



Civil Aviation Authority
CAA House
45-59 Kingsway
London WC2B 6TE

18th December 2014

Dear Sir or Madam

Heathrow Hub response to CAA consultation on Economic regulation of new runway capacity – a draft policy (CAP 1221)

Summary

Heathrow Hub Ltd/Runway Innovations Ltd. (HHL/RIL) welcome the opportunity to respond to the CAA's draft policy on the economic regulation of new runway capacity. In general, we support the regulatory framework set out by the CAA, with its emphasis on allowing private risk capital to be attracted into the financing of airport expansion, to the ultimate benefit of airport users. In particular, we support the CAA's three principles of allocating risk to those best able to manage it, encouraging commercial negotiations, and allowing for new capacity to be paid for both before and after it opens. We do not, however, agree with the CAA's proposed approach to limit the recovery of costs incurred by promoters of airport expansion schemes during the protracted period of engagement with the Airports Commission. We believe that this would run counter to the Government's intention of establishing the Airports Commission, in part, to assist in securing planning permission for the recommended airport expansion scheme.

Introduction

The CAA's draft policy document is a welcome and timely contribution to the ongoing consideration by the Airports Commission and stakeholders of options for the expansion of Heathrow or Gatwick airports. The CAA rightly recognises that in some areas, it is too early to provide definitive guidance on its relevant policy, while in others it can and has set out the guiding principles which will inform its future regulatory decisions. Given the long lead times in any project for airport expansion, it is helpful for the CAA to condition the expectations of airports, scheme promoters, airlines and potential investors in this way. At the same time, there will be new information which emerges in the coming months and years before an expansion scheme at Heathrow or Gatwick is finally approved for construction. During this period, it would be helpful for the CAA to provide periodic assessments and, where necessary, updates of its regulatory policy framework.

Treatment of construction costs (category C costs)

HHL/RIL support the three principles set out by the CAA to guide its future economic regulation of the construction costs of capacity expansion. It agrees with the CAA's premise that an overly prescriptive regulatory policy at this stage may not encourage airport operators, scheme promoters, airlines and investors to search for a viable commercial solution to the financing of airport expansion, if stakeholders were to focus primarily on seeking to negotiate the terms of the regulatory 'deal' rather than working together to develop a viable investment proposition.

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

We have no additional comments on the CAA's first principle, which we support.

Principle 2: commercial negotiations should be encouraged

We strongly support the CAA's approach. Innovative solutions to the financing of additional runway capacity at Heathrow are far more likely to emerge from concerted engagement between airport operator, airlines and investors. Indeed, the Heathrow Hub proposal is itself a good example of an innovative solution to question of designing additional airport capacity: it is a privately financed, independent and competitive scheme which has brought new thinking to bear on how best to expand Heathrow. This proposal has been developed, so far, without regulatory approval or constraint from the CAA – it is likely that a similarly liberal approach to the financing of new capacity will create the best environment for effective solutions to be developed. There may be a role for the CAA, *ex post*, to review the resulting structure put in place to finance the additional capacity, and where need be to reflect this in the economic regulation of the airport.

The CAA notes¹ that potential contracts between the airport and airlines, in which access to new runway slots is sold in advance to airlines, may be stymied by the European Union Slot Regulation and associated UK implementing regulations².

We recognise that any changes to slot allocation rules would present significant challenges and, even if possible, would be a very lengthy process. However we would support the CAA's ongoing consideration of this issue.

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

We strongly support this principle, for the reasons set out by the CAA.

Cost recovery of category A and B costs

We strongly disagree with the CAA's proposal that *"all costs associated with an airport operator's or HHL's submissions to the Commission, together with any associated lobbying costs, [so called category A*

¹ Paragraphs 3.19-3.22

² Regulation EEC 95/93 as amended, and The Airport Slot Allocation Regulations 2006

costs] should be borne by the proposer”³. In our view, this policy conclusion is based on a falsely sharp distinction between costs incurred now by HHL in providing detailed technical analysis to inform the Airports Commission, and costs incurred subsequently on very similar analysis to inform a planning application. The CAA “does not consider that proposals to the Commission can be considered as preparation for the planning process”⁴.

In our view, the CAA’s suggested stance on this issue fails to take sufficient account of the nature of the Airports Commission, in particular the fact that the Commission has been explicitly tasked with undertaking the precursor work to support Government planning processes, and thus expedite a subsequent planning application by the selected airport expansion scheme. The terms of reference of the Commission make clear this planning role:

“The Commission should base the recommendations in its final report on a detailed consideration of the case for each of the credible options. This should include the development or examination of detailed business cases and environmental assessments for each option, as well as consideration of their operational, commercial and technical viability.

As part of its final report in summer 2015, it should also provide materials, based on this detailed analysis, which will support the government in preparing a National Policy Statement to accelerate the resolution of any future planning applications for major airports infrastructure”. [Emphasis added]

The Commission has gone to some lengths to define the analytical framework for its own consideration of airport expansion options. It has conducted extensive analysis through 16 “appraisal modules” which encompass analysis of the economic, social and environmental impacts of each scheme, as well as their operational viability, commercial viability and risks to delivery. This analysis has been based in part on the Commission’s own consultancy studies, but also on the detailed technical submissions from HHL/RIL, other airport scheme promoters, and third parties.

In addition, as the CAA notes, category B costs [those incurred after the Government has decided in favour of a particular airport expansion] “may include costs for further development or modification of work done for the Commission where this is necessary to prepare the proposed scheme for a planning application”⁵.

Both factors point towards the work now being undertaken by the Commission as being an integral and necessary early stage of the protracted planning process (which includes developing a National Policy Statement for airport expansion). As such, category A costs incurred by HHL/RIL should be considered as a necessary investment in the ultimate delivery of new capacity at Heathrow, to the ultimate benefit of

³ Paragraph 5.3

⁴ Paragraph 5.4

⁵ Paragraph 5.7

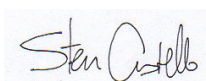
users. The CAA should therefore allow for these efficiently incurred costs (currently being borne fully at risk by HHL's investors) to be recovered through airport charges, were the HHL/RIL scheme to be supported by Government. It should be noted that relatively little of the cost which HHL/RIL has incurred relates to "*lobbying*", the majority being the legitimate cost of, for example, engineering and environmental studies and other technical development.

For these reasons, we strongly disagree with the CAA's conclusions⁶ that HAL would not be able to recover any costs incurred in purchasing HHL/RIL's intellectual property, in the event that HHL/RIL's scheme is recommended by the Airports Commission and/or supported by Government. We also disagree with the CAA's assertion that HAL, if it had been an efficient operator, should have taken steps to avoid the need to purchase a third party's concept related to its core business. In HHL/RIL's view the potential purchase of its intellectual property by HAL is no different to that involved in other capital projects where the acquisition cost includes associated intellectual property rights.

HAL may have significant market power in the South East England airport market, but no company can or should be expected to have a 100% monopoly on ideas regarding its business. Innovation in business ideas is one of the key drivers of productivity growth, and HHL/RIL's proposal illustrates the benefits to airport users and local residents from enabling vigorous competition for ideas. The history of proposed airport development in the UK illustrates that HAL and its predecessor company BAA did not have a strong track record in developing and implementing airport expansion plans. The divestment of Gatwick and Stansted from BAA and the introduction of new ideas about Heathrow development from HHL/RIL have enabled a wider range of competing concepts to be tested publicly.

The fact that stakeholders now have two well-developed competing proposals for the expansion of Heathrow can only result in users benefiting from rivalry between schemes to deliver the most cost effective additional capacity. To provide reasonable prospect of reward for such risk-funded innovation by scheme promoters, the CAA should allow the costs to HAL of purchasing HHL/RIL's intellectual property. Not to do so would have the effect of dampening competition, contrary to the CAA's own statutory duty.

Yours faithfully

A handwritten signature in black ink that reads "Steven Costello". The signature is written in a cursive, slightly stylized font.

Steven Costello
Director
Heathrow Hub Ltd/Runway Innovations Ltd.

⁶ Paragraph 5.29-5.32