrangements, and the simplicity and objective test of the scenarios defined by the CAA, so that it should generate the right incentives for industry to engage in a manner that furthers the interest of passengers.
5. We disagree with the asymmetric ranges proposed by the CAA. The CAA's position that "*We reserve the right to decide that HAL will be able to recover less than 85% of Category B costs, if there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process*" introduces an arbitrary and subjective element to the entire treatment of Category B costs and consequently increases the risk to Heathrow in delivering expansion. We urge the CAA to remove or reword the statement.
6. We understand that the CAA will now be turning its attention to the framework for the recovery of Enabling and Construction costs, Category C costs, in particular those pre-planning consent Category C costs that fall under the current price control (Q6). It is imperative to move at pace on proposals for treatment of Category C costs where it is efficient or socially responsible to invest before planning consent is granted. We urge the CAA to publish an initial policy proposal ideally no later than February 2017.

Introduction

7. Heathrow) welcomes the opportunity to respond to *The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: final proposals (final proposals)*. We look forward to the CAA converting this into a policy decision early in 2017 incorporating the changes suggested by Heathrow in this response. This will allow all parties to proceed with confidence.

8. We understand that the CAA will now be turning its attention to the framework for the recovery of Enabling and Construction costs, Category C costs, in particular those pre-planning consent Category C costs that fall in the current price control (Q6). It is also important that the CAA develops all other elements of the long-term regulatory framework in a timely manner. Certainty is in the best interest of passengers, supporting timely and efficient delivery of this much needed capacity.
9. Relatedly, the proposed timetable set out in Andrew Haines' letter of 25th October 2016 to progress regulatory matters does not reconcile with the agreed timetable set out in the Statement of Principles (SoP) agreed between the Secretary of State for Transport and Heathrow. We urge the CAA to reconsider the timetable so that it aligns with the one agreed in the SoP upon which many other milestones of the expansion programme are based.
10. We have sought to engage with airlines on the expansion programme over the last 24 months, albeit with limited success. This included making an opening proposal on Category B costs in the hope of further commercial discussions. The Government decision represents a significant step forward in policy certainty. We hope that it serves to encourage airlines to engage with us on all expansion related matters. We have more recently been encouraged by engagement late in 2016.
11. Expansion will only be successful if airlines are deeply involved in the design and scrutiny of airport development. We will continue to work hard to engage airlines, and be open to any proposal on commercial arrangements, alternative designs or engagement approaches. We would urge the CAA to continue to support us and airlines in seeking effective engagement, including regulatory mechanisms that support constructive approaches and disincentivises non engagement.
12. We note and agree with the CAA that an enhanced level of engagement is required to ensure a successful programme. To that end we have made a significant offer to the airlines regarding different ways to engage. It is important to note that Heathrow's opening offer on Category B costs went over and above that prescribed by the CAA in its *final proposals* in terms of commercial risk. Furthermore, our initial engagement proposals following the Government decision also exceeded already well developed levels of transparency and support for engagement that are established practice at Heathrow.
13. Part of our engagement offer was to run a three-day immersion session on expansion with our airline community. We ran the session in the middle of December 2016, which the CAA also attended. We were very encouraged by the significant number of airline representatives and by the meaningful engagement shown throughout these sessions. We have already scheduled a further two-day event with the airline community in January 2017, at which the airline community have committed to provide feedback on our proposals.
14. Heathrow welcomes the CAA's recognition that regulating capacity expansion is not the same as periodic price regulation and that different situations need to be addressed with different regulatory responses. Heathrow acknowledges the CAA's intention to partially replicate competitive market behaviour and, although we disagree with a number of elements of the proposal on Category B costs, we agree with the general principle of risk-sharing arrangements and consider that it should generate the right incentives for industry to engage in a manner that furthers the interest of consumers.
15. This response provides feedback to the CAA's *final proposals*. It should be considered in conjunction with our earlier responses on Category B costs, with which it is consistent. It first

deals with Category A costs followed by detailed consideration of the main elements of the Category B cost proposal. It then discusses Category C costs and outlines a set of principles that would facilitate timely and efficient delivery of expansion.

Category A costs

16. We continue to disagree with the CAA's policy proposal regarding Category A costs. We have consistently demonstrated that Category A costs are essential for the successful development of a project that the CAA has deemed to be in the interest of passengers. Without Heathrow's (or any promoter's) expenditure on Category A costs, we would not be close to delivering a project that will benefit millions of passengers in the future.
17. As we discussed in our previous submission, we consider it is fair and reasonable that the successful promoter should be allowed to recover Category A costs since these costs were essential to enabling local community consultation but also the Government's decision implicitly has converted these costs into effective expenditure.
18. We continue to believe that in order to allow the recovery of Category A costs the CAA should perform an efficiency test; we think that this could be carried out by the Independent Fund Surveyor (IFS) appointed to review Category B costs.
19. In the context of recoverability of Category A costs the CAA states that "...*competitive tenders issued by public bodies and private companies almost always exclude the recovery of bid or proposal costs from all bidders, irrespective of whether they become the chosen provider or not*". The CAA's interpretation of a competitive bidding process is incorrect, since in competitive tenders the winning bidder would recover the cost of bidding throughout the duration of the contract being tendered. This cost would be included in its "business case" and therefore ultimately reflected in the bidding price. This is completely aligned to Heathrow's proposal that Category A costs should only be recovered by the chosen promoter. As a regulated entity, Heathrow unlike say a commercial property developer, is unable to recover bid costs through risk adjusted higher ultimate returns.
20. The CAA states that reclassification of Category A costs into Category B would be done on an exceptional basis since for example airport design is bound to change throughout the airport and airline engagement process. The CAA appears to misunderstand the nature of optioneering in the context of project development. In order to progress the design and allow consultation, early works are needed. Subsequent changes to the design do not reduce the validity or the need for these early works. Heathrow urges the CAA to reconsider its rationale for raising the bar to reclassify costs into Category B.

Category B costs

Definition of Category B costs

21. Heathrow notes the CAA's *final proposals* regarding the definition of Category B costs. We broadly agree with the approach taken by the CAA to defining this cost category in that the CAA is not proposing a rigid licence modification that would undermine the flexibility needed to progress work at an expedient pace.
22. In order to provide initial guidance to Heathrow, the airlines and any prospective IFS, the CAA has published a set of cost items that would be recognised as Category B costs. We think

that this is the right approach but we are concerned that the CAA has not included in this list important elements of Category B costs, in particular additional security costs to maintain an effective and resilient operation for our passengers and airlines.

23. Additional security costs arising from actual or prospective protest action are directly related to the recent Government announcement, and were not included in the Q6 Decision. These costs are intrinsically linked to pursuing new capacity efficiently while also protecting existing passengers and airline's safety and operational resilience. It is clear that it is in the interest of passengers that Heathrow incurs incremental costs on security related matters, including Metropolitan Police overtime, extra Heathrow security provided by Wilson James, a response team to deal with protest that requires a heightened response and dedicated security associated with the Central Terminal Area road tunnel, to ensure that the current operation is protected.
24. Heathrow also notes that the CAA's proposed Category B costs definition includes a statement that "*Category B costs are capacity expansion costs that are, in general, incurred by HAL after a Government policy decision...*" We would like to bring to the CAA's attention a significant amount of Category B Costs that Heathrow incurred before the Government decision but after the Davies Commission decision in order to ensure that the programme is delivered in a timely and efficient manner. Examples include development of options for the passenger proposition and operating model, cost and schedule, airspace, legal advice, community engagement and environment and sustainability impacts.

First £10m incurred in each year

25. As set out in our response to the notice to modify the licence, Heathrow welcomes the CAA's decision regarding the first £10m of Category B costs. We think that the timely resolution of this matter by the CAA is a helpful step in laying out the foundations of the regulatory framework for expansion.

Scenario definition and risk/reward ranges of costs above £10m

26. As we have stated in previous responses we agree with the scenarios defined by the CAA. We believe that these two scenarios help to create an objective test of success or failure avoiding potential subjective debates as to stakeholders' merits or faults. This is in line with a more commercial approach. These scenarios therefore generate the right incentives to achieving planning consent in a timely and efficient manner.
27. However, we continue to disagree with the asymmetry in the risk/reward ranges proposed by the CAA. We do not believe that the underlying probabilities used by the CAA to inform the risk/reward ranges a fair representation of the likelihood of each scenario. We cannot emphasise enough that multiple attempts to deliver new capacity in the South East over 30 years or more have met with failure through no fault of airports or promoters. We believe that the significant asymmetry proposed by the CAA may impact our ability to finance these costs and therefore increase the risk of delivering expansion.
28. Redacted.

29. Redacted.

30. Redacted.

Remuneration of costs above £10m

31. As stated in previous responses, we disagree with the CAA's proposed timing of recovery of Category B costs. We firmly believe that the current approach to cost recovery – Assets in the Course of Construction (AICC) is in the best interest of passengers, as it generates a stable and predictable price profile, avoiding abrupt price increases or otherwise, while maintaining the healthy airport cash ratios necessary to continuing investment.
32. We agree with the stated rationale regarding the CAA's intention to reflect investors' time value of money and ensuring net present value neutrality. We would like to engage with the CAA in the coming months to work out the details of how investors' time value for money and NPV neutrality are going to be achieved.
33. Regarding the timeframe over which Category B costs are going to be recovered, (the depreciation period), we consider that 15 years is a reasonable compromise. It generates regulatory predictability for the airport while ensuring that Category B costs are paid by a wider group of passengers who will benefit from new capacity. Relatedly, if the CAA was to implement AICC principles to Category B costs alongside the proposed 15 years of recovery, it would achieve an even smoother price profile, while ensuring that an even wider group of passengers are contributing towards Category B costs. We encourage the CAA to implement the AICC principle to Category B costs, alongside the 15-year depreciation period.

Reporting and Efficiency processes

34. Heathrow welcomes the CAA's confirmation that Category B costs will be another line in the RAB. Heathrow considers that regulatory certainty will be improved if further guidance regarding the recording and treatment of the Category B into the RAB is issued. We consider the best option to do so is by updating the regulatory accounting guidelines. We stand ready to work with the CAA on the smooth implementation of this in the coming months.
35. Heathrow agrees with the CAA that only efficiently invested Category B costs are eligible to be recovered as is the case with business as usual capital investment in Q6. Regarding the process to ensure efficiency, Heathrow agrees with the high level principles set out by the

CAA in its *final proposals*, namely aiming to extend the remit of the current IFS, a well-defined governance structure around these costs, and the CAA having the ability to arbitrate in a timely way at points of potential disagreement between Heathrow and the airline community.

36. As we have already indicated to the CAA, the airline community and Heathrow have already engaged with the current IFS to expand their scope to expansion related investment. For Heathrow it is imperative that the IFS functions are defined as soon as possible in order to ensure that expansion works are not delayed.
37. Regarding efficiency processes we would also like to highlight the helpfulness of the guidance issued by the CAA in its *notice in relation to modifying Condition C1 to allow for an annual recovery of £10m of Category B costs*. In particular, we consider that a clear timeline of events and requirements enhances regulatory predictability. More generally, imposing regulatory requirements should always be assessed in light of the benefits and the costs that any particular requirement would impose on passengers. Onerous regulatory conditions can generate lengthy bureaucratic processes that do not achieve the intended outcome in the most efficient way.
38. The recognition that the arrangements defined for the first £10m of Category B costs could be extended to cover all Category B costs, assuming that they help to ensure efficiency, provides the right incentives for Heathrow and the airlines to make arrangements that work in the best interest of passengers.
39. Finally, regarding transparency around planning materials produced by Heathrow, one of the key elements of Heathrow's initial offer to airlines for expansion engagement is to set up an online portal through which the airlines can access the latest data and documents.

Category C costs

40. We welcome the CAA's recognition that a significant magnitude of Category C costs will be incurred before a planning decision. We also welcome the recognition of the need to provide regulatory guidance on the treatment of these costs. The CAA states that "*we are considering developing a specific policy on pre-planning construction costs in advance of our overall approach to Category C costs*".
41. The CAA also states that pre-planning Category C costs could be treated in a similar fashion to the way the investment projects are handled in Q6, whilst in principle we agree with this statement, we consider that formal policy is required to deliver the required certainty.
42. Our local community is one of our key considerations when delivering expansion. Heathrow is committed to ensuring that our local community is fairly treated and compensated for disruption that expansion may generate. We have included detailed mitigation plans as part of our delivery programme. We would note that in 2017 these plans need to be in place and that although costs are modest, compared to other Category C costs elements, these plans are very important from a social perspective. These plans include a hardship scheme and other property matters for local residents such as noise compensation. We would encourage the CAA to prioritise resolution of these elements early in 2017 as we have already received a number of hardship cases following the Government decision.
43. We believe that early policy guidance on pre-planning Category C cost is instrumental for the timely and efficient delivery of the expansion programme since early Category C costs are on

the critical path and include some of the most pressing costs from a local community perspective. These also include options to agree commercial property terms for key sites, and replacement facility planning that will save time and money later in the programme. We urge the CAA to publish an initial policy proposal before the substantial consultation on the long term regulatory framework for expansion planned for summer 2017 and ideally no later than February 2017. This will ensure efficient delivery of capacity and fairness for our local communities.

44. Heathrow would like to engage with the CAA as soon as possible to progress this important element of the regulatory framework for expansion. We are also keen to provide details of potential costs to the CAA and airlines, and to involve airlines in scrutinising such costs well before material decisions on particular items of spend are required.