

Virgin Atlantic Airways consultation response



CAA consultation on the recovery of costs associated with obtaining planning permission for a new north-west runway at Heathrow: final proposal (CAP1469)

Virgin Atlantic Airways (VAA) welcomes this opportunity to respond to the consultation on the recovery of costs associated with obtaining planning permission for a new north-west runway at Heathrow.

We have already responded to the CAA consultation regarding the proposed modification to Heathrow Airport Limited's economic licence to allow for an annual recovery of £10m Category B costs for a new north-west runway (CAP 1470). In this response, we will be outlining our considerable concerns with the final recovery model put forward for the remainder of the planning costs and its consistency with the CAA's primary duty to further the needs of consumers.

In November, we commissioned York Aviation to provide expert analysis and evidence to support our response. Much of that work is included in this response, but the content and commentary represents the views of Virgin Atlantic alone.

Summary of our views on CAA's final proposals

- We agree that Category B costs should be defined as costs which are directly connected with, and solely for the purposes of, seeking planning consent through the DCO process.
- On behalf of our current customers we are opposed to prefunding in any form for intertemporal and equity reasons. Therefore:
 - the £10 million per annum immediate pass-through of costs should be abandoned; and
 - cost recovery to HAL via charges to airlines should commence when the runway and association facilities are operational, not when the outcome of the DCO process is known.
- We agree that Category B costs should be capitalised and rolled into HAL's existing RAB provided that:
 - they are clearly identified and differentiated in the RAB to ensure transparency;
 - the IFS provides challenge and cost scrutiny; and
 - the depreciation period is 40 years to reflect the asset life of the runway that the planning permission supports.
- If the CAA proceeds with its proposal to allow HAL to recover costs via charges to airlines as soon as the outcome of the DCO process is known as proposed, then in addition to the points above, the depreciation approach should be unitised depreciation, not straight-line depreciation, to ensure a fairer share of the burden between current and future passengers.
- We are fundamentally opposed to the proposed 105/85 risk-sharing mechanism as no further incentives are required for HAL to secure planning permission and the level of risk allocated to consumers is disproportionate and excessive. The risk sharing mechanism should be reweighted to 100/25.

Introduction

As we have made clear in our previous submissions on Cat B costs, we are opposed to prefunding. Current passengers should not have to pay for additional capacity from which they do not derive any benefit. We are therefore fundamentally opposed to the proposal for cost recovery to commence after the outcome of the DCO process is known but before the runway and associated facilities are operational. However, this response scrutinises the proposals put forward by the CAA, and sets out a range of recommendations in order to mitigate the impact of any prefunding mechanisms that are pursued.

The current proposals depart from previous regulatory precedent in this area and are not fully aligned with CAA's primary duty. Planning costs relating to major airport infrastructure developments are normally capitalised into the Regulatory Asset Base (RAB) and then depreciated over the full life of the asset. This was the approach adopted for the last runway built in the UK, the second runway at Manchester, and the proposed approach to be taken in relation to the abortive Stansted G2 development. It is also the approach taken by the Irish Commission for Aviation Regulation (CAR) in relation to Terminal 2 at Dublin, and that is intended to be taken for the second runway at Dublin. We are not aware of any precedent for planning costs to be separated out from other CAPEX and depreciated over a shorter period.

While we accept that the scale of the third runway project is unprecedented, that regulatory frameworks evolve over time, and that evolution in approaches is indeed important in getting to more equitable and effective solutions for the consumer, the extent of the departure from the established approach is not justified, especially as the cumulative impact of the proposed approach places an unfair burden on current passengers in relation to future passengers. We acknowledge that there may be some advantages in terms of transparency in identifying individual costs separately and setting out clearly how they are to be treated, but this does not in itself mean it is reasonable that the costs in this case should then be treated differently from those connected with other major new runway and terminal developments.

This response focuses on our four key areas of concern.

- The balance of risk within any risk sharing mechanism. We believe that the current proposal is both inequitable for the consumer and ineffective in terms of its ability to influence the incentives facing Heathrow Airport Limited (HAL).
- The inclusion of £10 million per annum of planning costs for immediate pass-through. We have responded to this separately in our response to CAP 1470, but here we get into more detail as to what level of incentive this provides HAL to move quickly in bringing forward a planning application, and whether it is necessary.
- The appropriate form of depreciation to be used in relation to costs that are capitalised into the Regulatory Asset Base (RAB). The current proposals advocate straight line depreciation of the planning costs that enter the RAB. This has the effect of loading an uneven balance of costs onto existing users compared to the growing number of new users following completion of the runway. It has the additional perverse effect of existing passengers paying more on a per passenger basis for the new runway than future passengers. Furthermore, this approach is out of step with more recent regulatory

precedent around the funding of major airport infrastructure which has tended to follow a unitised depreciation approach that is more equitable to all users.

- The proposed 15 year depreciation period to be applied to planning is arbitrary and out of step with the totality of the investment programme associated with the third runway. Planning permission is not an asset in and of itself. It is an enabling investment which is part of a broader project. The depreciation period associated with it should be reflective of the asset life of the broader project. Decisions around the depreciation period are also important in relation to the balance of cost burden between existing and new users.

There are also a number of cross-cutting issues that need to be considered as they are important in providing context prior to more detailed analysis of the above specific issues.

- The duties of the CAA and the definition of users.
- The current treatment of risk within the regulatory process.
- The importance or otherwise of prefunding.

We reflect on each of these cross-cutting themes in more detail below.

Throughout this response we have sought to illustrate key points by considering the impact on HAL's financial returns or on the profile of cost recovery. This has been done using a basic model calculating earnings before interest, tax, depreciation and amortisation (EBITDA) that replicates the core elements of Heathrow's current regulatory regime and the CAA proposals regarding the regulatory treatment of planning costs. This model draws on data on operational costs, aeronautical and commercial revenues, CAPEX and traffic forecasts taken from the Airports Commission Final Report, including the costs of the overall third runway project and the planning consent costs. Having attended the Heathrow three-day Immersion Sessions in December, we understand that these costs will evolve, and there is still considerable uncertainty about the levels and timings. While we recognise that the Airports Commission data does not provide a perfect baseline, it does give an indication of the order of magnitude of the impact and reasonably articulates directions of effect and the timing of effects.

Duties of the CAA

The Civil Aviation Act 2012 sets out the CAA's duty to further the interests of the users of air transport, a group which is defined as follows:

“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) In this Part references to users of air transport services include future users of such services.”

This definition is focussed on the passenger or the owner of freight being shipped as the user and is careful to include future users as well as existing users.

We agree that affordable and efficient investment in additional capacity at Heathrow is in the interests of future users. However, existing users that travel through Heathrow before the new capacity is operational will not receive any discernible benefit, yet will incur additional costs under the CAA's proposal. There is a strong likelihood that these passengers will not be the same as those flying through the airport in 10 to 15 years' time. In other words, existing users are not synonymous with future users.

By allowing for the prefunding of planning costs, the CAA is failing in its duty to further the interests of existing users as they will be paying for infrastructure that significant numbers of them may never use. This is particularly true when there are relatively simple changes to the regulatory model that can be made that would address this issue, at least to some extent.

We also note the need for the CAA to have regard to promoting economy and efficiency and the general principles around transparency, accountability, proportionality and, importantly, consistency. We do not believe that the current proposals promote efficiency or that they are consistent with previous regulatory precedent.

Treatment of risk within the regulatory process

Risk within the regulatory process for airports in the UK is dealt with currently primarily via considering the riskiness of the airport operation as a whole as part of the assessment of the WACC. The sharing of risks around capital expenditure between the airport operator and users is not currently directly reflected. Such risk sharing is not typically a feature of regulatory frameworks in airports outside the UK either.

There are some arrangements around the sharing of traffic risks at some airports in Germany, notably Frankfurt and Hamburg where there is excess capacity and an ability for home based carriers to flex their hub-and-spoke network. This means those carriers have some control over the level of traffic and so have some ability to influence the outcome. These conditions do not apply at Heathrow where there are severe capacity constraints.

In addition, risk sharing around capital projects does not appear to be a feature in other sectors. A detailed review undertaken by Steer Davies Gleave for the Irish

Commission for Aviation Regulation (CAR) in 2014¹ did not identify any evidence of this practice in other sectors.

Nevertheless, we note the CAA's position on the potential for the regulatory settlement in relation to Cat B costs to influence the financeability of investment in the third runway by impacting on HAL's cost of debt (as reflected in the WACC) and so impacting on charges. We do not find this convincing. Firstly, the size of Cat B costs in the context of the third runway and in relation to HAL's existing RAB or EBITDA return is so small as to make it highly unlikely that any change could influence the overall asset risk. Secondly, from HAL's current debt position, it would seem reasonable to suggest that it has more than enough headroom against its covenants to deal with any funding requirements around Cat B costs.

Furthermore, we note the CAA's previous comments around the impact of HAL's debt structure on regulatory policy. In a statement made at the time of Ferrovial's offer for BAA, the CAA made clear that it *"will set caps on airport charges in accordance with its statutory duties and not in order to accommodate any particular financing arrangements adopted. In this context, it is particularly important that in making financing arrangements airport operators recognise the significant near- and medium-term investment required to upgrade airport facilities and accommodate a continuing increase in the demand for air travel in the south-east of England. This is likely to require the maintenance of credit quality sufficient to ensure the cost-effective financing of future investment."*² In our view, this means that it is HAL's responsibility to manage its debt position to deal with a regulatory framework that is designed to further the best interests of users. The framework should not be designed to accommodate its financing requirements.

In summary, the concept of risk sharing around planning costs for a capital project must be considered as a new departure with little precedent or detailed analysis upon which to base a framework.

The importance or otherwise of prefunding

In our view, any piece of infrastructure should be paid for by those that use it or benefit from it. Users should also be certain about how they are paying and for what. By providing for prefunding ahead of the opening of the new runway, existing users would have to assume risks around cost overruns, scheme specification and whether the project will proceed or not which is not within the users control. Under these proposals, users will prefund payment for something that costs more than was expected or does not deliver what they expected, or in this specific case, does not deliver at all.

We disagree with the CAA's premise that some degree of prefunding is either necessary or desirable to incentivise the airport operator to seek planning permission.³ Such a pre-funding commitment was not made in relation to a second runway at Manchester, nor in relation to Dublin's Terminal 2 or proposed second runway.

Heathrow has been seeking to build a third runway at the airport for at least 15 years. It has lobbied extensively and spent considerable time and effort on securing

¹ A Review of Regulatory Decisions in Relation to Cost Risk Sharing of Capital Projects – Steer Davies Gleave for Commission for Aviation Regulation (2014).

² Possible Offer for BAA Plc: Statement by the UK Civil Aviation Authority (2006).

³ CAP1469 – CAA (2016). Page 27.

Government support for the development, succeeding initially in 2009 and then again this year. Since the Government's announcement in October, HAL have been urgently pressing ahead with the project to secure planning permission, including commissioning designers, producing a draft Strategic Brief and holding airline immersion sessions. It is quite clear by the airport's actions that an additional incentive to seek planning permission in the form of pre-funding of planning costs is simply not necessary.

Furthermore, it is important to consider what incentives face HAL in developing the third runway. The volume of returns from the investment is forecast to be significant. We consider the scale of these incentives further below. Ultimately, it is these long-term returns that are the incentive for HAL to invest. It is not necessary to facilitate prefunding to incentivise this investment.

The existence of prefunding also raises further equity issues in relation to airlines and end users. By prefunding infrastructure investment, airlines and end users are effectively lending HAL money to invest. If this were to be the case, it would not seem unreasonable that a return should be made on this loan. It is certainly perverse that HAL is making a return on that element of the RAB funded by money lent from the group that are effectively lending it. This raises the question as to whether HAL should be receiving any WACC return on prefunded investment or indeed whether a negative return, equivalent to the WACC for airlines should in fact be applied.

Balance of Risk in Risk Sharing

While some form of risk sharing is a step forward from the previous treatment of risk for the Manchester second runway, Heathrow Terminal 5 and abortive Stansted G2 project, where 100% of the costs and hence all risk was allocated to end users, we do not believe that the proposals around risk sharing are either equitable or likely to provide effective incentives to HAL. The balance of risk, given the extent of control and potential impacts, is inappropriate. The ultimate impact of the current cost recovery rates on returns are not effective and, in the case of the upside rate, potentially unnecessary given the overall incentive effect from the total EBITDA returns from the third runway project as a whole.

As described above, regulatory precedent around risk sharing at airports is extremely limited. Some arrangements currently exist around traffic risk sharing at a number of German airports, but these do not present relevant comparators to the current proposal around Category B costs. Similarly, we have not been able to identify relevant precedent from other sectors either.

The ability of users and airlines to influence the planning process and, in consequence, the chances of success, is extremely limited, compared for example to the extent of influence that the airlines will have on the emerging design of the terminal(s), even accepting the level of detail which will be required for the Development Consent Order (DCO). Therefore, there is no real theoretical basis for assigning levels of risk within the process. As a consequence, the proposed 105% / 85% split appears to be entirely arbitrary and it is not clear on what basis it has been arrived at. In considering whether these proposed risk allocations are appropriate, we have focused on two areas:

- the risks being faced through the planning process, who bears them and who has control; and

- the incentives that the current proposals place on HAL and how the incentive effect might vary if different percentages were used.

In Table 1, we have set out an outline risk matrix in relation to the planning process, which examines the issues around the first of these points. This demonstrates clearly that the ability to control risks around the planning process fall primarily with HAL, while the impacts of either a failure to achieve planning consent or delays in the process or cost overruns are shared to a much greater degree.

This asymmetry of risk supports the use of an asymmetric risk sharing mechanism, in which any reward to HAL should be limited as they have the greatest control. Airlines and users should not ultimately bear the full cost of failure as this is either substantially or totally beyond their control. This lack of control would also suggest that their exposure to the costs of failure should be relatively limited.

Table 1: planning risks matrix

| Planning related risks | Airport | Airlines | Government/Others |
|---|--|---|---|
| Failure of DCO Application | The Airport is the applicant and, therefore, must carry the greatest risk of success or failure in terms of following due process with regard to statutory consultation and demonstrating adequate mitigation. | Airlines may be able to support the planning application process (e.g. in the provision of information and supporting mitigation packages) but have much less control over the overall success or failure of the application, although it is accepted that user specified elements of the design could impact on the chances of success. They would clearly be impacted by long term failure to address capacity constraints. | Government (i.e. the Secretary of State) could turn down the application or require greater mitigation in the face of political pressure or public pressure. Users would be subject to substantial detriment over the long term if capacity is not delivered and/or may be required to pay the cost of enhanced mitigation or accept restrictions, e.g. noise, on their operations. |
| Timing of the DCO Application (how long it takes to obtain) | The Airport has most control over the required initial consultation process, which it must instigate, and the preparation of the documentation supporting the application itself. | Airlines have little or no control over timing, but could suffer from protracted capacity constraints if there is a delay. | Usually subject to a 6 month limit for the examination, followed by a 3 month limit for decision by the Secretary of State, but could be influenced/lengthened by political factors. |
| Cost of DCO Application | The Airport has greatest control over the costs of the application, but will bear lower risk if allowed to recover these costs before the runway is constructed. | Airlines have little or no control over the application costs, but will be required to pay for them before the runway is built, or even if it is not built, and before they will benefit from increased capacity and thus carry greater risk. | Users (passengers) bear a level of risk as costs of the DCO application will ultimately be passed on to them before they can benefit from increased capacity. |

Table 2 considers the extent of the incentive effect of the current and alternate risk sharing arrangements on HAL based on the estimated planning costs identified within the Airports Commission final report in the context of HAL's total returns from the third runway. It shows the estimated Net Present Value (NPV) of total EBITDA returns to HAL in circumstances where DCO is granted and where it fails, i.e. with or without a third runway. It then examines the impact on these total EBITDA returns from different cost recovery percentages. It should be recognised that the model used in this table is based on relatively limited information and is simplified, but we believe it provides a useful assessment of the magnitude of effects.

Table 2: Estimated NPV of total EBITDA Returns to 2036 by risk level with and without a third runway

| <i>DCO Result</i> | <i>Planning Cost Recovery %</i> | <i>NPV (£ million)</i> | <i>Difference to 100% Cost Recovery</i> |
|-------------------|---------------------------------|------------------------|---|
| Granted | 105% | £30,115 | 0.01% |
| | 100% | £30,112 | - |
| Failed | 100% | £22,983 | - |
| | 85% | £22,976 | -0.03% |
| | 50% | £22,959 | -0.10% |
| | 25% | £22,947 | -0.16% |
| | 0% | £22,934 | -0.21% |

Source: York Aviation.

It is clear that the impact of all cost recovery levels is limited when compared to the overall EBITDA returns to HAL, with or without the construction of a third runway. However, there are a number of points to be made around incentives.

Firstly, in relation to the incentive effect on Heathrow to achieve a successful DCO, the incentive is primarily around the overall difference in total returns it can make with a third runway. The impact of a planning cost upside is negligible. The total volume of EBITDA returns to 2036 is around 31% higher with a third runway than without. It is, therefore, questionable as to whether there is any material value to an upside reward relating to planning costs. HAL should simply not require incentivising further and any such additional reward would be a double reward as HAL already receives a return via the WACC.

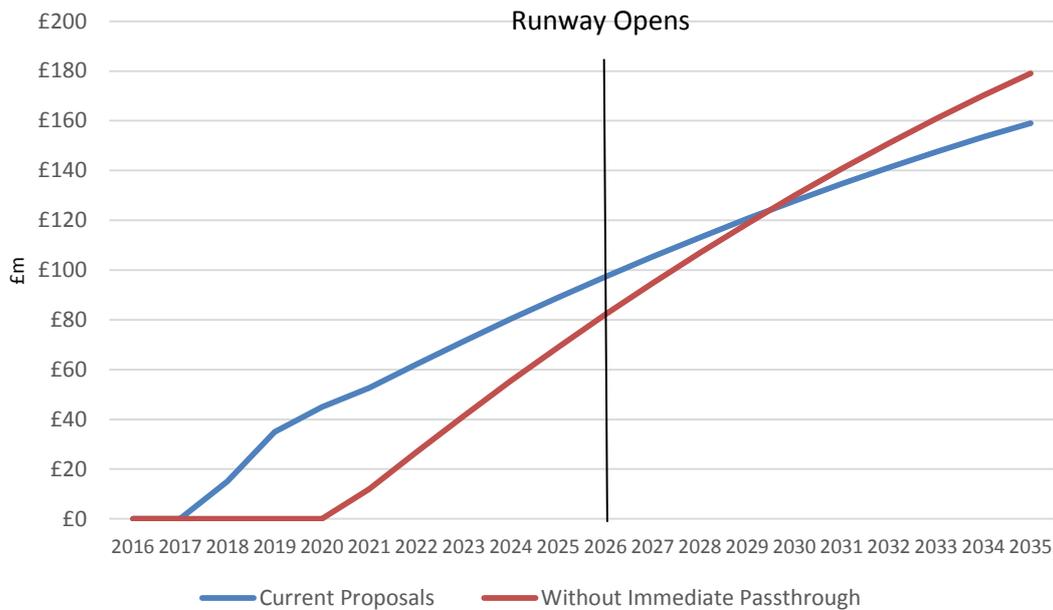
In relation to the downside risk of failure, 85% cost recovery has significantly less than a 0.1% effect on overall EBITDA returns without a third runway when compared to 100% recovery. This cannot be considered to provide a genuine incentive effect on HAL. Even with 0% cost recovery, the incentive effect appears limited. Allowing 0% cost recovery would provide the greatest incentive to HAL to ensure that it succeeds. However, accepting that users and airlines should bear some risk, a level of 25% or lower would appear to be substantially more appropriate. This figure remains arbitrary as, as we have said above, there is no real theoretical basis for allocating risk. However, it does at least provide an incentive that does not round to 0.0% of returns.

£10 Million of Immediately Recoverable Costs

As discussed in our response to the CAA CAP 1469 consultation, we do not agree with the CAA's proposals for the automatic recovery of £10million, particularly due to the level of prefunding that this represents. This has an impact on equity and efficiency by loading a significant amount of the financial burden associated with planning onto current users, many of whom will not benefit from the resulting consent, rather than future users who will. Figure 1 shows the cumulative cost

recovery profile (including WACC returns) of the CAA’s existing proposals compared to a scenario where immediate pass-through is not allowed and all costs enter the RAB when DCO is secured. The change in the balance of impact between existing and new users is dramatic. Based on figures from the Airport Commission, the CAA’s current proposals would see 56% of total planning costs falling on existing users. The removal of the immediate pass-through provision would reduce this number to around 39%. This is clearly a substantially more equitable solution.

Figure 1: Cumulative Cost Recovery with and without Immediate Pass-through – Successful DCO



Source: York Aviation.

A further concern is that any immediately recoverable costs will not be covered by any risk sharing arrangement put in place, given the exclusion of costs recovered via the K-factor. If the intention is that risk sharing should create incentives to engage all parties in the planning application process and ensure that costs and proposals are efficient and fit for purpose for all, then excluding a significant proportion of the costs is clearly perverse. No rationale has been offered so far as to why these costs should not be subject to risk sharing, while the rest of the planning costs are. Separate treatment in our view is inconsistent.

One justification offered for the inclusion of the £10 million per annum for immediate cost pass-through is that it is required to incentivise HAL to make a fast and early start on the planning application. This returns to the points above made in relation to the risk sharing arrangements. HAL (or previously BAA) has been seeking to build a third runway at Heathrow for in excess of 15 years, it can reasonably expect to make significant long-term returns from the project (see above) and it has already expended significant resource engaging in the lobbying process around the Airports Commission report and Government decision and has been proceeding with the project at pace since the Government’s October announcement. This is clear evidence that there is no need to incentivise HAL to progress with the planning process. In this context, we highlight the regulatory principles set out in the Civil Aviation Act 2012, notably that “*regulatory activities should be targeted only at cases in which action is needed*”. HAL clearly does not need incentivising here through the regulatory framework.

It is also unclear as to why the CAA has chosen to depart from its own approach to planning costs in relation to previous major airport infrastructure investments. In the cases of Manchester's second runway and in relation to the Stansted G2 project, planning costs were viewed as enabling costs within the overall capital expenditure and capitalised into the RAB and depreciated over the life of the asset. In fact, another enabling cost, land compensation, was specifically considered by the Monopolies and Mergers Commission and the CAA as part of the CAA's 1998 decision in relation to airport charges at Manchester⁴. The CAA decided such costs should not be subject to immediate pass-through (Manchester Airport's preference) as this tended to '*blunt the incentive effect of regulation*' and ruled that they should be capitalised and depreciated over the life of the asset. It is not clear what has changed and why there is now a need to treat these costs differently, particularly, as we have described above, as there is no need for additional incentivisation of HAL given the scale of returns from Runway 3. Looking overseas, the Irish CAR has also capitalised planning costs in its consideration of Dublin Airport Authority (DAA) investment in a second runway at Dublin⁵.

We acknowledge that provisions for £10 million per annum of planning costs to be passed through immediately have been made within the Gatwick Licence. We do not believe that this should act as any form of precedent for the position at Heathrow. The two airports are no longer regulated in the same way and the inclusion in one licence does not provide any justification for a direct replication.

Depreciation of planning costs

We have two significant concerns about the current proposals in relation to the depreciation of the planning costs that are intended to be capitalised into the RAB following the DCO decision - the form of depreciation used and the depreciation period.

Form of depreciation

The use of straight line depreciation is out of step with recent regulatory precedent in relation to the funding of major airport infrastructure. The Irish CAR, in considering the appropriate form of depreciation in relation to DAA's investment in Terminal 2 at Dublin Airport, and subsequently in relation to the second runway at Dublin, concluded that the use of unitised depreciation is a more equitable approach.

Unitised depreciation avoids the perverse outcome of straight line depreciation whereby existing passengers pay more on a per passenger basis than future passengers, as there are fewer of them to bear the costs. Unitised depreciation would partially address issues around prefunding and provide a more equitable solution in terms of the costs borne by existing and new users.

Unitised depreciation has been adopted by the Dutch Government in relation to the economic regulation of Amsterdam Schiphol Airport⁶ and was the approach used in regulating the investment in the fifth runway.

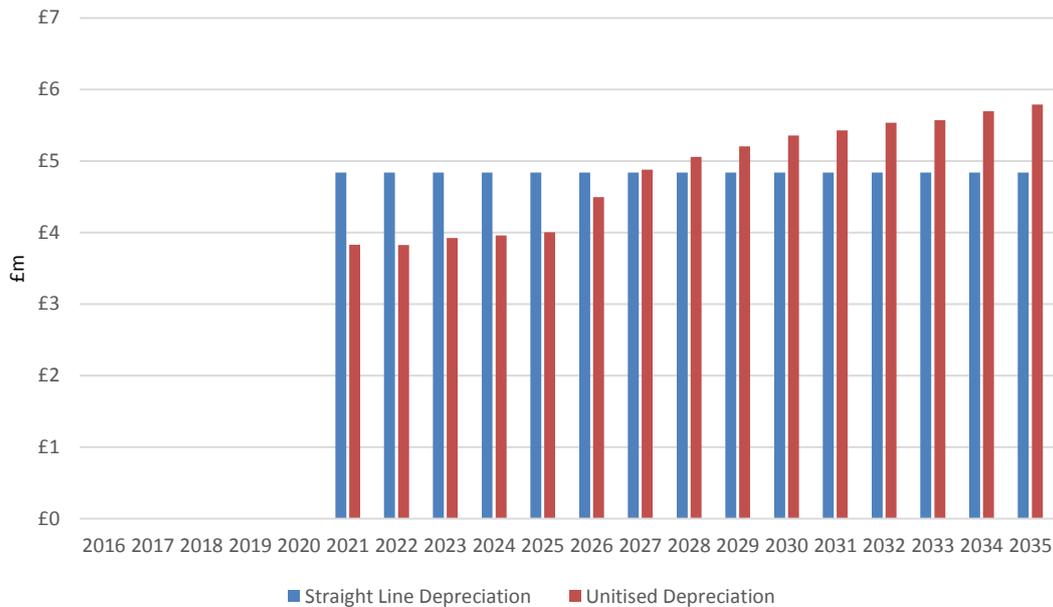
⁴ Manchester Airport plc: Conditions as to charges and other conditions under sections 40(4) and 46(2) of the Act – CAA (1998). Page 22.

⁵ Maximum Level of Airport Charges at Dublin Airport: 2014 Draft Determination – Commission for Aviation Regulation (2014). Page 55.

⁶ Decree dated 7 July 2006 entailing rules regarding the operation of Amsterdam Airport Schiphol (Amsterdam Airport Schiphol Operation Decree) – Kingdom of the Netherlands (2006). Chapter 1, Article 1, Point G and below.

Figure 2 shows the depreciation profile for capitalised planning costs based on both the current CAA proposals and with unitised depreciation as an alternative. This clearly demonstrates how the use of unitised depreciation would result in a more equitable and efficient distribution of the capitalised planning costs on to new passengers rather than existing passengers. While prefunding clearly still exists, as depreciation is now effectively linked to passenger numbers, the return of the RAB begins to increase as passenger numbers grow post opening of the runway in 2026 based on traffic forecasts taken from the Airports Commission final report.

Figure 2: Depreciation of Capitalised Planning Costs

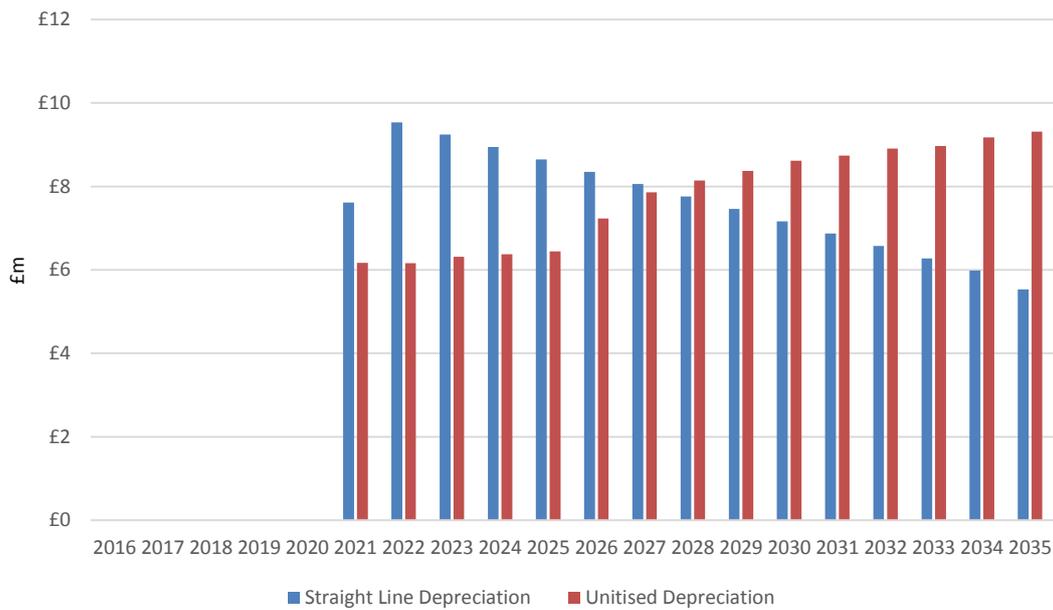


Source: York Aviation.

Under the Dublin⁷ and Amsterdam arrangements, the return on the RAB is also unitised and distributed over the same period. This has the effect of ensuring passengers all pay equally for the investment made. The effect on the profile of collection of capitalised planning costs can be seen in Figure 3. We estimate, based on the information available and assuming a DCO decision in 2020 and the runway opening in 2026, that with straight line depreciation around 39% of capitalised planning costs would be borne by existing users. Shifting the depreciation approach to a unitised approach, other things being equal, would result in this proportion falling to 27%.

⁷ At Dublin some later smoothing has taken place but the principle is as described.

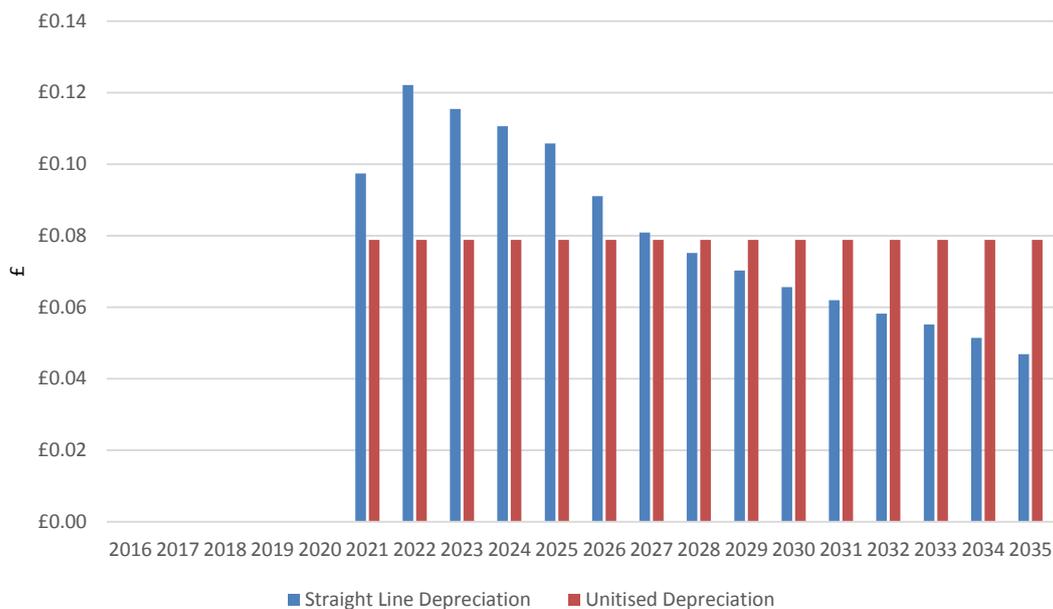
Figure 3: Capitalised Planning Costs (Depreciation and Return on the RAB)



Source: York Aviation.

Figure 4 shows the impact of a unitised approach compared to straight line depreciation on a per passenger basis over time. This clearly demonstrates the equity value of this approach. All users, existing or future, pay the same on a per passenger basis (notwithstanding general issues around whether existing users should be paying at all). This is counter to the current proposals being put forward by the CAA where users who may never use the infrastructure end up paying substantially more on a per passenger basis than the new users who do use the infrastructure. This proposal is clearly inequitable and inefficient, and needs to be addressed.

Figure 4: Capitalised Planning Costs per Passenger (Depreciation and Return on the RAB)



Source: York Aviation.

In our view, this analysis demonstrates that straight line depreciation is neither the appropriate method for application here or in line with current best practice. As discussed above, the primary duty of the CAA is to further the interests of users, existing or future. Under these proposals, it is difficult to see how the interests of existing users are served by not only paying for an asset they may not use but by in fact paying more on a per passenger basis than future users.

The experience at Dublin Airport since the opening of Terminal 2 helps to illustrate this point. By 2016, around 35% of the growth in seats on offer since 2010 (Terminal 2 opened in November 2010) has come from new airlines entering the market. Under unitised depreciation, new passengers on these services are paying the same amount per passenger as those that travelled prior to the opening of the Terminal. Under straight line depreciation, they would be paying considerably less on a per passenger basis.

The depreciation period

The other significant issue around the treatment of depreciation of planning costs is in relation to the period of depreciation involved. This is an issue that revolves primarily around the treatment of planning permission as an asset in its own right. The separation out of planning costs from construction costs in our view is uncommon and the assignment of a 15 year depreciation period appears to be arbitrary. The CAA describes the achievement of planning permission as a “*quasi-intangible asset*” and describes the uncertainty around the depreciation period for such an item⁸.

An additional complication is that the granting of planning approval does not mean that the asset would necessarily be constructed or brought into use. Whilst this is unlikely, given the financial incentive on HAL to do so outlined earlier, it could possibly arise should the planning conditions be deemed too onerous, e.g. overly restrictive operating regime and excessive mitigation costs are just two examples. In these circumstances, the mere grant of planning approval would not convey any asset value at all. This demonstrates the inherent problem in treating the expenditure in gaining approval as an asset before construction has actually been committed. One example of such a situation is Berlin Brandenburg Airport. The airport’s opening has been delayed for a range of reasons. The airport remains in public ownership with the Government taking the funding risks and not the existing users of Tegel and Schoenefeld airports.

We are not aware of any examples of where this practice has been done elsewhere and, indeed, the CAA’s own position in relation to the planning costs relating to the development of the last runway built at a major UK airport, the second runway at Manchester, was to treat it as part of overall capital expenditure and consequently to depreciate the costs over the life of the asset as a whole. Again, we note the CAA’s treatment of another enabling cost, land compensation, which was specifically considered by the Monopolies and Mergers Commission and the CAA as part of the CAA’s 1998 decision in relation to airport charges at Manchester⁹. The CAA decided such costs should not be subject to immediate pass-through (Manchester Airport’s preference) as this tended to ‘*blunt the incentive effect of regulation*’ and ruled that they should be capitalised and depreciated over the life of the asset. This is the approach being taken by the Irish CAR in relation to the second runway at Dublin

⁸ CAP1469 – CAA (2016). Page 5.

⁹ Manchester Airport plc: Conditions as to charges and other conditions under sections 40(4) and 46(2) of the Act – CAA (1998). Page 22.

Airport. Enabling costs, such as planning, design and house buyouts, are included within the total costs of the runway and depreciated over a 50 year period¹⁰. The same approach was again taken by the CAA in considering the economic regulation of the Stansted G2 development. Planning costs were treated as standard CAPEX and depreciated over the life of the asset.

We note the CAA's comments in CAP 1469 that if planning permission is not treated as an asset then it would have to be treated as OPEX¹¹ and be subject to immediate pass-through. We do not agree given the previous regulatory precedent. In any event, it is not usual for OPEX adjustments to be immediately passed through. They would be subject to consideration at the next quinquennial review to determine charges to be levied from 1st Jan 2019. This could provide a more appropriate mechanism for ensuring due consideration of how such costs should be treated as the progress of the NPS and the progress towards the DCO will be clearer. At this stage, the appropriate allocation of risk between the parties would be much clearer too. It could be argued that taking a decision as to the allocation of these cost risks now is premature and should be left until the next review, particularly as we believe any incentive effects to be negligible.

Ultimately, inclusion within overall capital expenditure and depreciation over the life of the asset is the logical approach to the treatment of planning costs and avoids the problem of trying to identify a depreciation period for planning permission in isolation. Planning consent is an enabling item within the broader third runway capital project and not an asset in itself. It should be depreciated in line with the asset it enables, which might typically be around 40 years.

The CAA has chosen a 15 year depreciation period for capitalised planning costs with seemingly little justification. Depreciating planning costs over a more appropriate longer period would further address the significant issues around prefunding of investment and the balance between existing and future users in terms of who pays for investment. Below, in Figure 5, we have set out the planning cost recovery profiles for capitalised costs for the CAA's current proposals and with depreciation periods of 30, 40 and 50 years. These periods reflect the weighted average asset life associated with the Runway 3 projected estimated in the Airports Commission work, the typical depreciation period for a runway and the depreciation period to be used at Dublin respectively.

The result of lengthening the depreciation period is that a more equitable balance between existing and new users is achieved and also the impact on airport charges is ultimately smoothed and lessened in real terms, thereby reducing traffic risks around the project.

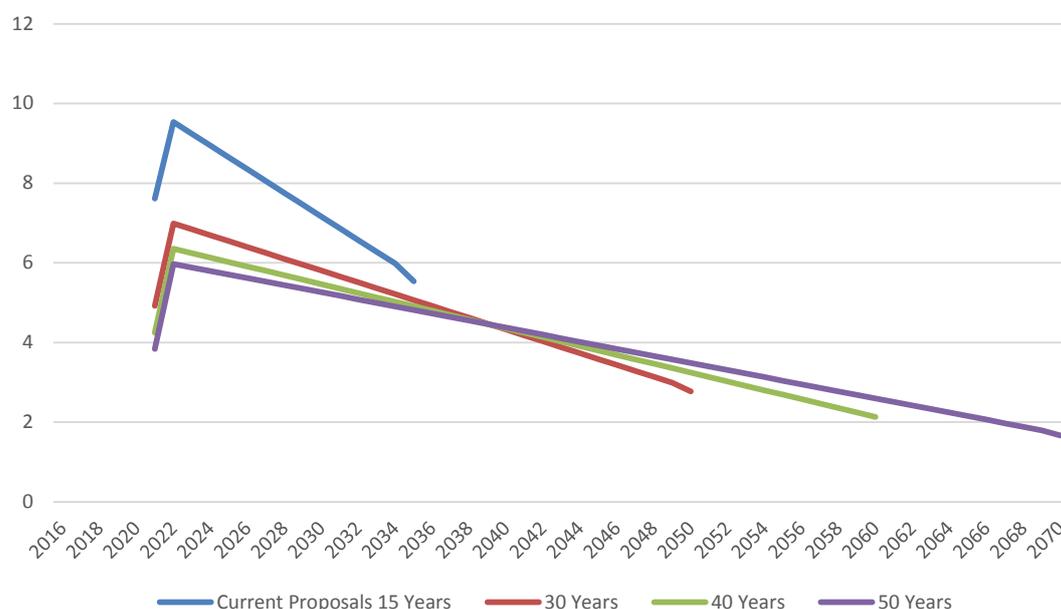
In terms of the amount paid by existing users and new users, the current proposals would see 39% of capitalised costs paid by existing users. Increasing the depreciation period to:

- 30 years would reduce this to 22%;
- 40 years would reduce this to 17%; and
- 50 years would reduce this to 14%.

¹⁰ Maximum Level of Airport Charges at Dublin Airport 2014 Determination: Commission Paper 2/2014 – Commission for Aviation Regulation (2014).

¹¹ CAP1469 – CAA (2016). Page 21.

Figure 5: Total Capitalised Planning Costs by Depreciation Period



Source: York Aviation.

In summary, the 15 year depreciation period is without basis. It is the erroneous product of seeking to separate out planning costs as a separate ‘asset’ within the third runway proposals. It is also without regulatory precedent elsewhere within the aviation sector. In our view planning costs should be incorporated within overall capital expenditure and depreciated over the full life of the asset.

Promoting transparency

Finally, it is important that appropriate governance arrangements are put in place in order to meet the CAA’s primary objective to further the needs of the consumer. Important steps have been taken on governance in Q6 and these should be built on for the runway expansion project.

We see a role for the Independent Fund Surveyor (IFS) to aid greater transparency and for the pass through of efficient costs deemed appropriate. It is important that the definition of cost efficiency is clearly distinguished and that a joint mechanism is in place for the pass-through of only efficient costs.

Recommendations for a more efficient and equitable outcome based on CAA’s proposed approach

- Planning costs to be capitalised and rolled into HAL’s existing RAB, provided that:
 - depreciation approach to be switched to unitised depreciation.
 - depreciation period to be extended to 40 years to reflect the asset life of the runway that the planning permission supports.
 - there is singular itemisation in the RAB to ensure transparency
 - the IFS provides challenge and cost scrutiny;

- Risk sharing to be reweighted to 100%/25%.

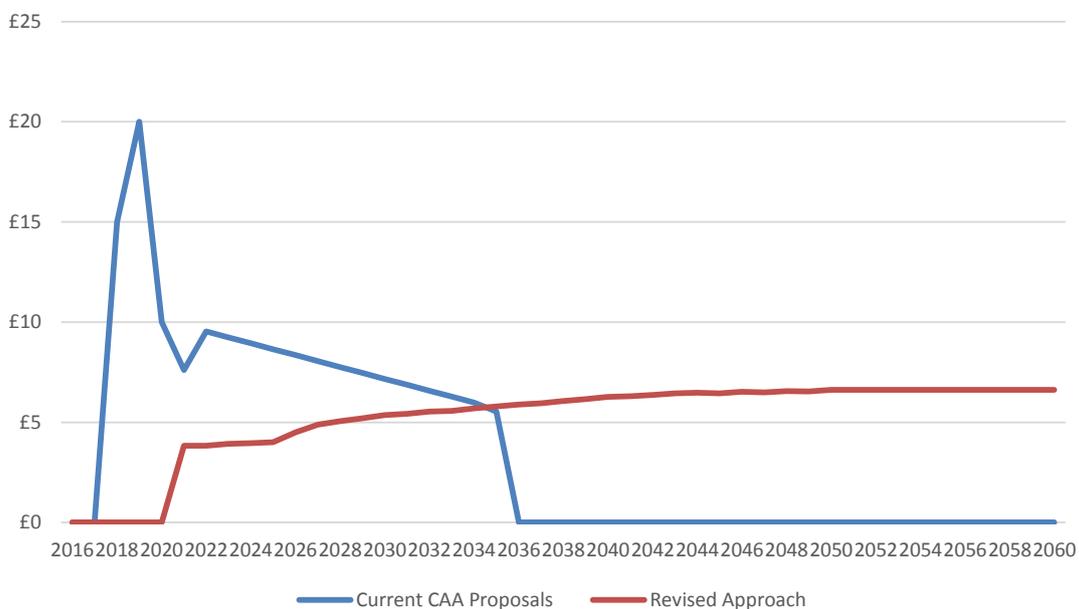
These recommendations result in major improvements in the distribution of costs between existing and new users. We estimate that around 56% of total planning costs are borne by existing users in the current proposals. Only 8% of costs are borne by existing users in the revised approach. This change is driven by:

- the removal of the £10 million per annum in immediate pass-through costs produces a 17% improvement;
- the switch to unitised depreciation results in a 12% improvement in the distribution of previously capitalised costs; and
- increasing the depreciation period to 40 years results in a 22% improvement in the distribution of previously capitalised costs.

The approach outlined above provides a ‘smoother’ profile in terms of the impact on airport charges.

In terms of risk sharing, the amounts associated with planning costs within the context of the overall scheme are very small. The incentives in relation to securing planning consent stem from the overall returns from the project. Hence, we believe that for there to be any significant incentive on HAL to avoid failure, its downside needs to be significantly greater than currently proposed. The impact of only being able to recover 25% of its planning costs is still limited in terms of HAL’s overall EBITDA returns over time but might at least have some incentive effect.

Figure 5: Planning Cost Recovery Profile: CAA Proposals vs Revised Approach



Source: York Aviation.