



London (Heathrow) Airline Consultative Committee

Final Jan 6

Response to CAA consultation – recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: final proposal (CAP 1469)

The Heathrow airline community has already responded to the CAA regarding its consultation regarding the notice of proposed modification to Heathrow Airport's Ltd economic licence to allow for an annual recovery of £10m of category B costs for a new northwest runway (CAP1470). In this response we outlined our concerns regarding the lack of evidence to support the CAA's assertion that its proposals would deliver outcomes which are aligned with consumer interest. We also believe that the decision by the Government to locate new capacity at Heathrow Airport is the right decision. As the costs of the scheme will fall to airlines and their passengers, the objective of the Heathrow airline community is to secure expansion at an affordable cost. This was recognized by the Chairman of the CAA when he wrote to the HAL CEO on the 25th Oct indicating that "keeping charges flat is also an outcome that many of the airlines hope to secure in exchange for their support".

The airline community recognizes and fully appreciates the critical role the regulatory treatment of cost (including planning costs) plays in ensuring that the construction of the new northwest runway at Heathrow Airport delivers outcomes that are aligned with consumer interest. The community considers this as the most important lever through which to influence the design and secure efficient delivery of the airport expansion scheme. The following comments are made to secure a fair and affordable solution which ensures a sustainable outcome for the planning phase.

1 Recovery mechanism for eligible costs

Headline: There is a need to give some regulatory certainty over treatment of planning costs

The airline community is of the view that there is a need to give some regulatory certainty over the treatment of costs incurred in planning future investment (the so called "Category B" costs). The approach to treatment of planning costs must be determined by assessing what approach is best aligned with safeguarding the consumer interest. The primary duty of the CAA is to further the interest of

consumers and it should not take decisions that will compromise this objective. In this context, the airlines believe that the following consumer interests should be pursued:

- efficiency of spend
- users pay but only when there new capacity becomes available
- risk is borne by those best able to control it – passengers are not the risk underwriters of last resort

2 Recovery of the first £10 million incurred each year

Headline: There is no objective reason for setting up multiple recover periods and arbitrary (£10 million) thresholds

Although the CAA has agreed the recovery of the first £10m we remain very disappointed that a decision has been taken without receiving the submission on CAP 1469. There is no additional incentive needed to motivate Heathrow to start working on securing planning permission. The subsequent section below explains how planning costs should be treated. Furthermore, HAL is fully incentivized to strengthen the option value it has been endowed with, through the government announcement on October 25 that it was in favor of a new northwest runway and associated infrastructure at Heathrow. The option value of undertaking the expansion will increase after it succeeds in securing the Development Consent Order. As expressed in our submission on 1470, we do not see any parallel with the Gatwick decision as it was taken under a varied regulatory framework, at another point in time and with a different level of uncertainty. It is now clear that the circumstances under which that decision was taken are not relevant for the situation we currently face at Heathrow.

3 Capitalization of costs above (and below) £10 million per year and clearly identified in the airport RAB

Headline: CAA should allow efficiently incurred planning costs to be recovered, one way is to place efficiently incurred Category b costs in a separate RAB

The CAA should indicate that efficiently incurred planning costs will be allowed to be recovered, one option for transparently handling such costs would be for them to be placed in a separate RAB, easily auditable and subject to separate regulatory treatment for the unique purpose of airport capacity expansion. Given that the project scope is currently undergoing a comprehensive review, at this point it is premature to specify the timing of when and over what time period these costs will need to be recovered. It is likely that the project scope as well as associated costs are going to change substantially. During the initial immersion session, HAL has already put forward an alternative proposal that does not materially change the capacity profile of the scheme but reduces scheme costs by about 8%. We envision that it is entirely possible and perhaps likely that fundamental changes may be needed to the design of the scheme. Furthermore, an initial review of the costs suggests that there is also room to optimize the delivery of the envisioned investments. Based on the information provided during the first immersion event it is likely that the capital needs of delivering the benefits envisioned in the project

(specific to airport expansion) have been significantly overestimated.

4 Cost recovery when planning permission is secured; Cost recovery spread over 15 years and irrespective of the outcomes of the planning process

Summary: Timing of when and over what time period planning costs are going to be recovered should start when the assets come into use with the recovery period being the lifetime of the commissioned assets. In addition, we do not regard that, from a passenger perspective, that DCO consent creates an asset which benefits the passenger.

If the CAA wishes to already indicate the timing of when and over what time period planning costs are going to be recovered then the starting point should be when the assets come into use and the recovery period would be the lifetime of the commissioned assets. This will ensure that the airport has an incentive to start delivering benefits early and to defer costs where possible. Crucially this approach will also ensure that the users paying for the costs are also the ones that are benefiting from the capital investments.

However, it is theoretically possible that a different approach to the recovery of costs may align better with the interest of the consumer. Deviation should only be allowed if it can be demonstrated, through supporting evidence and empirical analysis (for example cash flow analysis), that it is in the consumer interest to either bring forward the start time of when funds are recovered or accelerate the time period over which the costs are recovered. We have seen no evidence to support the assertion that either the advancement in the starting point of recovery of costs or acceleration of the time period over which these cost are recovered are in the interest of consumers. On the contrary, we are of the firm view that such an approach will be against consumer interest. It would lead to worse risk allocation outcomes and result in higher costs to consumers (when time value of money of consumers is considered). Furthermore, it would lead to inequitable inter-generational outcomes as consumers that do not benefit from the investment will have to incur higher costs. In addition, we do not see advancement of revenue in any form, including for covering of planning costs, reflective of what is observed under normal competitive market conditions.

5 Adjustment for time value of money

Summary: Recovery of cost should include the appropriate level of the cost of capital but financial analysis should also take into account the option value created from planning permission/intent

The decision on the appropriate level of cost of capital can be taken retrospectively based on an actual cost of capital observed during the time periods when planning costs are incurred. However, the appropriate level of cost recovery (underlying cost as well as capital cost) would need to take into account the option value the airport was endowed with through the government signaling intent and eventually permission for expansion.

In addition, decisions on the WACC are dependent on the regulatory regime. For example in the water industry, Thames Tideway was built with a separate company and a separate RAB. The right to build and run Thames Tideway was auctioned, and companies were asked to estimate what WACC they wanted. The WACC chosen by the winning business was significantly below both that granted to Thames Water,

and the WACC estimated for Thames Tideway by OFWAT

6 Risk sharing arrangements

We believe that there are two options regarding risk sharing prior to DCO consent

- Option 1: HAL bears all risk
 - If project does not manage to obtain DCO no cost recovered
 - If project is successful in obtaining DCO then efficiently incurred cost (including cost of capital) should be passed on (but whether costs have been incurred efficiently would still need to be reviewed post DCO decision).

- Option 2: HAL and airlines jointly agree on cost expenditures
 - If project fails to obtain DCO incurred costs are shared based on a 80/20 formula (no cost of capital recovered). The current proposal of the CAA is far too generous and has failed to take proper account of HAL's already fully demonstrable investment. The airline community believes that the airport's shareholders should carry 80% of the risk since it has the means, including the resources and externally recruited knowledge base, to manage the planning, development and design risk associated with securing planning consent. Neither should the passenger and the airline community whose skills base is, predominantly, limited to the operating environment assume responsibility as the risk underwriters of last resort. It must be emphasized, again, that the airline community cannot control the risks associated with securing planning consent

 - If project is successful all efficiently incurred costs are recovered (including cost of capital)

7 Promoting efficiency and transparency

Headline: Governance arrangement and decision making process will require clarification and strengthening in some areas.

It will be critical to agree a system of governance which is capable of overseeing all stages of expansion development and implementation. The current system has much to commend it and should be built upon. We are conscious that Heathrow Airport has already suggested a structure for engagement and governance. This proposal is being reviewed by the airline community. However, we think that a specific line of work should be commenced to agree a system of governance to which all parties are committed. This work should review regulatory approaches to infrastructure development and governance in other sectors as well as that which is already in place at Heathrow in Q6.

The following aspects are relevant and should be taken into account by the CAA in their review with particular reference to strengthening the governance model at Heathrow:

- The regulatory protocols agreed with the CAA for the Q6 provide a sound basis for further exploration. In this model “joint” agreement is required between HAL and the airlines before investment decisions are made.
- The current project gateway lifecycle model has been well developed and supported by both HAL and the airlines ensuring that about £2.1b of Q6 capital expenditure has been endorsed to date (Nov 16)
- Strengthening the IFS engagement model with a mandate derived from the CAA and reporting to the CAA, following consultation with industry, on all capital efficiency matters including examination of efficient spend
- Acknowledging that the next phase of planning require skills in National Planning and Development Consent processes which are outside the relevant experience and knowledge base of the airline community
- Widening the scope of IFS engagement to include all of the airport expansion scope from planning to construction.
- Ensuring that adequate financial provision is made for a wider terms of engagement by the IFS including the full expansion scope
- Recognise that a budget cap for the planning phase may be desirable in the light of the recent significant increases in HAL’s cost estimate
- Use of both ex post and ex-anti oversight arrangements in the oversight processes of the CAA including exploring all regulatory approaches necessary to maintain transparency and accountability in the interests of passengers.

The Heathrow airline community recognizes the importance of building on the current Q6 process and the associated governance framework. The learning from this model should be taken into account when designing the governance arrangements for airport expansion. The scale and scope of the expansion project is unprecedented and warrants special investigation by the CAA taking account of the specificities of the aviation sector, its application at Heathrow and the learnings from the Q6 process. The CAA has commissioned several H7 studies which may also provide valuable input into this review and we look forward to future exchanges with both HAL and the CAA on these matters.