Civil Aviation Authority

Economic regulation of new runway capacity

CAP 1279

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Enquiries regarding the content of this publication should be addressed to:
Markets and Consumers Group, CAA, 4th Floor, CAA House, 45-59 Kingsway, London WC2B 6TE.

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Executive Summary

Duties

1. The CAA is an independent economic regulator. Our duties in relation to economic regulation, including any required for new runway capacity, are set out in the Civil Aviation Act 2012 (the Act). Under the Act, our primary duty is to ensure that decisions are taken in the best interest of users (passengers and cargo owners). In carrying out our duties, we are required to act in a reasonable and proportionate manner.

Principles

2. On the recovery of the main construction and implementation costs of runway expansion, we can best meet our duties at this time by setting out a broad framework of applicable regulatory principles rather than by specifying a detailed regulatory regime.

3. The following principles will underpin our future regulatory decisions in relation to new runway capacity:

- *risk should be allocated to those parties who can best manage it.* There are a number of different players involved with capacity expansion and each has an important role in managing risk. We have a role in managing regulatory risk and Government has a role in managing political risk. By allocating risk to those best able to manage it, users' interests are most likely to be protected by producing the lowest expected out-turn cost (as incentives to manage the cost are maintained) and by revealing information about parties' valuation of risk;

- *commercial negotiations should be encouraged*, even where substantial market power is present. If a commercial agreement to underpin expansion is possible, including an agreement reached where we have set the broad parameters under which those negotiations should occur, it could incentivise efficiency, ensure that risks are borne by those best able to manage them, reveal information about parties' valuation of risk, and avoid any unnecessary regulation; and

- *capacity can be paid for both before and/or after it opens*. We consider the two main potential benefits of pre-funding are that it can help reduce the risk of a project, therefore reducing the financing cost, and it can lead to a smoother pattern of charges over time, both of which can be in the interests’ of users. We also consider that where there are capacity shortages, price rises can signal to market participants that additional capacity may be required.

Price control structures

4. Where regulatory intervention is required, we have a range of regulatory tools at our disposal. In selecting the most appropriate tool, we will adopt the least intrusive measure, while also ensuring that users' interests are protected.

5. We do not intend to fully elaborate our potential approach to economic regulation at this time. Providing too much information could undermine innovation and unduly shape any commercial negotiations. However, consistent with our draft policy, if a Regulatory Asset Base (RAB)-based approach is adopted, our current thinking remains that:

   - we are sceptical as to the benefits of a 'split RAB' arrangement as the commercial and operational risks of a new runway seem to be integrated with those of the rest of the airport and cannot, therefore, be easily separated. However, we are open to long term mechanisms by which the financing of new capacity can occur, where they are in users' interests and where the risks of the project are genuinely ring-fenced. Such mechanisms could include, but are not limited to, Special Purpose Vehicles;
   - we consider that allowing unanticipated, efficiently incurred capacity expansion capital expenditure (capex) to be recouped (including the full financing costs) is appropriate. However, we also consider that there is merit in further consideration of mechanisms to improve the incentive on airports to accurately estimate and manage their project costs;
   - we expect to allow efficiently incurred capacity expansion operational expenditure (project opex) to be capitalised. This means that we will treat project opex in the same way that we treat capacity expansion capex. (This is, of course, subject to our proposed approach to the recovery of costs, which is outlined below.);
   - we will consider sculpting depreciation to match recovery of costs to growing demand. However, as this approach is likely to increase risk and the cost of capital, we will need to ensure that it does not have a detrimental effect on users; and
   - we are open to extending the duration of price controls, or to fixing some elements over multiple control periods, although we recognise that there can be challenges with such approaches.

6. We will elaborate further when we consider it will be in users' interests to do so. We are not currently in a position to define when this will be as we face a high degree of uncertainty about how capacity expansion will develop.

Scrutiny of costs

7. We will scrutinise the efficiency of any capacity expansion capex. This scrutiny will take place in two, possibly three, phases:

   - after the Government decides where expansion can proceed, but before the planning application is lodged with the Planning Inspectorate (or before a hybrid bill process is completed). At this stage, we will review the efficiency of the proposed design of the capacity expansion proposal;
   - possibly after the Planning Inspectorate has considered a capacity expansion proposal and has requested material changes to it. At this stage, where we consider the changes are material, we will undertake an additional review of the efficiency of the revised proposal. (Where we consider the changes are not material, we will consider them as part of any *ex post* scrutiny.); and
   - where cost-recovery through regulation is allowed, an *ex post* scrutiny of the efficiency of the build (e.g. procurement, benchmarking of costs) will be undertaken.

Recovery of costs

8. We have categorised costs into three broad categories and will adopt different approaches to the recovery of each of these costs:

   - Category A costs: Airports Commission-related and associated lobbying costs incurred by an airport operator or Heathrow Hub Limited (HHL). These are costs that we consider will, in general, be incurred before a Government policy decision on capacity expansion is made;
   - Category B costs: capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision and are associated with seeking planning permission; and
   - Category C costs: those costs incurred by an airport operator, typically after planning permission is granted, in connection with implementation and construction of new capacity, up to entry-into-operation.

9. For Category A, recovery of *most* costs will not be permitted. We do not consider that lobbying costs to influence Government policy or other stakeholders are part of the costs of constructing new capacity, nor part of the planning process. We consider that these costs should be borne by the relevant proposer (airport operator or HHL). However, we do accept that some Category A costs could be viewed as the costs of seeking planning permission. Our policy for these costs is that we will allow them to be re-categorised as Category B provided that the airport operator makes a strong and clear case that the information submitted for planning is not materially different to that submitted to the Airports Commission.

In other words, costs will be permitted provided changes are of a level we consider minor, for example, costs being updated to reflect latest available macroeconomic or inflation forecasts. These costs will also be subject to a *de minimis* level and an efficiency assessment.

10. We see Category B costs as part of the costs of constructing new capacity and, therefore, costs which users can reasonably be expected to carry (in full or in part). However, we aim to avoid users bearing the whole risk of these costs in the event that planning approval is not granted, is rescinded or is withdrawn, as occurred with Stansted Airport Limited's second runway project. Our approach will therefore be:

- costs up to £10m per annum will be automatically recoverable by an airport operator; and
- costs over £10m per annum will be subject to an efficiency review. These costs may be recovered by an airport operator, subject to them being efficient and there being risk sharing arrangements in place that mean such charges are (in whole or in part) returned to airlines in the event that planning permission is not granted or is rescinded.

11. The £10m per annum threshold we have proposed for Category B costs is not an estimate of the level of costs that we expect an efficient airport operator in these particular circumstances to incur. The £10m per annum threshold is both intentionally and materially lower than the amount we expect either Heathrow Airport Limited (HAL) or Gatwick Airport Limited to incur in planning its capacity expansion. This threshold will create a strong incentive for them to engage and agree with their airlines on appropriate risk sharing arrangements and the commercial terms of any agreements on capacity expansion.

12. Our arrangements for Category A and B costs will also generally apply if HAL buys the relevant intellectual property from HHL in order to pursue the Extended Northern Runway scheme.

Market power

13. We do not consider that there would be any benefit in undertaking a market power assessment until much closer to, or even after, the opening of any new capacity. We are unconvinced that an earlier market power assessment would provide greater regulatory certainty at this time.

Next steps

14. With the broad parameters of our approach outlined, we consider that we have provided sufficient certainty for stakeholders to take forward their plans for capacity expansion. However, we recognise that the capacity expansion debate

will continue to evolve in a way that is fluid and at this time is difficult to predict. Our current intentions are to publish:

- a paper on how we could be involved in commercial negotiations and the parameters of possible commercial agreements. This paper will examine the parameters of possible commercial agreements between airport operators and airlines that could underpin new capacity and our potential role in relation to the negotiation and implementation of commercial arrangements. This paper will be released shortly after the Airports Commission publishes its recommendations; and
- a progress report on commercial negotiations no later than six months after any decision by Government on where expansion can occur.

Chapter 1
Introduction

1.1 This document outlines our regulatory policy on capacity expansion at Heathrow or Gatwick.[1] It builds on our October 2014 draft policy document 'Economic regulation of new runway capacity – a draft policy' (CAP 1103), June 2014 discussion paper and May 2014 workshop.[2]

1.2 This is the non-confidential version of this document and excisions from the text are marked with [✂].

Consultation responses

1.3 We received 10 responses to our October 2014 consultation and non-confidential versions of these submissions are available on our website. Responses were received from:

- Heathrow Airport Limited (HAL);
- Gatwick Airport Limited (GAL);
- Heathrow Hub Limited (HHL);
- Manchester Airport Group (MAG);
- Heathrow Airline Operators Committee (AOC);
- The Airport Consultative Committee at Gatwick (GACC) & the London Airport Consultative Committee (LACC) at Heathrow (the joint airlines);[3]
- British Air Transport Association (BATA);
- International Air Carrier Association (IACA);
- Virgin Atlantic Airways (VAA); and
- easyJet.

1 Heathrow and Gatwick have been identified by the Airports Commission as possible locations for capacity expansion in the South East of England. Information on the role of the Airports Commission is available at: https://www.gov.uk/government/organisations/airports-commission (accessed 22 October 2014).

2 See: http://www.caa.co.uk/docs/589/CAP1221.pdf, http://www.caa.co.uk/docs/78/CAP1195_capacity_expansion_discussion_paper.pdf and http://www.caa.co.uk/docs/589/CAA%20Workshop%2014%20May%202014.pdf.

3 This submission was endorsed by BATA & IATA.

1.4 We have considered all the issues raised by stakeholders and our conclusions are contained in the main body of this document. The appendices also summarise, along thematic lines, the main points made in submissions and our responses to those points.

1.5 Although this document is intended to offer a reliable steer on our final policy, in the event that fresh evidence emerges during the process of evaluating any specific project, we will modify our approach if that will better enable us to fulfil our duties.

Document structure

1.6 This document is structured as follows:

- First, it reviews our duties (chapter 2);
- It then discusses how we intend to treat different categories of costs:
  - Category A costs, those costs incurred by an airport operator or HHL for work in support of the Airports Commission (the Commission) and any associated lobbying to influence Government policy, before a Government policy decision on capacity expansion is made;
  - Category B costs, those costs incurred by an airport operator, after a Government policy decision, that are associated with seeking planning permission; and
  - Category C costs, those costs incurred by an airport operator, typically after planning permission is granted, for the implementation and construction of new capacity, up to entry-into-operation;
- Category C costs are likely to be the most material and are therefore considered first (chapter 3). Given current levels of uncertainty, our proposed policy is based on regulatory principles rather than a detailed regulatory regime;
- Our current thinking on aspects of price control design are addressed in chapter 4 (notwithstanding the principles outlined in chapter 3);
- Our proposed treatment of costs that fall into Categories A and B is addressed in chapter 5;
- How and when we will scrutinise capacity expansion costs to ensure they are efficient is discussed in chapter 6;
- Chapter 7 concludes by explaining why we consider that there would not be any benefit in undertaking a market power assessment (MPA) until much closer to, or even after, the opening of any new capacity;

- Chapter 8 outlines the next steps we intend to take on the economic regulation of any capacity expansion at either Heathrow or Gatwick airports; and
- The appendices cover a number of different issues, including our response to the key themes raised by stakeholders in their responses to our draft policy.

Contact information

1.7 If you would like to discuss any aspect of this document, please contact Stephen Gifford (stephen.gifford@caa.co.uk) or Ian McNicol (ian.mcnicol@caa.co.uk).

Chapter 2

The CAA's duties

Introduction

2.1 The Civil Aviation Act 2012 (the Act) sets out the matters which we must have regard to when coming to our decisions as an independent economic regulator. Specifically, section (1) (1) – (3) of the Act states:

1. *The CAA must carry out its functions under this Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.*
2. *The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.*
3. *In performing its duties under subsections (1) and (2) the CAA must have regard to—*

    a) *the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted,*

    b) *the need to secure that all reasonable demands for airport operation services are met,*

    c) *the need to promote economy and efficiency on the part of each holder of a licence under this Chapter in its provision of airport operation services at the airport to which the licence relates,*

    d) *the need to secure that each holder of a licence under this Chapter is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport to which the licence relates, facilities used or intended to be used in connection with that airport ("associated facilities") and aircraft using that airport,*

    e) *any guidance issued to the CAA by the Secretary of State for the purposes of this Chapter,*

    f) *any international obligation of the United Kingdom notified to the CAA by the Secretary of State for the purposes of this Chapter, and*

    g) *the principles in subsection (4).*

2.2 Section 69 (1) of the Act defines user as:

"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.

2.3 We also have concurrent powers with the Competition and Markets Authority (CMA) to enforce the UK and European Community competition law prohibitions in relation to the provision of the supply of airport operation services and air traffic services.[4] We are required to consider whether it would be more appropriate to use these powers prior to any regulatory action against an airport operator or air traffic services provider for example in relation to a licence condition breach. We may not take such licence enforcement action to the extent that we consider it would be more appropriate to proceed under the competition prohibitions.

2.4 Many of our regulatory objectives are consistent with the aims of competition law, which seeks to improve choice, quality and value for aviation consumers. However, when acting under our competition powers, we can only take into account our sectoral objectives where the CMA would be able to have regard to those same matters when exercising its competition law functions. So some matters, for example environmental effects and financeability, may not, therefore, be relevant considerations when we apply our competition law powers.

Passengers are at the heart of our decisions

2.5 Our primary duty under the Act is to users, which includes passengers. 'Users' implicitly includes future users as well as present users. Where conflicts between user interests arise, we must act to protect those interests as we think best.[5]

2.6 To inform our view of users' interests, we consider information from a range of sources, including:

- the CAA Consumer Panel;
- passenger surveys;
- airline-airport operator negotiations; and
- consultation processes.

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4 We are currently consulting on 'Guidance on the Application of the CAA's Competition Powers' CAP 1235, available at: http://www.caa.co.uk/docs/33/CAP1235Guidance%20on%20the%20CAA's%20competition%20powers.pdf.

5 See Section (1) (5) of the Act.

2.7 Established in October 2012, the CAA Consumer Panel acts (with internal independence) as a 'critical friend', scrutinising and challenging our work. The principal aim of the Consumer Panel is to be a champion for the interests of consumers, and the members of the Consumer Panel have a broad range of skills and experience in this area. Collectively, the Consumer Panel has a deep understanding of the regulatory environment both through the development of policy in the consumer interest, and through practical experience of how business best operates within a regulatory framework.[6]

2.8 Passenger research helps us understand passengers' airport experience and better understand passengers' priorities, requirements and expectations in terms of services provided at airports. This research can be undertaken by us or through different providers.[7]

2.9 Rigorous consultation processes, combined with an 'open-door' policy, also ensures that we obtain a wide range of views on the issues we need to consider. In particular, by outlining why certain decisions are being considered (and why others are not), we look to be proportionate, transparent, accountable, consistent and targeted in our approach.

2.10 While we have to apply judgement when coming to our regulatory decisions, our evidence-based approach ensures that our decisions can withstand scrutiny and can be tested if there are challenges, including through the CMA and/or the Competition Appeals Tribunal.

2.11 We have regularly emphasised that the interests of airlines and those of passengers often overlap. This means that we often look to airlines to protect their own interests, and rely on this as also protecting user interests. This approach has helped us to deliver on our objectives.

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6 The key activities of the Consumer Panel are: (1) to help us understand and to take account of the interests of consumers in policy development and decisions; (2) to undertake new targeted research and to gather intelligence to understand the aviation consumer experience; (3) to provide feedback from a consumer perspective on the effectiveness of our policies and practices; (4) to help us develop our approach to consumer engagement; (5) to challenge us on behalf of aviation consumers, as appropriate; and (6) to maintain an overview of developments in the aviation market from a passenger perspective and developments affecting consumers in other markets. The Consumer Panel publishes the minutes of its meetings and also publishes an annual report. Reflecting the way the Consumer Panel inputs into our policy development process (conversations and other informal means), detailed views on specific issues tend not to be published. However, where we agree with those views, they are reflected in the positions that we take on particular issues. For more information, see: '*The CAA Consumer Panel*', available at: http://www.caa.co.uk/default.aspx?catid=2488&pagetype=90.

7 For example, we undertook passenger research to inform our proposals for economic regulation of airports for the period from April 2014.

2.12 We consider that commercial agreements involving airlines have the potential to facilitate better outcomes for passengers, including with respect to price, service quality and new product/service development. This can hold even where an airport operator holds substantial market power (SMP), and where, as a result, we need to establish broad parameters under which such commercial negotiations can occur.[8]

2.13 However, airline interests do not always align with those of users. This can be due to:

- airline market power, including potentially a lack of competition in the airline sector;
- airport operator market power, which can mean agreements are distorted to favour the airport operator (although not all agreements by a company with market power need necessarily be so distorted);
- the cost of meeting the needs of certain user groups can outweigh the costs to airlines; and
- airlines focusing more than passengers on the present rather than the future.

2.14 This means that commercial agreements between airport operators and airlines do not guarantee that users' interests are protected. We, therefore, review such agreements when making regulatory decisions. Where commercial agreements are not sufficient to protect users' interests, we:

- will not rely on them as the best way to deliver our duties, and will act in other ways; and
- may intervene to ensure that passengers are adequately protected.

2.15 Our ability to rely on commercial agreements is also restricted as commercial agreements between airport operators and airlines may not be possible.

Intervention should be proportionate

2.16 Consistent with our duties under the Act, regulation to protect passenger outcomes should only occur where there is SMP.

2.17 Where intervention is required, this should be proportionate.[9] Proportionate regulation will minimise burdens and will be effective in delivering benefits for

[8] Our working assumption for this document is that SMP at Heathrow and Gatwick will continue to be present. Of course, if market conditions change, and there is evidence to support any change of view, we will reconsider our findings of SMP.

[9] Other factors that we need to consider when determining the appropriate regulatory intervention are transparency, accountability, and consistency – see section (1) (4) of the Act.

passengers, businesses and society. More broadly, effective regulation should not be considered a burden, as it can make markets work better and can bring numerous benefits, including reduced prices, improved quality, more choice and innovation.[10]

2.18 Where intervention is required, we have a range of regulatory options and, consistent with our duties, our initial preference will be to intervene in a proportionate, light-handed way (e.g. monitoring). However, the better regulation duty is subsidiary to our duty to protect users' interests, and we will give primary weight to ensuring our actions are effective in protecting those interests.

The interests of users

2.19 In delivering our duty to users, and promoting competition, we must consider a range of factors. Set out below are the factors we consider most relevant to the consideration of users' interests where capacity expansion is concerned.

- Financeability: This duty implies that when we act, we do so in a manner that does not unnecessarily undermine the ability of the airport operator to raise finance. This does not necessarily mean that the regulatory regime should be tailored to facilitate the raising of capital. Rather, it means we should have regard to the financeability duty when looking to address our primary duty to users.
- Reasonable demands: The scarcity of runway capacity has seriously damaging implications for passengers. We will therefore look to carry out our functions in a manner that facilitates the construction of new capacity. We expect that, after the Commission reports, only one capacity expansion project will have a reasonable likelihood of gaining planning permission in the medium term. We will, therefore, act in a way that promotes the construction of such a project provided it remains in users' best interests.
- Economy and efficiency: We should seek to ensure that the costs of new runway capacity represent good value for money. Our approach to achieving this needs us to take account of uncertainty and risk. This means that:
  - incentives must be created to keep costs low;
  - we should recognise our own lack of certainty about the future, and avoid where possible taking 'big bets'; and

[10] '*Better Regulation*', available at: https://www.gov.uk/government/collections/better-regulation (accessed 22 October 2014).

- risk should be explicitly recognised and managed. Risk has a price, and there is often a choice between users carrying a risk (which reduces the price but increases the impacts if the downside of risks crystallises) and users paying others to carry a risk.

- Environment: Sound handling of environmental externalities will be fundamental to the planning process for new capacity. This factor also applies within our economic regulation functions insofar as we must ensure that environmental protection built in by the planning process is not frustrated.

- Proportionality and targeting – see earlier discussion.

2.20 The following chapters set out the approach we propose to take to protect these interests and satisfy our other duties.

Chapter 3

Treatment of Category C costs – principles

Introduction

3.1 This chapter addresses the main costs of building new capacity – Category C costs: those costs incurred in connection with implementation and construction, up to entry-into-operation, and which are typically incurred after planning permission is granted (see also appendix D).

3.2 Our regulatory policy on this issue is set out in terms of principles. We consider this approach, rather than setting out a more detailed design for a regulatory regime, will best protect users for several reasons:

- all parties, including us, still have major uncertainties about what expansion will be permitted, and the market context in which expansion will occur. A detailed design published now may well turn out to be wrong and would need to be changed. Therefore, any apparent certainty would be illusory and could be misleading;
- we hope that uncertainty will be dispelled in part by stakeholders focusing their analysis on the fundamentals of expansion. However, if we published a detailed regulatory design now, there is a risk that effort would be diverted into analysing how best to profit from our decisions; and
- uncertainty can be dispelled if stakeholders are given incentives to reveal their true preferences. Publishing a detailed design now would not obviously create such incentives, and may stifle them.

3.3 We have identified three principles that will underpin our future regulatory decisions (and protect the user interests identified in chapter 2):

- Principle 1: Risk should be allocated to those who can manage it best;
- Principle 2: Commercial negotiations should be encouraged; and
- Principle 3: Capacity can be paid for both before and/or after it opens.

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

3.4 Risk means uncertainty as to outcome. At this stage, the uncertainties around airport expansion remain considerable (e.g. planning risk, procurement risk, construction risk, regulatory risk, political risk, demand risk).

3.5 Risk relates to cost in two ways:

- it reflects the fact that the out-turn cost is unknown. The party that 'holds' the risk (i.e. will benefit if the out-turn cost is better than expected or suffer if it is worse than expected), has an incentive to make the out-turn cost as low as possible; and
- risk has a price. Investors price this risk in a relatively transparent way, expecting greater returns for greater risks. Making users carry risk without being paid for it is equivalent to taxing them or charging them more.

3.6 There is no one single 'true' price of risk – parties will price risk depending on their risk appetite and their view of prospective out-turn costs. That is, the price of risk will ultimately depend on opinion. Market negotiations can allow parties to reveal the price they place on risks.

3.7 There are a number of different players involved with capacity expansion and each has an important role in managing risk. For example, we have a role in managing regulatory risk and an airport operator has a role in managing construction cost, traffic and financing risks. Similarly, Government has a role in managing political risk, particularly in light of recent attempts at capacity expansion in the South East of England.

3.8 Reducing risk for one stakeholder (or group of stakeholders) can mean increasing it for others. For example, most proposals for reducing an airport operator's level of exposure to passenger demand risk imply passing that risk on to airlines and, indirectly, to passengers. We will, therefore, carefully consider such effects in any decision that involves the allocation of risk.

3.9 As a broad regulatory principle, we consider that risk should be attributed to those who can best manage it (see also appendix A). Such an approach will ensure that:

- final out-turn cost is minimised. This is because the party with the strongest incentive to reduce costs is also the one that can do so. This is particularly important in the case of civil engineering projects, where large cost over-runs are not uncommon;
- perceived fairness will be strongest. The party that controls the risk can benefit or suffer from its own decisions, rather than those of others; and

- information about the price of risk is likely to be revealed. This is because the risk-holder may act to 'lay off' the risk to parties with a different view of the risk, for instance through insurance or procurement. However, it will only do so if it can find a party with a different idea of the price (perhaps because this party has even stronger capabilities to manage out-turn costs). The price of the transaction will reveal information about the two parties' estimate of the risk.

3.10 We will, in general, only pass risks downstream to users where there is a strong justification. This might be where:

- users are best-placed to manage the risk, or where there are challenges with allocating risk and no other party can or will carry the risk that is best managed by them; and
- this is, overall, in users' interests – for instance, because such an allocation is strictly necessary to get new capacity built.

3.11 We do not accept the view that risk should be allocated to the party with the lowest cost of capital. The next three paragraphs explain why.

3.12 The normal market mechanism is understood as follows. A party with a low cost of capital can raise funds cheaply because it is seen, overall, as a good risk. A company borrowing money can generally be seen as a bundle of different projects with different risks, but lenders assess it as a package (unless there are strong reasons to believe some risks are ring-fenced) and attribute a weighted average. If a substantial new risk (higher-cost than the previous average) is brought into the bundle, then the weighted average will increase.

3.13 Given this model, and assuming the investment market runs efficiently, it makes no difference for users whether the risk of new capacity is paid for through an airport operator's or an airline’s balance sheets. In either case, the weighted average cost of capital (WACC) of the risk-bearer will be adjusted to reflect the new risk, and the combination of the two (airport operator WACC plus airline WACC) will come to the same whichever balance sheet bears the risk.

3.14 The exception to this principle would be if the risks associated with the runway were uncorrelated with the other risks of an airline or airport operator. In that case, a portfolio benefit could be identified that would reduce the overall cost of capital. However, as the underlying drivers of risk associated with new capacity appear to be closely linked to the risks of the rest of the airport, we give more weight to the value of effective management of risk factors.

Principle 2: Commercial negotiations should be encouraged

3.15 The airline sector is generally competitive and incentives exist for airlines to seek the best deals through negotiations with airport operators. As airline and users' interests are often aligned, airline-airport operator negotiations, even where an airport operator may have SMP, could deliver benefits to users. This issue is also explored in appendix B.

3.16 There are several reasons why airline-airport operator negotiations, including those undertaken within a broad framework established by us, could deliver more benefits to users than a regulatory approach where we set all aspects of a determination. These benefits include:

- limits to the regulator's knowledge. Commercial negotiations have the potential to elicit more detailed and accurate information from participants about their opinions about, and appetite for, risk;
- the dynamism and volatility of the aviation sector, which places a premium on flexibility over time. Regulatory processes cannot be too flexible, since high flexibility means unpredictability, which can have negative implications for cost of capital and the willingness of investors and other companies to participate. In contrast, commercial agreements, including those that are potentially agreed under a broad framework set by the regulator, can often offer greater scope for flexible approaches that are more consistent with commercial risk-management; and
- the variety of user needs and preferences, which means the optimal outcome is not 'one size for all' but a complex mix of price and quality factors. As the resources of a regulator are often limited, it is likely to be less effective at addressing this variability, compared to the continual optimisation that can be achieved by a market-based system.

3.17 As we recently determined that HAL and GAL have SMP, we recognise that they are not operating in perfectly competitive markets. That power means, absent any other constraints, the airport operator is capable of imposing terms that favour it. However, the presence of SMP does not mean that the airport operator will necessarily choose to act in this way, nor that any potential abuse cannot be prevented. It would therefore be illogical to rule out commercial agreements because of the presence of SMP.

3.18 Even where SMP is present, provided we can establish an appropriate regulatory framework, there is scope for commercial agreements to be struck that would not necessarily involve an abuse of SMP or a distortion of competition. Indeed, our working assumption for this policy is that SMP at Heathrow and Gatwick will

remain for some time and that we will have an important role in, if nothing else, establishing a framework within which commercial agreements can be reached.

3.19 Where commercial agreements are struck, we will review them to make sure that no further action is necessary to deliver on our statutory duties. We will also review the compliance of any such agreements with other statutes that fall to us to enforce, notably competition law and the Airport Charges Regulations (ACR). More information on the ACRs can be found on our website and we plan to update our guidance on how we implement the ACRs in 2015.

3.20 Not all commercial arrangements would be effective as a means to reveal different parties' preferences and therefore the true cost of risk. Depending on the issues involved, the scope of negotiation and how engaged different parties are in the process, it is possible that information about risk will not be forthcoming. Careful consideration of any commercial arrangements will, therefore, need to occur to determine if they can be relied upon, for instance, to help produce the lowest expected out-turn cost by revealing information about parties' valuation of risk.

3.21 However desirable, commercial agreements on capacity expansion may not be possible. Reasons why a commercial agreement may not be reached include:

- different risk appetites;
- participants taking too short-term a view. (No criticism is intended by this comment, it is simply a matter of the strategic choices taken by shareholders and company boards);
- market power, whether this means an airport operator exercising its SMP in negotiations, or airlines seeking to exercise countervailing buyer power. In either case, the counter-party may prefer to seek a regulated outcome; and
- airlines and/or airport operator concluding that a more favourable outcome could be achieved through regulation.

3.22 It is also not clear what form a commercial agreement could take at this stage. The simplest such agreement might be to pre-sell the right to use the new capacity. However, the Slot Regulation[11] (and associated UK implementing regulations[12]) prevents airlines from pre-buying capacity at an airport. Indeed, the Slot Regulation facilitates new entrants obtaining capacity and might, therefore, discourage the incumbent airlines from supporting expansion at all. The Slot Regulation also creates grandfather rights on slots, and airlines with a legacy position at a particular airport may not face the full cost of congestion.

11 Regulation EEC 95/93 as amended.

12 The Airport Slot Allocation Regulations 2006.

3.23 What is possible, however, is the usual type of agreement already signed between airlines and airport operators, which sets the price at which slots can be used (rather than selling the slot itself). Typically, such prices are set as part of an arrangement that covers the number of passengers or flights that an airline will bring to an airport, quality factors, retail revenues, marketing support provided by the airport operator, as well as other elements.

3.24 Such agreements could be the vehicle by which an airline commits to bring demand and revenue to a new runway, which may be the crucial factor that enables new capacity to be financed. However, whether this is feasible or not may depend on whether airlines consider that any achievable price discount would give them effective access to slots once the new capacity was open. (They might foresee that capacity would not, in fact, need to be rationed; or even if it were, they might foresee a non-contracted airline winning a slot, but deciding not to use it because the price was too high, so it would be recycled to the contracted airline.)

3.25 Airlines, in general, appear to have some reservations on commercial negotiations, not least due to ongoing concerns with SMP. However, we consider that a period of negotiation, together with this policy and our further work on commercial negotiations (see below), will allow space to determine whether commercial arrangements could be a viable basis for financing and constructing new capacity. The success of such negotiations will also depend on whether an airport operator considers airlines as reliable counter-parties to such long-term arrangements, and this also is unclear.

3.26 Both HAL and GAL have indicated a willingness to explore commercial arrangements to support capacity expansion. As we see scope for passenger benefits to accrue from the successful completion of such negotiations, we are willing to give stakeholders space for these negotiations to occur.

3.27 However, we recognise that the uncertainty of waiting to see if commercial deals are possible will need to be contained. Therefore, around six months after a Government policy decision on capacity expansion we will undertake a progress report to determine if airlines, airport operators and investors have confidence that a commercial approach could support capacity expansion.[13] Following our assessment, we will determine the best way forward, which could include coming

[13] There are a number of different stages where the Government will have to make decisions on capacity expansion, although this is somewhat dependent on what process the Government adopts to facilitate the development of any new capacity. We have assumed that two main Government decisions will be required: (1) a Government policy decision on if and where new capacity can proceed – this is the stage referred to in this paragraph; and (2) a Government planning decision following the Planning Inspectorate's decision (although this could also take the form of Parliament passing an hybrid Bill). This assumption is, however, subject to some uncertainty.

back at a later stage to again consider if airlines, airport operators and investors have confidence that a commercial approach is a viable option.

3.28 We also recognise that commercial negotiations will not occur in a regulatory vacuum. While the broad regulatory approach that is outlined in this document should permit stakeholders to move forward with capacity expansion discussions, we also appreciate that more information on our potential role in commercial negotiations may be beneficial. This is why, as part of our next steps (see chapter 8), we will be:

- exploring the parameters of possible commercial agreements between airport operators and airlines that could underpin new capacity and our potential role in relation to the negotiation and implementation of commercial arrangements; and
- issuing a progress report on commercial negotiations no later than six months after any decision by Government on where expansion can occur.

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

3.29 We consider that payments for new capacity can be made before and/or after it opens (see also appendix C). There are two main reasons for this:

- pre-funding (or front-loading) can help to reduce risk and therefore the cost of financing a project; and
- pre-funding will typically lead to a smoother pattern of charges over time.

3.30 There are several different ways that pre-funding may help reduce the risks associated with a project and therefore the likely cost of financing it:

- by increasing revenues during the time when upfront design and construction costs are being incurred, pre-funding can reduce the risk of project failure;
- by bringing forward the point where investment is paid back, pre-funding can reduce exposure to demand and other risks later in the life of a project; and
- by recovering some costs at a time when demand is relatively inelastic (because of capacity constraints), pre-funding can further reduce demand risk compared with the case where costs are recovered through a large increase in airport charges once the runway comes into operation (the results of which would be more difficult to predict).

3.31 Pre-funding can also constrain the nature and potential size of government support, thus reducing the risk of a project falling foul of European State Aid rules.

3.32 In addition, pre-funding can also help to smooth the increase in charges that users may ultimately face. That is, rather than having a significant step change in charges at the point when new capacity becomes operational, pre-funding can spread the costs over users, which results in a smaller step change. Reducing the size of the uplift in airport charges in any given year means that fewer passengers are likely to be priced off (to the extent that any are priced off by the cost of airport capacity), and also should provide relatively more certainty to users.[14]

3.33 We also consider that pre-funding could result in a profile of charges over time that is closer to some of the outcomes that we would expect to see in competitive markets. That is, in a capacity constrained environment, price rises may be seen before any new capacity is built and is in operation. Such an outcome is, however, only one of a range of possible competitive outcomes and we therefore attach more weight to the advantages of reduced risk and a smoother profile of prices as reasons why pre-funding may be in users' interests.

3.34 There are, moreover, grounds for us to remain cautious as to whether pre-funding will be in users' interests. Whether pre-funding arises as a result of commercial negotiations or through regulatory intervention, it will be important that the mechanism through which any pre-funding is achieved does not introduce new disadvantages, for example, by weakening incentives for cost minimisation.

3.35 While in many cases users who will have paid for the expansion will be the same as those that use it, this may not always be the case. Given the dynamism of aviation, the services provided using capacity may be quite different twenty or thirty years later than those provided when a runway opens, and therefore the users might not be naturally seen as the heirs of those who provided the pre-funding. Also, a later generation of users may choose not to use the capacity at all – to fly less, or from elsewhere.

3.36 Pre-funding can therefore raise inter-generational concerns and implies that, individually or collectively, users are carrying demand risk. The benefits from pre-funding need to be at least large enough to compensate users for this demand risk.

3.37 Where a regulatory approach to capacity expansion is required, we will, therefore, only allow pre-funding where we are satisfied that the benefits from it are at least large enough to compensate users for any demand risk. Moreover, we will also consider whether any concerns about the impact of pre-funding

[14] See, for example, Thames Water Customer Challenge Group, Supplementary Report to Ofwat on Thames Water's Representations on the Draft Determination of its PR14 Business Plan, 2 October 2014, p. 5, available at: http://www.ofwat.gov.uk/pricereview/pr14/res_stk201410pr14tmsddrepccg.pdf.

could be mitigated. For instance, we are open to sculpting depreciation, which could ensure that those who use the new capacity will bear more of the cost. This is, however, a complex issue that we discuss in chapter 4.

Chapter 4

Current thinking on some aspects of price control structures

Introduction

4.1 This chapter outlines our views on some issues relating to price control structures. It considers:

- regulatory options;
- current thinking on RAB-based regulation; and
- the duration of a price control.

4.2 At this stage we do not intend to elaborate further, beyond the discussion in this chapter, on how we may regulate. We appreciate that there is often a preference for more, rather than less, information; but we have struck what we consider is an appropriate balance between providing sufficient information to allow commercial discussions to commence, against providing too much information which could undermine innovation and/or unduly influence any commercial negotiations and agreements.

Regulatory options

4.3 It follows from the principles in chapter 3 that commercial agreements, including ones agreed under broad parameters that we may have set, should be encouraged, subject to the outcomes being in users' interests.

4.4 The tests for whether regulation is applicable are set out in section 6 of the Act (the market power test). This section states:

(1) The market power test is met in relation to an airport area if tests A to C are met by or in relation to the relevant operator.

(2) For the purposes of tests A to C "the relevant operator" means the person who is the operator of the airport area at the time the test is applied.

(3) Test A is that the relevant operator has, or is likely to acquire, substantial market power in a market, either alone or taken with such other persons as the CAA considers appropriate (but see subsections (6) and (7)).

(4) Test B is that competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that substantial market power.

(5) Test C is that, for users of air transport services, the benefits of regulating the relevant operator by means of a licence are likely to outweigh the adverse effects.

4.5 So, for example, a commercial agreement could:

- provide evidence that an airport operator has no market power; or
- substantially contract away the scope to abuse market power. This could have the effect that, even though an airport operator had market power, the benefits of regulation were less than the potential adverse effects, so regulation was not justified; or
- on a similar logic, the ill-effects might be contractually mitigated to such an extent that only high-level regulation was required, or that competition law was a sufficient remedy.

4.6 Where regulatory intervention is applied, it should be proportionate and we would define the form of regulation by considering the range of options available.

4.7 Given the proportionality objective, we have a preference towards light-handed regulation (e.g. monitoring), with more interventionist approaches (e.g. licence-backed commitments) further down the ranking.

4.8 The main regulatory options available to us (from a lighter to a more interventionist approach) include:

- monitoring (which can be light-handed, such as occurs in some Australian airports, or progressively more intrusive);
- commercial arrangements, compliance with which is enforced by a licence (such as that currently applied to GAL). These could be multi-lateral or bi-lateral or both; and
- RAB-based regulation (such as that currently applied to HAL).

4.9 We explored the potential for monitoring in the Stansted Airport Limited (STAL) Initial Proposals[15], which provides one model; but there are numerous alternative ways such an approach could be developed.

4.10 Similarly, there are a number of ways by which commercial arrangements supported by a licence could be developed. The licence-backed commitments approach adopted at GAL, if it proves successful over time, could provide a useful framework for us to build on.

[15] CAA, Economic Regulation at Stansted from April 2014: Initial Proposals, CAP 1030, available at: http://www.caa.co.uk/cap1030.

4.11 With respect to RAB-based regulation, there are a number of different approaches that could be adopted and these are explored below.

Current thinking on RAB-based regulation

4.12 Where a RAB-based approach is applied to an airport operator that is undertaking or has undertaken capacity expansion, our current thinking is that:

- we are sceptical as to the benefits of a 'split-RAB' approach or a separate RAB for new capacity as the commercial and operational risks of a new runway seem to be integrated with those of the rest of the airport and cannot be easily separated. This is likely to result in the market taking a 'blended' view of the risk that the airport as a whole is facing. Thus, the same funding costs would be incurred in the multiple RABs. If the primary aims of using multiple RABs were better to manage risk (usually reflected in the cost of gaining finance), this suggests little would be gained from using multiple RABs. However, we do recognise that there may be situations where different treatment of some capital expenditure (capex) within a single RAB may have merit;
- we are open to long term mechanisms by which the financing of new capacity can occur, particularly where the risks with the project are genuinely ring-fenced. Such mechanisms include, but are not limited to, Special Purpose Vehicles. While we are open to considering such arrangements, provided they are in users' interests, we are unclear if investors would back them, not least as many of the risks of a new runway are intertwined with those of the rest of the airport;
- it has been our practice that unanticipated, efficiently incurred capex should be added to a RAB at the end of a control period, including the full financing costs (the WACC of the current control period). We understand that this is different from the approach in some other sectors, where unanticipated capex is not always allowed to be added to a RAB, and this difference of approach reflects the volatility of aviation. While we consider that efficiently incurred capex should be recouped, airport operators should be accountable for the accuracy of project projections. We will, therefore, be considering if there are regulatory approaches that would strengthen the incentives for airport operators to accurately forecast and manage costs (see chapter 8);
- efficiently incurred capacity expansion operational expenditure (project opex) should be capitalised. This means that we will treat project opex in the same way we treat capacity expansion capex;[16] and

[16] This is subject to any provisions that we have outlined, including with respect to costs incurred as a result of the Commission process.

- sculpting depreciation may be appropriate – this means that the recovery of costs by the airport operator could be delayed so as to reflect growing demand levels/utilisation levels. This can help avoid a step increase in charges when new capacity opens and can create a strong incentive for an airport operator to fully utilise the capacity that it has available. However, compared with applying straight line depreciation, this approach may increase airport operator risk (included with respect to stranded assets) and increase the cost of capital. We will, therefore, carefully consider the merits of such an approach following development of a detailed plan, and consideration of market conditions.

4.13 There is little that can be said at this time on the appropriate WACC. However, in the event that we need to set the WACC, it will appropriately reflect the conditions that we expect the airport operator to face over the duration of a price control.

The duration of a price control

4.14 Under the Airports Act 1986, we were required to set price caps for five years. However, the Civil Aviation Act 2012 provides us flexibility on the duration of price control periods and we took advantage of this new flexibility in the Q6 settlements.

4.15 There may be merit in setting longer price controls, or 'locking in' some elements of a price control for longer periods (i.e. across multiple control periods) through a policy statement, given the scale of the capex required to build new runways.

4.16 One of the potential benefits of either of these approaches would be a reduction in regulatory risk. By providing assurance that we do not intend to reconsider our regulatory approach for a longer period of time, airport operators/airlines may be exposed to lower financing risks and lower costs of capital than would otherwise have been the case.

4.17 A longer price control may also:

- give airport operators a clear financial stake in controlling their costs over a longer time horizon;
- change the way airport operators plan their activities, anticipate customer needs and innovate; and
- reduce administrative and regulatory burdens of the price control regime.

4.18 However, there are potential drawbacks of longer price controls:

- the regulatory regime is likely to be less adaptable, making it difficult to make changes to what airport operators are required to deliver and to improve the regulatory arrangements over time; and

- forecasting over a longer timeframe increases the risks that airport operators either find themselves unable to finance their activities or earn what could be perceived as 'windfall profits'.

4.19 We are open to setting longer price controls or ‘locking in’ some elements of a price control for longer periods through a policy statement, but the assessment of the relative costs and benefits of this will need careful consideration of the applicable circumstances, for instance, the state of the UK economy and financial markets, which are not known at this time. It is, therefore, too early to make a decision on the appropriate duration of any price control (or elements there-in).

Chapter 5

Cost recovery of Category A and B costs

Introduction

5.1 This chapter sets out how we will treat costs in Categories A and B (with more information available at appendix D):

- Category A costs are, in general, the costs incurred by an airport operator or HHL in seeking to influence the Commission, and associated lobbying. These costs will, in general, be incurred before a Government policy decision on capacity expansion is made; and
- Category B costs are capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision and are associated with seeking planning permission.

5.2 These costs have in common the fact that they relate to expenditure that might not crystallize into something tangible. As we are an independent economic regulator with a primary duty to users, we are keen to ensure that users, including passengers, do not bear risks by default in the event that planning approval is not granted (or is rescinded or is withdrawn), as occurred with STAL's second runway project.

Category A costs

5.3 In Category A, recovery of most costs will not be permitted. We do not consider that lobbying costs associated with an airport operator's/HHL's submissions to the Commission and to the broader community should be borne by users.[17]

5.4 However, we do accept that some Category A costs could be viewed as the costs of seeking planning permission. Our policy on these costs is that we will allow them to be re-categorised as a Category B provided that a strong and clear case is made by the airport operator that the information submitted for planning is not materially different to that submitted to the Commission. In other words, costs will be permitted provided changes are of a level we consider minor, for example, updated to reflect latest available macroeconomic or inflation forecasts. These costs will also be subject to a *de minimis* level and an efficiency assessment.

[17] We consider that lobbying costs include but are not limited to the costs involved in developing and implementing advertising campaigns, the cost of any strategy experts employed to assist with their campaign, and the costs associated with engaging (lobbying) the public, Councils, Ministers and Members of Parliament.

5.5 Our proposed approach to treatment of Category A costs aims to ensure that:

- all short-listed proposers are treated equally (including HHL, the only non-airport operator that has a capacity expansion proposal that has been short-listed by the Commission);
- users do not carry costs that have been incurred as part of a political or public relations strategy to convince stakeholders about the merits of a particular proposal, rather than in delivering capacity; and
- users may carry some Commission process costs as these are costs that would otherwise have been incurred for a planning inquiry, and the development of new capacity will be in their interests. Airport operators will, however, have to demonstrate that these costs are efficient and that they pass a *de minimis* level.

Category B costs

5.6 Category B costs are capacity expansion costs that will be, in general, incurred by an airport operator after a Government decision and are associated with seeking planning permission. These costs are likely to be much more substantial than Category A costs.

5.7 Category B costs can be seen as part of the costs of building more capacity. For this reason, users can reasonably be expected to carry some or all of these costs. Category B costs do not include development of proposals to the Commission unless they met the required conditions outlined above for Category A.

5.8 We are keen to maintain strong incentives to keep costs as low as possible. The simplest way to create such incentives is to place a limit on the cost that the airport operator can automatically recover. Provided that this threshold is set materially lower than the amount that an airport operator is expected to incur, the incentive to manage costs effectively will be strong. Our policy therefore:

- sets the fixed allowance for Category B costs at £10m per annum, an amount materially lower than that which we would expect an efficient airport operator to incur; and
- requires that a risk sharing arrangement be established for Category B costs in excess of £10m per annum.

5.9 Some stakeholders have expressed concern that our approach to Category B costs implies that pre-funding as part of a regulatory settlement will be the basis by which any capacity expansion occurs. This is not the case:

- our preferred approach, as outlined in this policy, places a strong emphasis on a market-based solution to capacity expansion; and

- we will only consider pre-funding as part of a regulatory settlement where we consider that a commercial approach to capacity expansion is not possible and where it will be in the interests of users to do so.

GAL's recovery of Category A and B costs

5.10 In the event that the Government supports the development of a second runway at Gatwick, GAL's commitments in its licence permit it to recover the reasonable capital, operating and financing costs of up to £10m incurred in any one charging year for the purposes of applying for planning permission for a second runway and for the subsequent development of the runway and associated airport infrastructure. Recovery of these costs is subject to GAL following any policy guidance issued by us in relation to the recovery of costs.

5.11 Under its licence, if GAL wants to recover costs above £10m a charging year, it must inform us in writing, setting out its reasons and justification in accordance with any guidance issued by us. In addition, recovery of its expenditure will be subject to the process governing modification of licences set out in sections 22 to 30 of the Act.

5.12 Assuming that the appropriate procedures (as outlined above) are followed (and that the Government supports the development of a second runway at Gatwick), this means that reasonable planning costs (Category B costs) can be passed through to airlines. This holds whether or not these costs are smaller or greater than £10m per annum.

5.13 We consider that it would be unreasonable for any of our guidance on cost recovery to prevent recovery. However, for the recovery of sums over £10m per annum, we can, through the licence modification process, introduce further conditions that must be complied with for cost recovery to proceed.

5.14 Assuming that the planning costs of £10m per annum or less are incurred, GAL's licence allows these costs to be automatically passed through to airlines following the completion of the work of the Commission and after the Government has indicated that capacity expansion at Gatwick can proceed.[18] We consider that these costs can start to be passed through in the year following the Government's policy decision on where capacity expansion can occur. The process outlined in GAL's Conditions of Use (2014/15) illustrates how the recovery of these costs can occur.

[18] Government support can take a number of forms and it may be difficult for us to judge how the Government will articulate its response. Potential options include but are not limited to a policy statement/press releases or a National Policy Statement. We will carefully consider the available evidence to determine when we consider a Government decision on new capacity has been made. As part of this process, we would encourage an airline operator to notify us, with supporting evidence, as to when it considers this milestone has been met.

5.15 Where GAL has been unable to secure an arrangement on risk sharing with airlines for capacity expansion costs in excess of £10m per annum we will look to determine the appropriate risk sharing agreement. More broadly, where GAL is unable to secure an agreement with airlines on Category B costs above £10m per annum, we can, as noted above, look to change the £10m per annum threshold through a modification process,

5.16 If GAL wishes to recover Category B costs over £10m in any given year, we will conduct an efficiency review of the proposed costs to ensure that they are reasonable (and can be passed through to airlines).[19] Inefficient costs may not be recovered from users, including passengers.

5.17 We also consider that it is appropriate for GAL and the airlines to develop appropriate risk sharing arrangements for capacity expansion costs in excess of £10m per annum. This means that in the event that planning permission is not given, or is rescinded, there will be a mechanism by which airlines will be able to recover (in whole or in part) the charges that GAL has collected over the £10m per annum permitted. Where a risk-sharing agreement is not reached, we will determine what these risk sharing arrangements should be.

5.18 Any licence modification to enable the recovery of costs greater than £10m per annum will include provisions that reflect the intent of our policy, including that we will have efficiency reviews for sums over £10m in any year.

5.19 Where a risk-sharing arrangement to recover costs in excess of £10m per annum has been established, we will allow those arrangements to remain (provided that they are in the interests of users and otherwise that is the course of action most consistent with our statutory duties).

HAL's recovery of Category A and B costs

5.20 For HAL in Q6, Category B expenditure up to £10m per annum will be allowed to be added to annual charges. The approach (formula) by which this can occur will need to be developed but we may draw on the approach we adopted for GAL in the Q6 settlement.

5.21 Consistent with the approach adopted for GAL, we will allow each year (assuming the Government allows a new runway at Heathrow) the first £10m of Category B costs to be passed through to airlines. However, where these costs exceed £10m in any year of Q6, we will review these costs to ensure that they are efficient.

[19] We currently consider that this review will feed into the licence modification process outlined in section 22 of the Act.

5.22 Subject to such efficiency review, and consistent with the approach taken in respect of GAL, Category B costs over £10m per annum can be recovered subject to risk sharing arrangements being established. This means that, absent any commercial agreement, these sums must be returned (in whole or in part) to airlines if planning permission either is not granted or is rescinded.

5.23 We will make proposals to amend HAL's licence to give effect to these provisions. However, we would welcome risk sharing arrangements and commercial agreements being reached without our involvement. Commercial agreements could, for example, be based on 'pot of money' that the airport operator could spend across a number of years, provided there was airline agreement (an approach not unlike the core and development approach to capex recently adopted at Heathrow). As is made clear earlier in this document, commercial arrangements can result in innovative solutions that can be good for users.

5.24 We consider that our approach to both HAL and GAL fulfils our duties to users. It foresees users bearing the lion's share of the planning costs associated with capacity expansion. However, it should prevent users from having to carry the total planning costs of a project that does not get past planning approval or where any approval is rescinded.

HAL's recovery of costs where HHL is involved

5.25 If the Government determines that a HHL capacity expansion option should be developed, we assume this would be likely to lead to HAL acquiring the intellectual property rights to HHL's concept. We understand that this is at least one primary commercial driver behind HHL.

5.26 In such circumstances, our current thinking is that the approach outlined with respect to HAL (above) should, in general, apply with some modifications to reflect the fact that HHL is not an airport operator.

5.27 We expect that, in this scenario, the bulk of the costs that HHL would have incurred would be Category A costs and in principle we do not consider that users should carry these costs.

5.28 Consistent with what we have outlined earlier, HHL or HAL will only be able to recover the Category A costs if these relate to developing material that subsequently are used without material changes for planning purposes. In addition, HAL or HHL will need to demonstrate a clear and strong case for this expenditure to be considered a Category B cost, including that it exceeds a *de minimis* level and is efficient. We will also expect HAL to demonstrate that:

- it has and will not be looking to recover Category B costs for other work that covers substantially the same ground; and
- it is looking to only recover the lower of either the cost that HHL paid for this material or the cost that it paid HHL for that material. In other words, HAL shareholders will pay for HHL's profit, not users.

5.29 No other costs associated with HAL purchase of HHL's intellectual property will be recoverable through users.

5.30 Any Category B costs that HAL subsequent incurs would be subject to the policy we have outlined for HAL (above).

Chapter 6

Scrutiny of design and costs

Introduction

6.1 This chapter outlines how we intend to scrutinise airport operator capacity expansion design and costs through *ex ante* and *ex post* reviews of the proposal that the Government decides can go forward. Given the scale of the investment required to build new capacity, these reviews will protect users as regards the economy and efficiency of expansion.

6.2 Undertaking *ex ante* and *ex post* reviews will help ensure:

- efficiency in the proposed design;
- only efficient costs are passed through to airlines; and
- the interests of users, including passengers, are protected.

6.3 As we are likely to use information on how airlines and airport operators have engaged with each other, and with other stakeholders, as part of our assessment, we encourage all stakeholders to maintain appropriate records of their consultations with other parties.

Ex ante review(s)

6.4 Building on analysis already undertaken by others, we will undertake a detailed *ex ante* review of the proposed design of any capacity expansion proposal. This will occur after the Government decides where expansion can proceed but before the planning application is lodged with the Planning Inspectorate (or before the hybrid bill process).

6.5 Our proposed timing for the *ex ante* review recognises that we cannot ask for a 'frozen' design. However, we seek to ensure that we will consider broadly the proposal that the airport operator intends to introduce into the planning process.

6.6 We recognise that the Planning Inspectorate may request material changes to the plans that an airport operator may have submitted (and which we will have considered). Where material changes to an airport operator's proposal are required we will undertake an additional review of the efficiency of the revised proposal. However, where we consider that the requested changes are not material, or for any other reason we do not re-open our review, then consideration of these changes will be rolled into any *ex post* review of costs (see below).

Ex post review

6.7 Assuming that a RAB-based approach is in place at the airport where capacity expansion occurs, we will complement any *ex ante* reviews with a detailed review of costs later, before they are added to the RAB.

6.8 This review will focus on how the project has been delivered: for instance, tendering, project management, benchmarking. It will be based on how well the work was undertaken, in the light of information that was available at the time (rather than with the benefit of hindsight).

6.9 The regulated airport operators and airlines will be familiar with this approach as, under our traditional RAB-based approach, the efficiency of a project has been assessed at the end of a regulatory control period before it has been added to a RAB.

6.10 The success, scope and level of commercial discussions an airport operator has had with airlines, including as part of any Constructive Engagement (CE) style processes, will be used by us to inform the scope and magnitude of our reviews.[20] We will also consider the behaviour of participants in any engagement process.

6.11 Successful commercial negotiations could negate the need for us to undertake an *ex post* assessment, or at least greatly diminish the level of *ex post* reviewing that we will be required to undertake.

[20] CE is a process that helps to inform the scope and size of any expansion project through outcomes agreed and the discussions held between airlines and the relevant airport operator.

Chapter 7

Market power

Introduction

7.1 This chapter provides information on our current thinking on market power. In considering these issues we have assumed that the Act remains unchanged. More information on market power is also available in appendix E.

Market power

7.2 Our policy concerning MPAs is that one should not occur until much closer to, or even after, the opening of any new capacity. However, we remain open to considering requests for an MPA should prevailing market conditions alter.

7.3 Practically, there is likely to be a shortage of robust evidence that we would be able to draw in coming to any decision. That is, while new runway capacity may result in airlines and airport operators changing their long-term business strategies and investment plans, there is unlikely to be substantive evidence in the market for many years after the government planning decision.

7.4 These issues combine to increase the likely risk of challenge to the Competition Appeals Tribunal in relation to a forward looking MPA. This would impose costs, delays and uncertainty. It could also potentially add additional risk to the capacity expansion process.

Chapter 8

Next steps

8.1 Our current thinking is that, following the release of this policy, we will publish two deliverables related to commercial negotiations:

- a paper on how we could be involved in commercial negotiations and the parameters of possible commercial agreements. This paper will not outline what we consider the specific scope and nature of an agreement should be. Rather, it will examine the parameters of possible commercial agreements between airport operators and airlines that could underpin new capacity and our potential role in relation to the negotiation and implementation of commercial arrangements. We are aiming to release this paper shortly after the Commission publishes its recommendations; and
- a progress report on commercial negotiations no later than six months after any decision by Government on where expansion can occur.

8.2 We will also have to give further consideration to our potential approach to a range of regulatory issues, including the duration of price controls (or elements there-in), the appropriateness of sculpting depreciation and the treatment of efficiently incurred project over-spend under a RAB-based approach.

8.3 Some licence modifications may also be required and we will look to ensure that these occur in a timely manner.

8.4 In all the above steps, stakeholders' views will be required and we thank them in advance for their continued engagement in these important issues.

APPENDIX A

Risk should be allocated to those who can best manage it

Overview of the CAA's draft policy

A1 The draft policy highlighted that risk should be allocated to those parties who can best manage it. We considered that this was most likely to protect users' interests, by producing the lowest expected out-turn cost and by revealing information about parties' valuation of risk.

Stakeholder views

A2 The majority of respondents supported the principle that risk should be allocated to those who can manage it best. No respondents disagreed with the general principle of allocating risk in this way.

A3 However, some airline responses raised doubts about whether such an allocation would be delivered through commercial agreements, given the presence of SMP at airports and information asymmetries. They also questioned whether commercial negotiations would reveal different parties' true cost of risk.

A4 The AOC questioned whether the party that holds a risk will always have the strongest incentive to manage it effectively. It argued that airlines operating in a competitive environment have the strongest incentive to pursue lower costs, whereas an airport operator's incentives are mainly confined to risks within a particular regulatory period. In the case of investment costs, it also considered that incentives to act efficiently are weakened as we have typically only disallowed small amounts of expenditure (relative to the capital budget) as part of our regulatory processes.

A5 The joint airline response and other airline responses questioned the statement that risks might be passed downstream to users where no other party is better placed to manage them. They argued that this would be inconsistent with our primary duty towards users, and that passengers should only take risk when it is in their best interests to do so. BATA also questioned whether minimising the overall cost of the project is in the best interests of passengers, if it means they are allocated risks and costs that could be borne by other stakeholders.

A6 A number of respondents commented on how particular risks are allocated at present, or how they should be allocated in future. For example:

- the joint airlines argued that political risk should be taken by Government, regulatory risk by us and construction and planning risk by the airport operator; and
- GAL argued that it is best placed to manage the main project risks, within a framework that adequately remunerates it for doing so.

A7 Some respondents also questioned whether specific aspects of the draft policy, for example, our proposed treatment of Category B costs, were consistent with those principles. These issues are considered in appendix D.

CAA response and final policy

A8 Under the Act, our primary duty is to users and we consider that risk should be allocated to those best able to manage it. The Act also outlines a number of other issues which we must have regard to when making our decisions and it is by carefully considering all these duties that we come to our decisions.[21]

A9 We are encouraged that respondents agree that the principle we outlined on risk was reasonable, albeit with some concerns. We consider that the adoption of this principle is most likely to protect users' interests (that is, the interests of passengers and those with a beneficial interest in freight), by producing the lowest expected out-turn costs (as incentives to manage costs are maintained) and, through commercial negotiations, reveal information about parties' valuation of risk.

A10 We agree with the suggestion that passengers should not necessarily bear the risk if ‘no other party is better placed’. There are a number of different players involved with capacity expansion, including passengers, airport operators, airlines, the Government and the regulator, and each has an important role in managing risk. For example, we have a role in managing regulatory risk and an airport operator has a role in managing construction cost, traffic and financing risks. Similarly, Government should play a role in managing political risk, particularly in light of recent attempts at capacity expansion in the South East of England. While there are a number of different forms this could take, we do not consider it appropriate to indicate what form the Government’s risk mitigation strategy should take.

[21] See Section 1(3) of the Act. This section states, for example, that in performing our duties under subsections (1) and (2) we must have regard to (among other issues) that (a) each holder of a licence is able to finance its provision of airport operation services in the area for which the licence is granted; (b) the need to secure that all reasonable demands for airport operation services are met, and (c) the need to promote economy and efficiency.

A11 It is, however, important that when considering such risks, passengers are not allocated risk by default. We therefore encourage all relevant parties to engage in appropriate and timely discussions on risk management strategies, for the benefit of users.

A12 We also recognise that allocating risk can be complex. Therefore, if airlines and airport operators cannot come to an arrangement on risk and we need to come to a decision on allocating risk, we will carefully consider how:

- reducing risk for one stakeholder (or group of stakeholders) can mean increasing it for others; and
- imperfect competition and information asymmetries can limit the scope for airlines to engage with the airport operator to effectively manage risk or may lead it being allocated inefficiently (to a lesser or greater extent).

A13 We also recognise that there are circumstances where risk arrangements and more broadly, commercial arrangements, will not be in the interests of users as they could limit the scope for effective risk management or may lead to it being allocated inefficiently. In such circumstances, we may be required to intervene to set the appropriate regulatory framework to allow information on risk to be revealed, or to intervene more directly. For example, as part of the Q6 settlement for GAL, we recognised that it has SMP and set parameters under which a more commercial approach could be adopted. We considered that an approach characterised by licence-backed commitments was in the best interests of users, as it provided some of the benefits of a commercial arrangement while also providing sufficient protections for users.

A14 When we do allocate risk, our overarching approach will be that we will only pass risks downstream to users where there is a strong justification for doing so. For example, political and regulatory risk is capable of being shaped through adjustments to government and regulatory policy, activities that market players are better able to undertake than ordinary users. That said, where we consider that it would be in users' interests for them to carry risk – for instance, because such an allocation is strictly necessary to get new capacity built – we will look to achieve this.

A15 With respect to the criticism that we do not undertake capex assessments appropriately, which results in airlines carrying more risk than they should, we:

- carefully examine capex proposals as part of the regulatory process and we also place emphasis on CE as part of this. Improvements in the level of engagement by airlines and airport operators in CE should help airlines reduce any perceived risks associated with a project;

- are continuously looking for ways to improve the way we assess capex for the benefit of users, be it through addressing information asymmetries, innovation or other means;
- accept that how we treat efficiently incurred cost over-runs is an important issue, and is considered in more detail in appendix A;
- are subject to challenge by parties, including, for example, in relation to our decision on capex. We note that no stakeholder appealed our recent Q6 settlement decisions; and
- would expect all stakeholders to engage in robust debate in relation to any consultation we issue around the assessment of capex in the future, as this will assist us in reaching the best possible outcome.

A16 We also consider that capacity expansion risk may be better managed by ensuring that an Independent Fund Surveyor (IFS) is used. The IFS is effectively a framework panel of independent experts that are used to provide an ongoing assessment of the reasonableness of all major decisions made on key projects and to give a real-time opinion that capital is being used effectively to deliver the outcomes of the project's business case. An IFS is currently used at Heathrow and we see merit in an IFS being retained and/or adopted if the development of new capacity proceeds at either Heathrow or Gatwick.

A17 We also consider that extending the duration of a price control may help improve an airport operator's management of risk (see chapter 4). Extending the duration of a price control is, therefore, an issue we will be giving further consideration to as it may:

- give airport operators a clear financial stake in controlling their costs over a longer time horizon;
- change the way airport operators plan their activities, anticipate customer needs and innovate; and
- reduce administrative and regulatory burdens of the price control regime.[22]

[22] We do, however, also recognise that there are drawbacks with extending the duration of a price control and these are also explored in chapter 4.

APPENDIX B

Commercial negotiations should be encouraged

Overview of the CAA's draft policy

B1 The draft policy set out the principle that commercial negotiations should be encouraged. We outlined that a commercial agreement could underpin expansion, incentivise efficiency, ensure that risks were borne by those best able to manage them, reveal information about parties' valuation of risk, and avoid the downsides of extensive regulatory intervention.

Stakeholder views

B2 GAL, HAL and HHL all supported the principle that commercial negotiations should be encouraged. However, it was also argued that some of our existing policy proposals (such as not allowing Category A costs to be recovered from users) might limit the scope of negotiations. HAL is keen to see us act as 'a facilitator' of commercial negotiations and noted that this could work in many different ways including some that would give strong incentives for the parties to reach agreement. GAL considered that expansion increases the need for, and the opportunities from, commercial contracts, which it considered could work in a similar way to those under its existing Commitments. HHL argued that innovative solutions to the financing of expansion are more likely to emerge from concerted engagement between airport operator, airlines and investors.

B3 While supporting the principle of commercial negotiations, MAG stressed the need for us to ensure that our approach does not distort or undermine competition between airports.

B4 Airlines were more cautious about the prospects for commercial agreements. Many noted factors, including airport operators' SMP, information asymmetries and the length of contract required, that could make such agreements less likely. Even if agreements were reached, a number of challenges were identified which could mean that they were not in the best interests of passengers. Potential problems identified included, inefficient pricing, excessive profits and unjustified differentials in pricing. easyJet also highlighted that our perceived support for pre-funding might bias and potentially quash any commercial discussions.

B5 Some airline respondents, including the AOC, went further and argued that a regulated solution would be preferable, for reasons including both market power and the greater information that is available to us relative to airlines.

B6 HAL stated that the proposal to review progress on commercial agreements after six months was broadly consistent with its own view. easyJet also supports the proposal to review progress after six months, though it urged us to use the intervening period to carry out a full review of any potential regulatory approach, in case such an approach is ultimately needed. GAL expressed concern that a review after six months could be premature, given its own view of the timing of contract discussions, and argued that we should initially consider the benefits from its proposed R2 Commitments in isolation from contracts.

CAA response and final policy

B7 Our approach to commercial negotiations is dependent, to a large extent, on our views on the allocation of risk and who is best placed to manage it. We continue to consider that a process based on commercial negotiation will, in general, result in better allocation of risk compared to the situation where we determine this. We do not, therefore, necessarily agree that we have particular advantage over commercial parties in obtaining the types of information needed to manage risks.

B8 We therefore expect some or all of the capex required for new runway capacity could be underpinned by commercial arrangements between airport operators and airlines. To the extent that such structures are used, fewer charges will be based on a fixed standard tariff structure.

B9 We do, however, recognise that a negotiation process, solely between the commercial parties, may face some constraints. For example, some types of commercial agreement may not be compatible with the needs of investors given the large upfront commitments needed, and the length of time over which returns will be made. There is, therefore, a financeability test associated with any proposed commercial arrangement.

B10 Secondly, some commercial arrangements may not be compatible with legal requirements, particularly around how capacity at airports is allocated. Despite the new capacity, the airport operator affected is likely to be subject to the requirements of the Slot Regulation. This, for example, constrains the extent to which physical capacity can be bought and sold in advance and may rule out some potentially workable solutions.

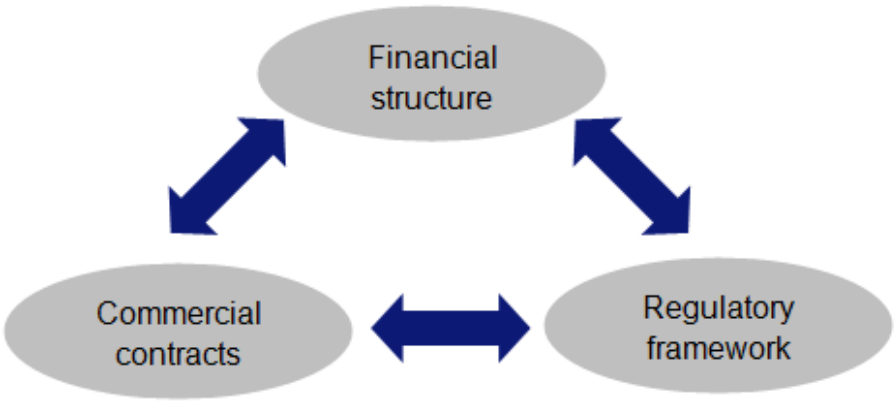
B11 Finally, as noted in the consultation, there are issues relating to the existence of SMP. In developing this policy our working assumption is that SMP will continue, but that there is scope for competitive conditions to change over time. And, as has already been demonstrated at Gatwick, the presence of SMP need not be an obstacle to commercial agreements being made. What we have seen at Gatwick (recognising that its approach will be reviewed in 2016) is the airport operator engaging with its airlines and agreeing bilateral commercial deals on a range of issues, all within a broad regulatory framework that we have set. This outcome

has been possible as under the Act, as we are required to assess the existence of SMP and make a judgement about the extent of any economic regulation that is required in airport licences.

B12 This means, assuming that some SMP remains present at either Heathrow or Gatwick, we are likely to have some intervening role in setting a broad regulatory framework under which commercial negotiations can take place, and where risk is allocated as efficiently as possible, thereby reducing the cost of capital associated with the project. The more that regulatory and political uncertainty can be minimised, the lower will be the cost of the project and, therefore, in general, the better for users.

B13 In addition, investors' decisions to support the project will be underpinned by their expectation of what the airport operator will be allowed to charge its customers and the future cash flows that are available to pay either interest or dividends to service the finance provided. Some financing possibilities will probably need to be directly underpinned by a projection of future revenues and earnings. This may be in the form of a prospectus, a debt rating or some form of commitments entered into by the company.

Figure 1: Key inter-relationships



In summary, as described in Figure 1 (above), there is an inter-relationship between the financial structures, the nature of commercial agreements and the regulatory framework. These need to be consistent for the project to be implemented in an efficient way.

B14 At this stage, it is worth clarifying that we would expect commercial negotiations to be focused on bilateral agreements between the airport operator and airlines which sets the price paid and/or the quality of service for the provision of the airport operation service. Such agreements can occur with or without us setting the broad regulatory framework, but where there is SMP, we will have an

important role, not least in setting the broad regulatory framework and intervening where it is in the interests of users to do so.

B15 Any such agreement will also have a duration over which the agreed conditions will be in place. There is, therefore, expected to be a bespoke element to any agreement. This contrasts with the provision of a service based on standard contract terms and on the basis of a common tariff methodology. For example, under the Q6 settlement, GAL was able to enter into contracts with airlines and offer different terms and conditions that cover different periods of time. That is, GAL was able to agree with airlines terms and conditions that better reflected their individual business needs (relative to the more generic conditions of use which GAL publishes annually).

B16 While the success of our regulatory approach at Gatwick will be informed by a review we will undertake in 2016, the 'Economic regulation at Gatwick from April 2014: Notice granting the licence', highlighted how we considered our approach would further our primary duty to users. Among other factors, this document concluded that:

- while the price in the commitments is higher than our view of a fair price, our monitoring and the threat of additional licence conditions create incentives for GAL to moderate price increases and deliver growth at the airport and further the interests of passengers;
- embedding the commitments within a licence provides a timely and effective backstop protection for users in the form of a licence enforcement regime, for instance if there are reductions in service quality or price increases that are against users' interests;
- licence-backed commitments will provide a better framework to diversify the service offering and to incentivise volume growth. This is because the commitments encourage bilateral contracts which can allow service quality, capital investments, operational practice, volume commitments and price to be better tailored on an integrated basis to the needs of individual airlines and their passengers. RAB-based regulation allows for bilateral contracts only on a limited basis, and cannot provide the same degree of tailoring;
- licence-backed commitments should promote competition by facilitating innovation and diversity of the services offered. These are important, although not sufficient in themselves, for effective competition between airports. Although existing and future capacity limits reduce competition between London airports, it is nevertheless an expansion of choice for at least some users if airports are enabled to diversify their service offerings;

- licence-backed commitments will encourage GAL to improve its efficiency as the airport operator can retain savings during the commitment period. The longer time period of the commitments should provide GAL with greater incentives to reduce operating expenditure and outperform commercial revenue assumptions;
- licence-backed commitments will facilitate efficient investment as GAL will have flexibility to tailor its investment to the needs of airlines, while the licence will provide users with timely and effective backstop protection to ensure that investment is undertaken in users' interests;
- a specific licence condition has been inserted which requires the licence to be amended before the main costs of a second runway can be passed through to users. This will ensure that the development of any second runway is undertaken in a manner that furthers users' interests in the cost and quality of airport operation services (amongst other interests) and promotes competition in airport operation services;
- licence-backed commitments will prospectively ensure that an efficient GAL has adequate financial resources and can finance its provision of airport operation services. We have checked GAL's potential financial ratings and assumed that GAL would not have proposed commitments that it could not finance;
- licence-backed commitments will provide protection on operational resilience, by allowing us to undertake licence enforcement action if there are problems with operational resilience; and
- licence-backed commitments will provide protection on financial resilience through commitments and licence obligations.[23]

B17 We also consider that relative to standard contract terms on the basis of a common tariff methodology, the striking of individual contracts has the scope to reveal more information on different airlines' and the airport operator's risk preferences, how they value risk and how they manage it.

B18 As GAL's various commitments are backed by a licence, we can also ensure that its commitments are honoured and that we can continue to act, where appropriate, to protect users.

[23] CAA, Economic regulation at Gatwick from April 2014: Notice granting the licence, CAP 1152, available at: http://www.caa.co.uk/docs/33/CAP1152LGW.pdf, pp. 7-8.

B19 We recognise that different airlines may wish to make greater or lesser use of commercial arrangements. Some may wish to make a longer term commitment to operate at the airport concerned. This could be because it is a strategic choice for them to do so. A longer term commitment could give the airline lower or more stable charges, or ensure a higher level of service for its customers. Meanwhile others may use particular airports on a more 'opportunistic' basis where they may be experimenting with new routes. In this case, a longer term commitment may be less appropriate, at least initially.

B20 Beyond this, we do not, at this stage, have specific preferences with respect to the structuring of commercial arrangements or the financing of new capacity. However, there are a number of outstanding questions which we aim to explore once the Commission has delivered its recommendations. We will be approaching stakeholders directly to explore these questions (see chapter 8).

APPENDIX C

Capacity can be paid for before and/or after it opens

Overview of the CAA's draft policy

C1 The draft policy set out the principle that capacity can be paid for both before and after it opens. Whether this arises through the natural operation of a market or through regulatory intervention, some measure of pre-funding is likely to be in users' interests.

Stakeholder views

C2 Expansion proponents (HAL, GAL and HHL) strongly supported pre-funding/front loading:

- HAL argued that pre-funding was in passengers' interests, as it would reduce the overall cost of financing the project, smooth airport charges over the development and implementation of the project, and provide the appropriate cash flows to support its cost-effective implementation. Disallowing pre-funding would be more likely than not to cause HAL (and other airport operators) to slow and/or reduce investment programs;
- GAL highlighted a number of benefits of pre-funding, including reduced funding risk, smooth pricing, improved pricing signals (which help to reduce traffic risk) and the importance of early cost recovery for the business case; and
- HHL strongly supported our view that capacity could be paid for both before and after it opens.

C3 MAG was not opposed to pre-funding, provided it was consistent with the typical operation of a well functioning market. It suggested that we consider the extent to which airport operators with little or no market power could secure access to pre-funding and use this as a benchmark.

C4 The remaining submissions (airlines and airline industry bodies) opposed pre-funding. Many argued that users should only pay for additional capacity when it comes into operation. The reasons for this included:

- the risk of passengers being asked to pay for infrastructure they may never use;
- the likely benefit to existing passengers from deferring payments;

- the impact on competition, as airlines operating at Gatwick and Heathrow today may not be operating there when new capacity becomes operable, and new entrants will benefit from the new capacity without any of the costs of pre-funding;
- ensuring that the airport operator has incentives to start delivering benefits early; and
- the lack of empirical or other clear evidence of benefits to passengers from pre-funding.

C5 There was a similar difference of opinions about whether pre-funding is consistent with the working of a competitive market:

- HAL and GAL agreed that pre-funding is a feature of competitive markets, also arguing that charges would be related more to the balance between supply and demand over time than the opening of new capacity, and that price rises can be a signal for increasing output and investment; and
- airline respondents argued that the pre-funding does not occur in competitive markets, that users only pay for new capacity once it is in place, and that price rises due to scarcity do not give rise to pre-funding. Respondents highlighted the lack of empirical evidence, and easyJet gave several examples of agreements which it states do not include pre-funding.

CAA response and final policy

Approach and assumptions

C6 HAL and GAL both have SMP.[24] Finding SMP was fundamental to developing the form of regulation we applied in the Q6 settlement and in developing our regulatory policy for capacity expansion. Indeed, our working assumption for this policy is that both HAL and GAL will continue to have SMP.

C7 As an independent economic regulator, we are bound by the Act and our primary duty is to ensure that users' best interests are looked after. Ensuring the lowest possible price is an important, but not always sufficient, way to meet this duty, as there are a number of different factors that users will be interested in. For example, when making a decision we consider a range of issues, including price, quality, efficiency, competition and finaceability.

[24] Information on our market power assessments is available at: http://www.caa.co.uk/default.aspx?catid=78&pagetype=90&pageid=12275.

C8 By carefully balancing the different duties outlined in the Act, and drawing on the relevant evidence, we come to our conclusions on what is in the best interests of users. Importantly, our decisions are appealable, and if stakeholders consider that we have not appropriately carried out our duties, there are mechanisms by which our decisions can be challenged.

C9 As noted earlier, pre-funding may be in the interests' of users. However, we remain cautious of it and will only consider adopting it if we are satisfied that it will be in users' interests. If pre-funding is used, we will look to ensure that the means of achieving pre-funding does not reduce the expected benefits (e.g. by weakening incentives for cost minimisation), and that the benefits are sufficiently large to outweigh potential concerns about inter-generational affects.[25]

C10 Pre-funding can be a benefit to users by reducing risk and therefore the cost of financing a project:

- pre-funding can reduce the risk of project failure by increasing revenues during the time when upfront design and construction costs are being incurred. This reduction should, in turn, flow through to users in the form of lower charges and/or better quality services; and
- pre-funding can reduce a project's exposure to demand and other risks later in the life of the project by bringing forward the point where investment is paid-back. Again, this can reduce the price-of-risk that users may have to pay.

C11 Demand risk may also be further reduced to the extent that some costs are recovered through higher airport charges at a time when demand is relatively inelastic (because of capacity constraints). In contrast, if a higher proportion of costs are recovered through a large increase in airport charges once the runway comes into operation, demand risk may be increased as the responses to such increases first by airlines (e.g. changes to frequencies and fares) and then by passengers may be difficult to predict.

C12 Some respondents have argued against pre-funding on the basis that it is not necessary to ensure that expansion is financeable. We agree with this view. Our support for the potential use of pre-funding is based on its potential to reduce the cost of finance rather than a concern that finance would not be forthcoming.

[25] In considering this issue we will need to take into account both the overall cost of a project as well its phasing. As highlighted by stakeholders, any assessment will be specific to the specific proposal and this is one of the reasons that we remain cautious on this issue.

Price smoothing

C13 Our draft policy highlighted that pre-funding could help smooth increases in charges that users may ultimately face. That is, rather than having a significant step change in charges at the point when new capacity becomes operational, pre-funding can spread the costs to users over a longer time period, which results in a smaller step change.

C14 Minimising the size of any uplift in airport charges in any given year means fewer passengers are likely to be priced off (to the extent that any are priced off by the cost of airport capacity), and also should provide more certainty to users.

C15 We recognise that a smoother profile of charges can be achieved through either or both of pre-funding and sculpting of regulatory depreciation. However, whereas pre-funding may reduce different types of risk and allow the project to be financed at a lower cost, sculpting depreciation would delay the recovery of capital costs and potentially increase financing costs. As noted in the draft policy, further consideration of the potential benefit to users from sculpting depreciation is an issue we intend to give further consideration.

C16 Because of the potential advantages from a lower cost of finance and a smoother profile of charges we therefore consider that Principle 3 – that capacity can be paid for both before and/or after it opens – remains appropriate. This does not mean that pre-funding will be implemented; rather we remain open to it. As is evidenced through-out this document, we are hopeful that successful commercial agreements will underpin capacity expansion rather than a regulatory-led approach.

Commercial negotiations

C17 Whether or not pre-funding arises, our aim is that a commercial approach, rather than a regulatory approach, will underpin capacity expansion. We consider that such an arrangement will better reflect different parties' views on capacity expansion, including their views on risk.

C18 Some stakeholders have highlighted that it may be possible for a commercial arrangement on capacity expansion to be reached which results in lower, long-term prices (and therefore without any significant increase in prices). We agree that such commercial arrangements do exist and that, within the context of aviation, for example, long-term contracts, potentially with obligations for airlines to bring increased passengers through the airport, could be the basis of such arrangements. We have also received some information from easyJet on how capacity expansion can occur at unregulated airports without pre-funding. It noted, for example, that London Luton airport is planning a significant expansion, almost doubling capacity to at least 18m passengers. This expansion will involve a very significant increase in the value of the airport's fixed assets. easyJet reached a long term agreement with Luton in 2014, replacing an older contract.

This agreement spans the period of Luton's expansion. Under the new contract, easyJet's charges are lower (if it reaches agreed passenger volume targets) than those of the earlier contract, which did not anticipate any airport expansion. There is no increase to pre-fund the investment.

C19 [✂]

C20 We recognise the potential benefits that commercial arrangements can bring and that is why we consider that facilitating such arrangements should be encouraged. However, as discussed earlier, the size of the proposed capacity expansion program at Heathrow or Gatwick is quite significant, and this may pose some challenges to what may be possible.

C21 Further information on commercial approaches is outlined in appendix B.

Consistency with the working of a competitive market

C22 Our draft policy highlighted that pre-funding appears consistent with the working of a competitive market, and that this seemed a reasonable basis against which to design regulation. As highlighted above, this justification for pre-funding attracted a number of comments, especially in those submissions that opposed pre-funding. Overall, these submissions illustrate the difficulty of applying theoretical tests, especially in cases where there are different views about what a hypothetical competitive market might look like.

C23 Mimicking the outcome of an equivalent competitive market is often a useful point of reference for regulators, as the outcomes from this often feature desirable properties (such as efficient price-cost margins). However, replicating competitive outcomes is not a regulatory objective in its own right. As a consequence, and in light of the differing views expressed in consultation responses, our policy now places more weight on the potential benefits to users from reduced risk and smoother prices from the application of pre-funding.

C24 We continue to consider that pre-funding, in a capacity constrained environment, can result in a pattern of prices that is closer to that which may occur in a competitive market. This is based on the following considerations:

- we agree that individual investment decisions will be based on the expected revenues and costs that flow from the investment, rather than the level of prices that happens to apply when the investment decision is made. However, it would not be unusual for optimism about future prospects to coincide with times when current prices are relatively high. Conversely, unless they had strong reasons to expect a significant improvement in circumstances, firms might be more reluctant to undertake lumpy investment projects at a time when prices were relatively low;

- the pre-funding that occurs in competitive markets might well be implicit rather than explicit, particularly where there are capacity constraints in the market. The prices paid by customers would be determined by current market conditions, rather than built up from different types of operating and capital cost in a way that would allow users to identify specific elements associated with particular investment projects (and therefore the ways that investment costs are recovered); and
- as a general observation, we would expect the time profile of prices in a competitive market (even one with lumpy investment) to be smoother than the profile of charges that results from a strict application of RAB-based economic regulation with no advancement or postponement of revenues. RAB-based charges would be unusually high as soon as a new large investment project is added to the RAB, and unusually low prior to this point. To the extent that pre-funding (or other policies, such as sculpting depreciation) lead to a smoother profile of charges, this might seem closer to the outcome of a competitive market than the more volatile charges that can result when RAB-based economic regulation is applied to lumpy investment projects.

C25 However, as stated above, we recognise that pre-funding and the associated price path is just one possible outcome from a competitive market. Therefore, in coming to our final policy position on pre-funding, we have attached more weight to the benefits to users from reduced risk and a smoother profile of prices.

APPENDIX D

Treatment and categorisation of costs

Overview of the CAA's draft policy

D1 The draft policy identified three categories of costs:

- Category A: those incurred by regulated airports in support of the Commission, or subsequently, but before a Government policy decision;
- Category B: those incurred after a Government decision, and associated with seeking planning permission; and
- Category C: those incurred in connection with implementation and construction, up to entry-into-operation, and which are typically incurred after planning permission is granted.

D2 Our draft policy outlined that no recovery would be permitted for Category A costs. We considered that Category B costs were part of the costs of constructing new capacity and should reasonably be borne by users. However, to avoid users bearing all of the risk associated with these costs in the event that planning approval was not granted or was rescinded, we put conditions on the expenditure. We granted a fixed allowance of £10m per annum, with costs over £10m per annum subject to efficiency scrutiny by us and to risk sharing agreements being in place. Provided Category C costs were efficiently incurred, we were, in general, open to allowing them to be recouped from users.

Stakeholder views

Category A costs

D3 A number of stakeholders (BATA, MAG, the joint airlines, AOC and VAA) agreed with our draft proposal that Category A costs should not be passed through to users as part of a regulatory settlement.

D4 In contrast, expansion proponents (HAL, HHL and GAL) considered that Category A costs should be recoverable through a regulatory settlement. In general, these costs were considered to be part of a process that was requested by Government, through the Commission, and were, in effect, part of the planning process. It was also argued that some of the activities carried out during this stage would reduce the subsequent costs of obtaining planning permission, expedite the process and would therefore be in the interests of users.

D5 Both HAL and HHL disagreed with our proposal that the costs associated with HAL purchasing the intellectual property from HHL in order to pursue the Extended Northern Runway scheme should not be recoverable through the regulatory settlement. HAL argued that all efficiently incurred costs associated with developing capacity in accordance with the Commission's preference ought to be recoverable. HHL disagreed with our view that HAL should have taken steps to avoid the need for such a purchase, arguing that no company can be expected to have a 100% monopoly on ideas regarding its business, and that users will benefit from the rivalry between the two schemes.

Category B costs

D6 Airline responses, including the joint airlines, the AOC, BATA and VAA, disagreed with the proposed treatment of Category B costs, as it potentially exposed airlines to risks associated with the planning process or a change of government policy.

D7 The joint airlines response accepted the case for efficient planning costs being passed on, but argued this should only happen once a runway is in use. They also considered that planning risks should be covered by airport operators and the Government, rather than users. As planning costs are a fraction of the overall costs, they also indicated that it was not clear why these costs could not be treated in the same way as Category C costs. The AOC argued that we should require the airport operator to engage constructively with the airlines in the development of a planning application, including discussion of the costs incurred by the airport operator, the efficiency of these costs and what should or should not be passed on to users.

D8 HAL argued that our proposals imply a limited risk to airlines for Category B costs in the event that planning approval is not granted, rescinded or withdrawn. It considered that this placed unfair risk on the airport operator and also misunderstood the potential scale of costs associated with planning.

D9 HAL also questioned the £10m per annum threshold on costs that are automatically recoverable, stating that this figure appears arbitrary (a concern that was also shared by some airline respondents), it is too low (as it is likely to cover only a small proportion of planning costs). HAL considered that the draft policy was unclear as to whether costs over £10m were 'at risk', and to what level, both in the case where commercial agreements are reached and where a more interventionist approach is applied.

D10 HAL and GAL both raised concerns that they might incur costs related to the planning process before a Government decision, and that such (efficient) costs should be recoverable. While the type of costs they considered should be recoverable varied, they included Commission, blight and planning costs.

Category C costs

D11 There was general support from a number of a respondents for the broad principles proposed for the treatment of Category C costs as part of a regulatory settlement. Many respondents supported the proposal to carry out both *ex ante* and *ex post* assessments.

D12 Some specific concerns were, however, raised around how we would scrutinise costs and how we should treat costs which changed over time. For example:

- HAL noted that *ex ante* cost estimates tend to understate costs and it was inevitable that cost estimates would need to be revisited. It argued that, to preserve investment incentives: (1) any adjustments should not be applied retrospectively; and (2) any efficient over-runs should be added to the RAB.
- BATA, the AOC and the joint airlines all commented on the criteria for assessing efficiency and stressed the importance of incentives for airport operators to specify and cost projects correctly. The AOC considered that, for efficiently incurred but unanticipated capex to be added to the RAB, HAL must demonstrate that the need for, and costs of, the investment had been discussed and agreed with airlines. The joint airlines suggested that we should consider Ofgem's three pot approach:
  - capex that is inefficiently spent or not required - not allowed in the RAB;
  - capex that is required and efficiently spent - allowed in the RAB; and
  - capex that is efficient overspend (e.g. efficiently incurred but due to things like project misspecification) - not allowed in the RAB for 5 years and depreciated as normal. After 5 years, the depreciated asset value is added to the RAB.

D13 The joint airlines also agreed that an *ex post* assessment is an essential element of providing effective incentives. They noted that the current process considers whether airlines were consulted, but not their responses to the consultation, whether the capex was initially mis-scoped or whether it delivers airline and passenger requirements. They argued that there needs to be a clear process for the criteria determining efficient investment and the timing of when any scrutiny will occur. They also considered that the introduction of an Independent Fund Surveyor (such as introduced in HAL for Q6) may be useful.

CAA response and final policy

Category A costs

D14 Having considered stakeholders' responses to our proposed treatment of Category A costs we have decided that our draft policy should be amended, albeit that it remains similar in substance. Our policy is now that the recovery of *most* Category A costs will not be permitted as part of a regulatory settlement. We do not consider that lobbying costs to influence Government policy or other stakeholders are part of the costs of constructing new capacity, nor as part of the planning process. We consider that these costs should be borne by the relevant proposer (airport operator or HHL). However, we do accept that some Category A costs could be viewed as the costs of seeking planning permission. Our policy for these costs is that we will allow them to be re-categorised as Category B provided that a strong and clear case is made by the airport operator that the information submitted for planning is not materially different to that submitted to the Commission. In other words, costs will be permitted provided changes are of a level we consider minor, for example, updated to reflect latest available macroeconomic or inflation forecasts. These costs will also be subject to a *de minimis* level and an efficiency assessment.

D15 With respect to the scenario where HAL has to purchase HHL's intellectual property, which is likely to include Category A costs, not permitting the cost of HHL commissioned work which was submitted to the Commission would be inconsistent with our policy for those costs directly incurred by HAL or GAL. Assuming that HAL acquires HHL's intellectual property, which includes the purchase of material that can be used, with minor adjustment, for planning process, we consider that it should be able to recover these costs from users.

D16 However, consistent with what we have outlined earlier, recognising that HHL is not an airport operator, HHL or HAL will need to demonstrate a clear and strong case for this expenditure, including that it exceeds a *de minimis* level and is efficient. We will also expect HAL to demonstrate that:

- it has and will not be looking to recover Category B costs for other work that covers substantially the same ground; and
- it is looking to only recover the lower of either the cost that HHL paid for this material or the cost that it paid HHL for that material. In other words, HAL shareholders will pay for HHL's profit not users.

D17 No other costs associated with HAL purchase of HHL's intellectual property will be recoverable through users.

D18 We also remain unconvinced that it was reasonable for HAL not to have looked to protect its business assets by protecting an idea that was related to its core business. When considering capacity expansion, HAL would have had to look at

the now named HHL option, and would have had to have made an assessment as to the risk of not progressing with that option. One such risk that it should have considered is the possibility of this option being taken forward. In the absence of an appropriately dated risk assessment, appropriately verified by an independent entity, we consider that this risk is something that HAL has implicitly accepted and it is only on reflection that it has determined that it wants to be insulated from the normal commercial risk of another business finding a hole in a company's plan and exploiting it. We do not consider that it is appropriate for users to pay for this.

D19 We also consider that in the event that HAL has to purchase HHL's intellectual property to proceed, not allowing HAL to recover the full cost of HHL's intellectual property will place a strong incentive for it to take a strong stance in its negotiations.

Category B costs

D20 We continue to consider, assuming the Government agrees that capacity expansion should occur, that it would not be appropriate to disallow efficiently incurred Category B costs or for them not to be capitalised (for the proposer of the winning design) if there were appropriate risk sharing arrangements in place for costs above £10m per annum. We see Category B costs as part of the costs of constructing new capacity and that these are costs which users can reasonably be expected to carry. This broad approach is consistent with how we have treated costs that we would have identified as Category B costs in the past.

D21 To avoid users bearing the whole risk of these costs, in the event that planning approval is not granted, is rescinded or is withdrawn, as occurred with STAL's second runway project, our approach will also continue to be:

- costs up to £10m per annum will be automatically recoverable by an airport operator; and
- costs over £10m per annum will be subject to an efficiency review. These costs may be recovered by an airport operator, subject to them being efficient and there being risk sharing arrangements in place that mean such charges (in whole or in part) are returned to airlines in the event that planning permission is not granted or is rescinded.

D22 We consider that this approach, together with any approach the Government may wish to establish to help manage Government risk (notably the risk that it may, after allowing capacity expansion to proceed in the South East of England, change its view), would be in the interests of users.

D23 A number of stakeholders expressed concern with the £10m per annum threshold that we have proposed, particularly that it appears arbitrary and that it

did not reflect the level of costs that may actually be incurred by an airport operator.

D24 We have deliberately set the £10m per annum threshold at a level that is likely to cover only a proportion of all potential Category B costs. We consider that allowing a small but guaranteed amount of these costs to be recouped is appropriate. The £10m per annum threshold we are proposing:

- is intentionally lower than the amount we expect will be incurred by an airport operator, thereby creating a strong incentive for the airport operator to manage its costs effectively. Provided that the threshold set is below the amount that an airport operator is expected to incur (by any material amount) the incentive to manage costs effectively will remain;
- can be amended provided airport operators and airlines can agree. The £10m per annum can therefore be considered the lowest threshold possible, with the relevant parties able to establish other (higher) thresholds through risk sharing negotiations, which we consider should be encouraged. Only where we consider that an agreed position is not in the interests of users would we look to intervene in any such agreements;
- has not been demonstrated to be inappropriate, and that another threshold would be in users' interests, including through evidence submitted in responses to the draft policy; and
- is consistent with the level of costs that GAL's Q6 settlement allows to be recovered from users should a Government decision allow it to build a new runway. While this is not the determining factor, given the nature of the costs under consideration (Category B), and given the nature of the costs allowed to recover by GAL under its licence, setting a level of costs that is materially lower than that which we expect, and which is broadly consistent with other amounts outlined in GAL's licence, appears to be not an unreasonable approach.[26]

D25 This mechanism is, of course, just one approach through which we can look to manage risk.[27] This approach, together with other approaches potentially being developed by stakeholders, should help ensure that risk is appropriately managed, and those who are best able to manage it do so.

D26 On some of the other Category B costs concerns that stakeholders have raised, we note that:

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[26] We also note that GAL's licence, including the £10m per annum threshold, was consulted on as part of the (lengthy) process associated with setting its licence.

[27] An alternative or complementary approach that could be used to facilitate the development of a new runway would be for licences to be amended to facilitate capacity expansion.

- issues associated with costs not being passed through to users as there was 'no one better placed' are explored in appendix A;
- airport operators are free to incur capacity expansion costs before a Government decision but this is at their own risk; and
- if either HAL and/or GAL consider that their current licences are not sufficient to deal with the recovery of capacity expansion costs before a Government decision is made, and consider that a licence modification is required, we request that any evidence which would demonstrate that their proposed modification would be in the interests of users be brought forward.

Category C costs

D27 In general, stakeholders agreed with our proposed approach to Category C costs and we are not therefore proposing to fundamentally alter the approach we outlined in the draft policy. Efficiently incurred costs will be added to the RAB (assuming that a RAB-based approach is in use).

D28 However, a number of concerns were raised about the assumption that cost over-runs, even if efficiently incurred, would be automatically added to a RAB (if this was being used). While this approach is consistent with the approach we have used previously, we consider that there is some merit in examining whether a greater incentive should be placed on airport operators to ensure that their forecasts for projects are accurate and that they have an incentive to deliver projects within the costs that they have outlined. This is a particular concern given the potential cost of capacity expansion at either Heathrow or Gatwick.

D29 We therefore consider (consistent with our discussion in appendix A), that there is merit in ensuring an IFS is used to provide ongoing assessment of the reasonableness of all major decisions made on a capacity expansion project. This will give a real-time opinion that capital is being used effectively. While an IFS is currently in use at Heathrow, we see merit in an IFS potentially being retained and/or adopted irrespective of where new capacity is developed.

D30 On how Category C costs will be treated under RAB-based regulation, we do not intend to fully elaborate our potential approach to regulation at this time. We will, however, be considering these issues going forward (see chapter 8) and will elaborate when we consider it will be in users' interests. In the mean time, we will continue to place emphasis on providing sufficient space for commercial negotiations.

APPENDIX E

Other policy issues

Market power

E1 Our draft policy indicated that a MPA should not, in practice, be undertaken until much closer to, or even after, the opening of any new capacity. We were unconvinced that an earlier MPA would provide greater regulatory certainty.

E2 A number of stakeholders agreed with this position, including the joint airlines and BATA. Other stakeholders also broadly agreed albeit with some caveats:

- GAL agreed that the timing of the next MPA should be closer to the opening of new capacity. However, it also saw merit in potentially conducting an assessment before the new capacity is opened. It, did, however, note that this would depend on there being a material change in circumstances (which may not be limited to the opening of new capacity).
- MAG considered that, while an early MPA may not be appropriate, some guidance on the potential impact of expansion could be beneficial, not least for financing arrangements. It also considered that greater emphasis on competition should be reflected in the policy statement and in the CAA's engagement with other stakeholders.

E3 HAL indicated that we should not prejudge the situation with respect to market power and that we should not fetter our discretion to act in accordance with the statutory regime in due course if necessary.

E4 The AOC indicated that it will be important for us (and stakeholders) to determine when it would be most appropriate to undertake an MPA.

E5 Having carefully considered stakeholder responses we continue to consider that an MPA should not occur until much closer to, or even after, the opening of any new capacity. We are unconvinced that an earlier MPA would provide greater regulatory certainty. However, we remain open to considering requests for an MPA, particularly if prevailing market conditions alter.

E6 While an early, forward looking MPA suffers from a number of limitations, we agree that releasing relevant information in a timely manner, be it on market power or other area falling within our remit, provided it is in the interests of users, has benefits. We will, therefore, look to ensure that appropriate information is released in a timely manner.

Facilitation and CE

E7 HAL expressed a view that it is keen to see the CAA act as a 'facilitator' in relation to commercial negotiations with airlines. It noted that we need to set the 'rules of the game' for the negotiation so that each party understands its respective role, and understands how *ex ante* and *ex post* regulation will apply under the various possible outcomes for the negotiation, to ensure that efficiently incurred costs of expansion can be recovered either via commercial arrangement or via the regulatory framework in due course.

E8 However, HAL also noted that it did not consider its consultation response was the correct place for these ideas to be developed and that it would welcome the opportunity to discuss options – beyond the existing CE scheme – with us on how these negotiations might be constructed.

E9 On our potential role, including with respect to facilitation, as outlined in chapter 8, we intend to release:

- a paper that will examine the parameters of possible commercial agreements between airports and airlines that could underpin new capacity and our potential role in relation to the negotiation and implementation of commercial arrangements; and
- a progress report on commercial negotiations no later than six months after any decision by Government on where expansion can occur.

E10 On CE, as outlined in appendix A, improvements in this process could help ensure that the protection of passengers' interests is improved. We are currently considering previous CE processes and expect to engage with stakeholders on how CE could work soon.

APPENDIX F

Abbreviations

Abbreviations	
AOC	Heathrow Airline Operators Committee
ACR	Airport Charges Regulations
BATA	British Air Transport Association
capex	capital expenditure
CE	Constructive Engagement
CMA	Competition and Markets Authority
GAL	Gatwick Airport Limited
GACC	Gatwick Airport Consultative Committee
HAL	Heathrow Airport Limited
HHL	Heathrow Hub Limited
IACA	International Air Carrier Association
IATA	International Air Transport Association
IFS	Independent Fund Surveyor
MAG	Manchester Airport Group
MPA	market power assessment
opex	operational expenditure
Q6	the current (sixth) control period
Q7	the control period that may follow Q6
RAB	Regulatory Asset Base
SMP	substantial market power
STAL	Stansted Airport Limited
the Act	Civil Aviation Act 2012
the Commission	the Airports Commission
the Slot Regulation	the European Union airport slot regulation
WACC	weighted average cost of capital
VAA	Virgin Atlantic Airways