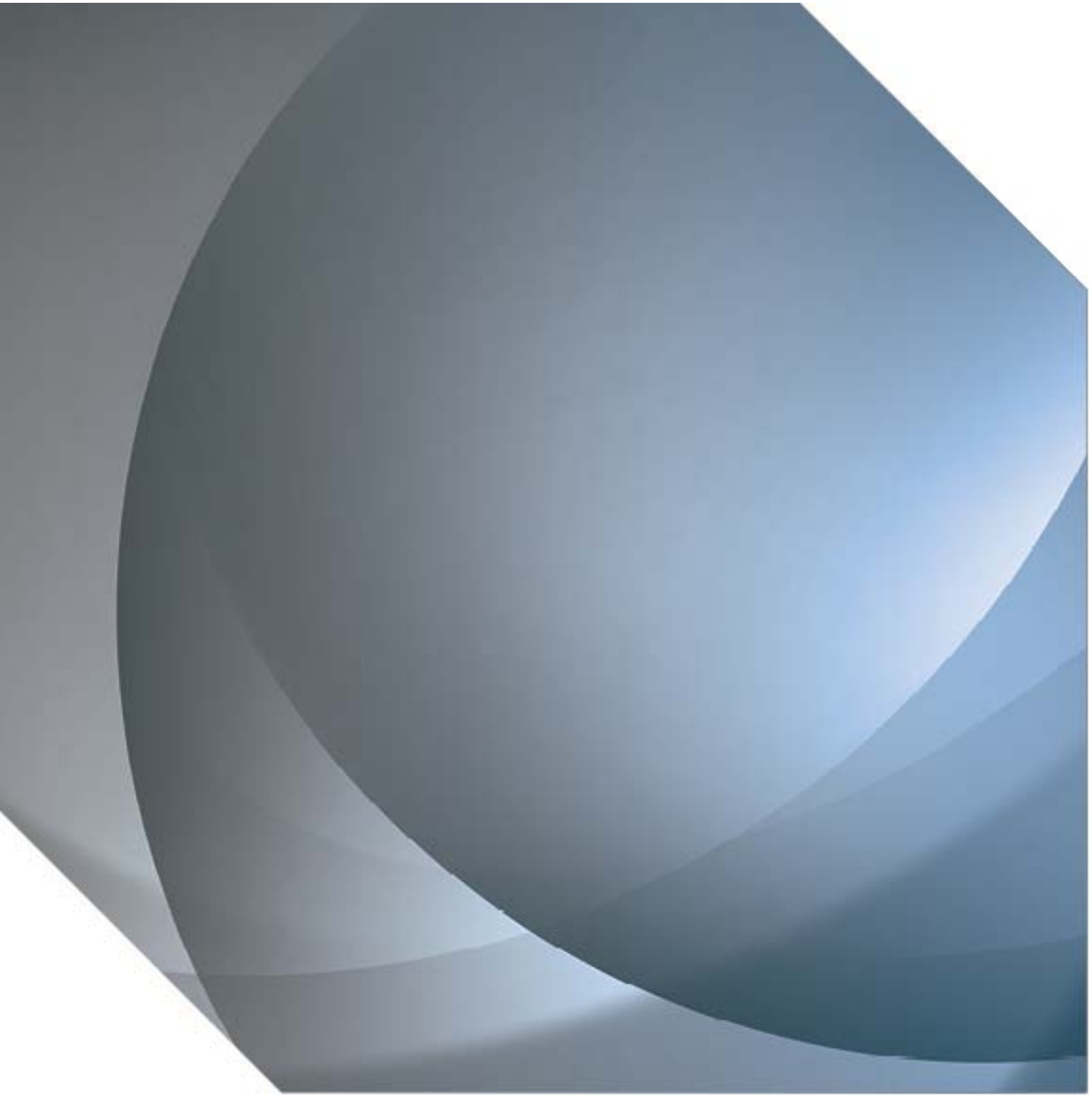
Economic regulation of new runway capacity – Update

CAP 1332



Published by the Civil Aviation Authority, 2015

September 2015

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

Introduction

Our regulatory policy on capacity expansion at Heathrow or Gatwick was outlined in March 2015[1]. We are now planning our possible next steps under a scenario of an imminent Government decision that capacity is needed and a preferred option is identified. Our current plans are to publish one or more consultation documents in the coming months to build and expand on the regulatory principles outlined in March. This will help ensure that the regulatory regime is clear and robust and will support the timely delivery of any new capacity.

The objective of our consultation(s) will be to provide more specific details on how we may, if required, regulate new capacity. We currently envisage the consultation(s) will focus on issues such as:

- the treatment of planning costs;
- the long-term nature of capacity expansion;
- adjusting the successful airport operator's weighted average cost of capital (WACC) to reflect any increase in its risk as a result of undertaking capacity expansion;
- the treatment of surface access costs;
- promoting delivery;
- compensation to third parties, for example, in relation to noise, blight or other compensation paid to local communities; and
- the extent to which costs can be dealt with by commercial agreement between the airport operator and its airline customers.

Where it appears that there is a need to develop specific elements of our policy (such as in relation to the treatment of planning costs) more urgently than others, we will seek to bring forward consultation on those issues earlier than others.

We have outlined below our current thinking with respect to each of these issues and an indication of how this thinking may develop, followed by an overview of a potential consultation process. The consultation process will be rigorous and aim to obtain views from a wide range of stakeholders on the issues we need to consider.

Developing our policy and approach will also require an assessment of the relative costs and benefits for each issue and careful consideration of all the relevant factors and circumstances. These are likely to include, for example, the prevailing state of the UK economy and financial markets (which are not, and cannot be, known at this time), as well as our duties under the Civil Aviation Act 2012 (the 2012 Act).

1 Civil Aviation Authority, Economic regulation of new runway capacity, CAP 1279, March 2015, available at: http://www.caa.co.uk/docs/33/CAP1279%20Economicregulationofnewrunwaycapacitynon_confidential.pdf

1. Treatment of planning (or Category B) costs

Our current policy view on planning costs is set out in our March 2015 policy document. This is that airport operators and their airline customers should, in the first instance, look to agree risk-sharing agreements for planning costs dealing with the associated risks. These may include, for example, the risk that planning costs are larger than expected (and more than £10 million per annum) and the risk that planning permission is not granted and these costs have to be written off.

We see planning as a cost which users can reasonably be expected to carry in full or in part. The £10 million per annum threshold that we have set is intentionally lower than the amount we expect to be incurred by an airport operator. We consider that this arrangement will create a strong incentive for an airport operator to reach an agreement with its airlines on risk sharing.

To avoid a repeat of situations that have occurred in the past, where users have had to bear the planning costs of a project that did not proceed, we consider that risk sharing arrangements for these costs should be agreed between the airport operator and its airline customers.

We will, therefore, look to an airport operator and its airline customers to agree to risk sharing arrangements where costs are expected to exceed £10 million per annum. However, where the airport operator and its airline customers cannot agree to risk sharing arrangements, we will consider how to set these arrangements. In doing this, we would be guided by principles such as:

- the party best placed to manage each risk should manage the associated costs;
- a sufficient level of risk needs to be allocated to each party to ensure engagement in, and ongoing support for, the project; and
- risk-sharing arrangements should be as comprehensive as possible.

We recognise that the promoters of runway expansion projects have indicated that the treatment of planning costs is a specific policy area where they would like to see our policy develop more fully within a relatively short timescale. At present, we are considering possible options for a specific consultation process on planning costs and envisage our regulatory decision becoming effective within 7 to 8 months after the Government decision:

- Shortly after the Government decision, we intend to publish a short note on the process and timetable for any agreements to be entered into between the successful airport operator and its airline customers;
- We would then conduct a 3 month process of encouraging discussions between the airport operator and airlines on risk sharing arrangements;
- If no (or limited) progress has been made on risk sharing arrangements, we will request information and updates from the airport operator and airlines. This will take place towards the end of Month 3 of the process;

- We would then publish a 6 to 12 week consultation on our proposed treatment of planning costs, including with respect to risk sharing arrangements. This would commence around Month 4 of the process; and
- Following the consultation, and having assessed the evidence provided to us in response, we will publish our decision on planning costs and make a licence modification as appropriate.

Should a Government decision be made in December 2015, we envisage that this process would start in earnest in January 2016 and we may be in a position to publish our decision by late summer 2016. Any decision made could be back dated to allow for recovery of any planning costs already incurred.

2. Reflecting the long-term nature of any capacity expansion project

Given the long period over which we anticipate that any new capacity will be constructed, operated and financed, we anticipate that our consultations would be likely to consider whether to:

- set longer price controls or accept longer term pricing commitments; and/or
- 'lock in' some elements over several price control periods or set a mechanism for determining any restrictions or commitments on the prices which the relevant airport operator may charge for longer periods.

In doing so, we would need to consider carefully the implications of any such proposals, which are likely to be complex, to ensure that they do, in fact, reduce developer risk and that users do receive a fair share of the benefit of that reduction in risk.

There are different mechanisms by which this could be achieved, including through the use of a policy statement or, possibly, through amendments to a licence. We would, therefore, look to examples in other sectors where similar issues have been considered to determine:

- whether they provide any useful pointers as to how such approaches may work; and
- what protections for users may be built into these mechanisms, to take into account the changing circumstances during the different phases of a project (such as planning/development, construction and operational phases).

In addition, we will consider any proposals to phase the construction and delivery of new capacity at the relevant airport. Our present view is that it is likely that each phase will need to be assessed separately for the purposes of the economic regulation of the additional capacity that it brings. This is because the delivery of later phases of additional capacity expansion are likely to be subject to final design, construction and financing at a point in time that is too far into the future for us to be able to assess all the relevant factors and circumstances applicable to those later phases at the same time we are assessing the first phase of capacity expansion.

One of the benefits of stability in economic regulation policy and the underlying form of regulation 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 costs of capital than would otherwise have been the case.

3. Risk premiums and the cost of capital

When setting the weighted average cost of capital (WACC) for an airport operator that is building new capacity, we are willing to consider different approaches that may, potentially, include:

- separate treatment of the costs of the increased capacity;
- fixing elements of the WACC for longer durations, while leaving other elements to change with market conditions;
- the role of prefunding; and
- developing mechanisms to provide confidence on how elements of the Regulatory Asset Base (RAB) would be treated in future.

We will consider these approaches, provided it is clearly demonstrated that:

- developing a new runway and associated infrastructure would involve managing more risk than 'business as usual' at the relevant airport operator; and/or
- fixing the full WACC (or parts of it) to provide certainty would help manage significant long term financial risks for sponsors;
- returns to the airport operator are commensurate to the risk of the investment; and
- taking such an approach would be in the interests of users.

We would also consider what implications this may have for airport price controls/pricing arrangements and the airport operator's financial sustainability. Our financing duty requires us to have regard to the need to secure that the airport operator can finance its services.

We are also prepared to consider treating different elements or phases of any capacity expansion project separately. For example, we may treat the runway separately from new terminals and/or new surface access infrastructure, or compensation arrangements. However, any such change may be accompanied by further development of our existing efficiency improvement mechanisms. For example, we may consider (among other issues) the merits of:

- strengthening the role of the Independent Fund Surveyor;
- new incentives around capital expenditure forecasts; and
- incentives and penalties around capital expenditure being different from levels previously agreed between the regulator and the airport operator.

The use of such mechanisms may have the scope to help ensure the timely and on-budget delivery of new capacity. If we pursue these issues, we would consider carefully how these aspects of the regulatory regime would work together as part of our approach to new capacity.

As part of our assessment of the appropriate level of the WACC, we also anticipate reviewing our approach to gearing. Under our existing approach, we set a notional gearing

target but the regulated airport operator determines the level of gearing that it sees fit. In looking at this issue, we may need to take into account the risk that the operator of the expanding airport may be (or may become) incentivised to create a financing structure that creates undue risk to the delivery of any expansion project.

4. Surface access

For airport capacity expansion which requires significant investment in surface access infrastructure, we would, as required by our statutory duties, assess costs from the viewpoint of airport users (such as passengers and cargo-owners). To include costs in the RAB, or for these costs to be taken into account in the setting of any pricing restrictions or commitments, we would expect the airport operator to provide robust evidence on how the investments would meet the following criteria:

- the extent to which surface access investment by the airport operator is in the long-term interests of passengers and cargo-owners (rather than third parties);
- the investment delivers positive benefits to passengers and cargo-owners (rather than third parties);
- costs have been efficiently incurred and the scope of the project minimised;
- surface access users (and third parties) would contribute to the cost where appropriate, for example, through the payment of fares; and
- the costs added to the RAB are proportionate to the benefits to passengers and cargo-owners.

Any planning obligations relating to surface access are also likely to be important additional considerations. We have previously acknowledged that it may be necessary for an airport operator to make a contribution greater than that strictly necessary for its own efficient operation, as part of a requirement to obtain the necessary planning consents. We also appreciate that we may need to consider the extent to which the costs of meeting these planning obligations can be included in an airport operator's RAB.

5. Promoting delivery

We will consider the need for, and scope of, arrangements that can be developed for inclusion in a licence to manage the delivery of new capacity by ensuring the project is managed efficiently and effectively. In particular, the wide discretion provided by the 2012 Act gives us scope to develop a range of financial incentives on a promoter, if we consider them necessary or expedient to deliver new capacity on time and on-budget.

Options that we could develop, either individually or as part of a larger suite of incentives, to promote the delivery of new capacity might include:

1. a requirement for an airport operator to use best endeavours to develop its airport infrastructure/capacity in an economic and efficient manner to meet the reasonable requirements of users for additional capacity; and/or
2. incentives that could change the level of income that would be achievable by an airport operator, including the use of:
    - capex triggers to remove the return to capital in the event that delivery milestones of the project are not delivered on the agreed schedule;
    - reductions to the overall allowed revenue to reflect non-delivery. The calculation of the WACC might be designed in such a way that a lower WACC is applied across the whole of the airport's operations if there was non-delivery;
    - clawback provisions that remove an airport operator's risk-weighted returns on previous expenditure (for example on planning costs) so that it could only recover its bare costs for those elements if expansion did not proceed;
    - passenger satisfaction or resilience incentives designed to address the impact on the passenger experience of non-delivery and any associated overcrowding; and
    - enhanced governance around allowing costs into the RAB, such as the use of an Independent Fund Surveyor.

While the above options may appear relatively straight forward to develop, we will need to consult extensively to ensure that any policy we do develop furthers the interests of users in accordance with our statutory duties.

The licence could also provide for any price control or commitments to be automatically re-opened (as a whole or in part) if a promoter did not follow through on the development. The impact of non-delivery of the promised new capacity might even justify amendments to the revocation provisions of a licence.

Timely and proportionate enforcement of any breaches of any licence conditions would also help delivery, not least as contravention of a licence condition or an enforcement order can result in penalties up to 10% of a promoter's qualifying turnover.

6. Compensation to third parties, for example, in relation to noise, blight or other compensation paid to local communities

We recognise that spending on noise, blight and air quality compensation or mitigation may be significantly higher than the norm in the UK due to the level of potential detriment to those affected by new capacity. Indeed, we have stated that airports seeking expansion should significantly increase spending on noise mitigation schemes to get closer to international competitors.[2]

It is worth noting that UK spending on compensation and mitigation at airports in Europe and the United States of America that are undertaking expansion projects is significantly higher than the UK statutory minimum. Furthermore, the compensation package offered to those impacted by the construction of the new High Speed 2 rail line highlights that nationally significant infrastructure projects may require the adoption of a more ambitious approach to compensating those most affected.

Compensation may therefore need to be enhanced above the historical norm. However, our approach would also need to guard against users being exposed to open-ended financial commitments. Where expenditure is mandatory (for example where the airport operator has no discretion as part of the “price” for airport expansion), our starting point is that this should normally be automatically added to the RAB.

Where expenditure goes beyond mandated expenditure (or where expenditure is required but there is discretion as to how this obligation can be met) our approach is that it would only be added to the RAB if it can be demonstrated to be in users’ interests and to be efficiently incurred. In other words, there is no presumption that all compensation expenditure has been efficiently incurred. We consider that this approach is in the users’ interests.

2 See CAP 1165, Managing Aviation Noise http://www.caa.co.uk/docs/33/CAP%201165%20Managing%20Aviation%20Noise%202.pdf

7. Potential role of commercial agreements for construction (or Category C) costs

Since we published our March 2015 policy, we have had useful preliminary discussions with a number of stakeholders about the potential role of commercial agreements for Category C costs. We have continued to consider how agreements might be structured and the possible advantages that they might offer over a purely 'regulated' approach.

In broad terms, it appears that there may be two distinct types of commercial agreement that the airport operator and airlines might enter into in relation to capacity expansion:

- agreements that provide airlines with incentives to maintain or grow traffic volumes (typically through lower airport charges, but the agreement may also cover certain operational aspects of the airport service); and
- agreements that cover other commercial terms, such as the future level of charges (rather than simply a discount from the airport's standard charge), the timing of revenues or the allocation of certain risks.

The first type might help to clarify likely future demand and to reduce demand risk, and can operate alongside a traditional regulatory approach where we determine the main parameters of a price cap. In contrast, the second type of agreement, if it leads to agreement over the future level of charges, might reduce or replace elements of RAB-based regulation or the service quality regime.

Negotiations could provide an opportunity for both the airport operator and individual airlines to agree a deal that better meets their needs than a regulatory approach. We are keen that stakeholders have a good opportunity to enter such negotiations.

We also recognise the challenges associated with agreeing commercial terms and that it may not be possible for stakeholders to conclude such agreements, especially over the long time period that would be required if contracts are to reduce or replace the need for regulation by us.

Irrespective of whether these negotiations progress well or not, we will continue to develop our proposed approach to regulation, which will facilitate expansion should commercially-negotiated contracts not emerge.

8. Next steps in the consultation process

Publication of any consultation document will need to be predicated on a clear indication from Government that capacity is needed and on which capacity expansion scheme will be allowed to proceed.

Where this is in place and changes to our current regulatory approach may be required, as indicated above, we would seek first to consult with stakeholders as part of the development of any new, clarified or revised policies. We envisage that any such consultation would occur at the policy development stage in order to provide stakeholders an opportunity to respond to the direction of travel of our policy prior to any statutory consultation process required under the 2012 Act.

We would undertake any subsequent statutory consultations in a timely manner to ensure implementation of any changes would take place before the start of any new price control (or, where appropriate, to build on any existing licence obligations at another suitable point) and to ensure any changes that are made are necessary or expedient to promote our duties, particularly our primary duty to users.

We are currently in the process of designing the framework for the next Heathrow price control review, given that the current price cap expires on 31 December 2018. We intend to publish a ‘scene setting’ document in early 2016, although the precise date for this publication will be linked to the timing of the Government’s decision on new runway capacity. We are also intending to undertake a review of the licence-based commitments at Gatwick Airport in the second half of 2016. This is a mid-term review as the current licence and regulatory settlement at Gatwick does not expire until 31 March 2021.

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