

The recovery of costs associated with obtaining planning permission for new runway capacity: CAA initial proposals

GAL'S RESPONSE TO CAA CONSULTATION CAP 1435

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Purpose

This paper provides the response from Gatwick Airport Limited (GAL) to the CAA's consultation on its initial proposals for the recovery of costs associated with obtaining planning permission for new runway capacity.

Summary

- GAL broadly supports the CAA's initial policy proposals, as far as these have been developed so far. They represent a reasonable package of incentives on the airport operator to invest in a timely and efficient manner in the costs associated with obtaining planning permission for an additional runway
- GAL considers that the CAA should as a matter of urgency develop similarly supportive policy for the treatment of the costs associated with mitigating blight. In the event that the Government made a runway location decision in favour of Gatwick and the GAL Board announced an intention to seek planning permission for a second runway, such costs are likely to be material, and would be triggered by its announcement to proceed. Deferring consideration of this issue would serve to add unnecessary regulatory uncertainty.
- With regard to definition of eligible costs, GAL considers that it should be able to recover, as so called Category B costs, those costs on technical and legal analysis and advice, which had been efficiently incurred prior to any Government decision on the runway location, and which are subsequently deployed in support of GAL's planning application. The CAA's current policy proposal would result in such legitimate costs becoming stranded, without means of recovery via airport charges.

CAA duties in relation to runway planning costs

We broadly support the CAA's analysis of the relationship between its statutory duties and their application to the policy issue of how to treat the preparatory costs associated with developing runway plans. In particular, we support the conclusion that the CAA should, through its actions, aim to maintain incentives to invest. The CAA rightly recognises that its proposed treatment of Category B costs could send a positive signal to potential investors.

In our view, the same argument should be applied to those costs incurred to date, prior to any Government decision on runway location, which nevertheless support the development of plans (a subset of the so-called Category A costs). GAL undertook this investment in a suite of technical studies in the period 2013-2016 in order to participate fully in the process designed by the Government. Many of these studies will be directly relevant to any subsequent application by GAL for a Development Consent Order for runway development. One of the stated purposes of the Government's approach in establishing the Airports Commission was to bring forward evidence

and analysis on runway options that could be considered in public before any planning application, with aim of ensuring that such subsequent application was well-founded and more likely to progress to fruition in a reasonable time period. This required airports to invest, at their own risk, in building a body of evidence to engage with the Airports Commission and the Government itself. For the CAA not to allow such reasonable and efficiently incurred costs to be recovered subsequently through airport charges would create a precedent that the regulator was willing to strand assets even where they have been efficiently incurred and serve to further agreed investment. This action would run counter to the CAA's proposed approach, would be at odds with the CAA's regulatory policy to date and would not therefore contribute to the CAA's stated goal of maintaining incentives to invest in the UK airport sector.

We also support the CAA's objective of promoting economy and efficiency on the part of the airport operator undertaking runway expansion. With regard to the Category A costs discussed above, we consider that this objective could be met by subjecting the costs to the same degree of scrutiny and approval by an Independent Funds Surveyor as the CAA proposes for Category B costs.

Definition of eligible costs

Definition of Category B costs

The CAA defines Category B costs as those "costs which are directly connected with and solely for the purposes of seeking planning consent through the DCO process". We agree with the scope of costs in paragraph 3.3, in so far as this defines part of this cost category associated with planning, technical, legal and other advisory work.

There is, however, a further group of property-related costs which are directly connected with seeking planning consent, and should thus be included within Category B. These are costs which will be incurred by GAL were it to announce an intention to seek planning permission for a second runway, and would be paid to home owners whose land would be required for the R2 development and those in a wider noise contour whose house values would be affected by the development. GAL has publicly committed to two comprehensive property value support schemes, the Property Market Support Bond and the Home Owners Support Scheme (scope and terms of each are summarised at Annex A to this paper). We have briefed the CAA on the details of these schemes and the potential level and timing of costs which GAL could incur.

We consider that such property support schemes are an essential element of any runway development scheme, as they provide timely and secure financial support for those affected in neighbouring areas. This would be a necessary pre-condition to achieving planning permission. They would also represent a material and early cost to the GAL runway development project. As such, we consider that the CAA should include these costs within Category B.

Category A costs

As noted above, a significant proportion of GAL's costs associated with its second runway proposals have been incurred to date on technical design, planning, environmental and other advisory work. These costs have been incurred in a timely and efficient manner in order to participate in the Government-mandated Airports Commission process and its aftermath, with the ultimate objective of facilitating the achievement of planning permission for a new runway in the South East of England. The types of expenditure GAL has incurred align with the CAA's definition at paragraph 3.3 of allowable Category B costs; the only difference being their timing, prior to any Government decision on the location of a new runway.

For the reasons set out above, we consider that the CAA should allow for such costs to be recovered through airport charges, using the same mechanism as proposed for Category B costs. In order to ensure that charges only reflect relevant costs efficiently incurred, we suggest a two stage test, to be conducted by the Independent Funds Surveyor:

1. Were the costs necessary to produce material which contributed directly to any subsequent planning application by GAL, and
2. Were the costs efficiently incurred?

Category C construction costs

For the reasons set out above, we consider that the property support costs to which GAL would be exposed, were it to seek planning permission for a second runway, should be re-categorised as Category B costs. We agree that any regulatory mechanism for the recovery of such costs should allow both for GAL to adjust charges upwards to reflect the anticipated gross costs of property support when provided, and subsequently to make any downward adjustment in the event of property disposals generating net proceeds for GAL.

Recovery mechanisms

We agree with the CAA's outline proposal for recovery mechanism (subject to comments above regarding definition of cost categories):

- Category B costs up to £10 million per year should be automatically recoverable in the year they are expected to be incurred;
- Category B costs above the allowance of £10 million per year should be capitalised and rolled up into a separate 'planning RAB' (or pRAB);
- cost recovery (both the allowed WACC return and depreciation) should only start when the asset (planning permission) comes into use, that is when the result of planning application is known. Returns earned before this time will be tracked in the pRAB, rather than added to airport charges;
- costs in the pRAB should be recovered over a 10 year depreciation period under the scenario that the DCO is granted, and over a shorter 3-4 year period if DCO is not granted;
- the airport operator should earn a return on any Category B costs that are added to the pRAB. This return should be calculated using the WACC at the level determined in the Q6 settlement (i.e. 5.7% for GAL).

Risk sharing

We welcome the CAA's intention behind its proposed risk-sharing mechanism to ensure that both the relevant airport and the airlines bear some risk in the event that planning permission is not granted, is rescinded or is withdrawn. We would question though whether the balance of risk-reward as currently proposed is set at the right level.

Under the proposed mechanisms for promoting efficiency and transparency, GAL would face some material risk that costs may not be allowed into the recovery mechanism, and therefore written off, even though (in GAL's view) such costs were necessary to support the runway development. So in practice, the CAA's proposed 105/85% risk-reward mechanism would be likely to lead to a materially less favourable outcome to GAL on the costs that it actually incurred, as opposed to

those which would be approved by the Independent Funds Surveyor. If the CAA holds to the proposed cost-recovery mechanisms, we consider that the parameters of risk sharing should be changed to 110/85%. This would preserve the asymmetry of risk between airport and airlines, maintain the airlines' and airport's exposure in the event that DCO is not granted, and reward the airport appropriately for investing risk capital for several years (potentially stretching from 2013 through towards 2020) were it to seek planning permission for a second runway. This approach would also have the secondary benefit of providing a mechanism for airport charges to rise at a faster rate than otherwise in the period of planning and construction leading up to the opening of a second runway: such profiling would assist the financing of the project and enable a smoother transition to the higher charges necessary in the medium term once the runway became operational.

If the CAA were to accept our proposal that efficiently incurred property costs, described above, should also be included within Category B, then we consider that it could be more appropriate for GAL simply to recover 100% of these costs, without the proposed reward premium. This is because this element of R2 related expenditure is very largely driven by long standing commitments given by the airport to local communities and/or by compulsory purchase legislation. With little discretion for GAL now and in future as to what costs are incurred and when, the risk-reward mechanism would be less relevant to this cost category.

Promoting efficiency and transparency

We agree with the CAA's objective of promoting efficiency and transparency through:

1. the establishment of a specific planning Independent Funds Surveyor, to scrutinise costs and report back to stakeholders and the CAA; and
2. any materials produced by the airport operator for the planning process should be made available to stakeholders.

In particular, we support the CAA's proposal that the IFS would "verify the need and efficiency of the Category B costs incurred", and that this would in practice enable the IFS, subject to ultimate decision by the CAA, to veto expenditure by GAL which it considered to be unnecessary and/or inefficient. We would hope that this control and oversight by the IFS of GAL's R2 planning costs would provide airlines and the CAA with a practical ongoing scrutiny and assurance that charges would subsequently only reflect necessary costs.

In setting up the IFS, we suggest the following issues should be considered carefully in the terms of reference and operating practices of the IFS:

- GAL would endeavour to share all relevant materials relevant to R2 planning costs with the IFS. Some of this material may be commercially confidential, with respect to GAL and/or to other organisations affected by R2 development (e.g. companies which would be relocated). There should be clear processes established at the outset for the handling of such confidential information, including for GAL to request that detailed commercially confidential information not be shared with airlines.
- The IFS should be established so as to be able to conduct regular assessments of the information flow from GAL regarding R2 planning costs, so that this regulatory check does not in itself become a drag on the development programme. To that end, the IFS should be able to provide forward guidance on proposed expenditure, as well as backward-looking approval of expenditure incurred.

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Annex A GAL property support schemes

	Property Market Support Bond	Home Owners Support Scheme	
		Market Support	Early Movers
Benefits	If GAL announces intention to apply for planning permission for R2 property owner can sell for un-blighted price based on index linked 2002 value plus 25% and legal fees and stamp duty	If GAL receives planning permission for R2 and announces intention to proceed with construction property owner can sell for un-blighted price based on index linked 2002 value	If GAL announces intention to apply for planning permission for R2 then: <ul style="list-style-type: none"> (i) If owner cannot sell for a price within 15% of market value (based on 2002 index linked) GAL will buy at that market value (ii) If owner can sell for a price within 15% of market value (based on 2002 index linked) GAL will contribute 1% of sale price plus stamp duty payable by purchaser up to total of 5% of sale price
Area	Within land required for R2 development	Projected 66 – decibel leq contour	Projected 66 – decibel leq contour
Applicant Eligibility	Can apply for Bond at anytime from 3rd October 2005 until GAL receives R2 planning permission	Can apply for Option Agreement once GAL has announced its intention to apply for planning permission for R2	Can apply once GAL has announced its intention to apply for planning permission for R2 but <u>not</u> if the property was bought after August 2005