

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

Heathrow's response

Date: September 2016

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Status: Final

Contents

Executive Summary	3
Introduction	5
Category A cost: definition and recovery	5
Category C costs: definition and recovery	6
Category B costs	7
Background	7
Cost definition	7
Scenario definition	8
Automatic recovery of up to £10m each year	9
Risk sharing mechanism	9
Planning RAB and timing of the remuneration.....	10
Depreciation and net present value neutrality	11
Use of an IFS.....	11
Transparency around planning materials produced	11

Executive Summary

1. Heathrow welcomes the opportunity to respond to the CAA's initial proposals on *The recovery of costs associated with obtaining planning permission for new runway capacity*. We also welcome CAA's willingness to consider new approaches for regulation of a programme as unusual as a major long term expansion and its preparedness to engage before a Government decision to help accelerate work after a decision.
2. We believe that Category A costs should be recoverable by the promoter that is given Government support. These costs are integral to the success of a project that the CAA has deemed to be in the interest of users. They are also costs that under normal commercial conditions a non-regulated promoter would seek to recover in the event of a successful project through charging for its product. Clearly any such recovery in a non-regulated environment would have an appropriate risk and reward balance, which might differ from ongoing business.
3. Whilst a detailed framework still needs to be developed, Category C costs should be treated in a similar fashion to capital projects undertaken in Q6.
4. Early clarity on cost recovery of Category B costs is required to ensure that investment proceeds in a timely way. We support the CAA's definition of Category B costs as "capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision on the location of new capacity and are associated with seeking planning permission."
5. Heathrow supports the scenarios as defined by the CAA, based on either success or failure of planning consent. The objectivity and simplicity of these scenarios is helpful, it is thus essential that the CAA reconsiders paragraph 5.14 to align it with its duties.
6. We believe that the risk sharing parameters should be sufficiently large to provide strong incentives and stand by our proposal of an 80%/120% range. We feel this provides the appropriate incentives to all parties and is a fair balance of risk given the level of control each party has.
7. We believe that planning costs should be included in the airport RAB and agree that, from a transparency perspective, it is important that these costs can be clearly understood. We believe a separate p-RAB is overly complex and will create extra financing costs.
8. We fundamentally disagree with a move to an Assets in Operation (AIO) approach as proposed in the consultation document. This does not align with how we are remunerated or how our financing takes place. We see no reason to move away from Assets in the Course of Construction (AICC) so long as Category B costs remain sufficiently transparent in the normal airport RAB. This will ensure that any future additions or subtractions can easily take place to account for the risk sharing parameters.
9. We believe 10 years is the appropriate timeframe for depreciation in any outcome – this ensures a smooth charging profile which is in the interests of users. We agree with the CAA's intent that Category B costs are treated in the same way as any other projects undertaken in Q6 to ensure net present value neutrality.
10. Heathrow supports the use of the current Independent Fund Surveyor (IFS) and will share as much material as practicably and legally possible with stakeholders as well as seek

their full participation in the expansion programme as part of (but not limited to) the high quality consultation that will need to be undertaken on the proposals before a planning application is submitted. We wholeheartedly agree that this will ensure the best outcome for passengers and commercial future for the airport community.

Introduction

11. Heathrow's vision is to give passengers the best airport service in the world. Heathrow considers that in order to fulfil its vision and accommodate future expected growth, capacity expansion to the airport is needed as soon as possible.
12. We welcome the CAA's view that a new runway in the south-east of England is in the interest of users of air transport services. We agree with the CAA that this consumer interest should be the guiding principle for its future policy making regarding capacity expansion.
13. Heathrow welcomes the CAA's recognition that regulating capacity expansion is not the same as periodic price regulation. We agree that different situations should be addressed with different regulatory approaches. Heathrow would like to highlight the importance of this consultation in itself and also as a signal to achieving the best outcome for the future of aviation and consumers in the UK.
14. It is important to Heathrow that the CAA is partially replicating competitive market behaviour. As such the CAA has recognised that an element of reward over and above the regulated allowance is granted to the airport in the event of a successful planning application. Similarly, the airport is taking on additional risk linked to an early stage of a project. We believe this is reasonable and appropriate.
15. This response provides feedback to the CAA's initial proposals. It first deals with Category A and Category C costs. Further consideration is then given to the key elements of the Category B costs risk sharing proposal.

Category A cost: definition and recovery

16. As already discussed with the CAA, Heathrow considers that splitting non-construction related costs into Category A and Category B costs is an artificial delineation. It does not follow any robust market or commercial logic. Leaving this aside, Heathrow urges the CAA to reconsider its policy proposal regarding Category A costs.
17. The CAA has established that capacity expansion is in the interest of users and therefore, needs to recognise that Category A costs are integral to the success of the project. Put simply, without Heathrow's expenditure on engaging with the Airports Commission, Government, regulatory authorities and gaining local and national support, it would not be possible for Heathrow to achieve a Government recommendation.
18. If Heathrow is granted Government support, that implies that already incurred costs (Category A costs) would have been effective. If that is the case, Heathrow considers that, subject to an efficiency test from the IFS, these costs should be recovered.
19. We are clear, however, that in the case where Heathrow does not receive Government support that these costs would not have been in users' interests and we would not expect to recover them. The recovery of Category A costs should be linked, as with any commercial project, to a successful project delivery. As in our previous proposals we believe the higher risk nature of the more speculative Category A costs could be reflected in recovery being delayed until planning consent is secured.

Category C costs: definition and recovery

20. Heathrow broadly agrees with the definition of Category C costs provided by the CAA. In particular, the CAA recognises that potentially significant expenditure on preliminary works, early hardship mitigation or enabling construction costs will take place before Development Consent is granted and that these are considered Category C costs. This will include land and property acquisition costs as the Planning Act 2008 requires promoters to engage early with affected landowners and attempt to reach agreement with them prior to submitting a planning application. It is necessary to demonstrate a compelling case in the public interest for the compulsory acquisition of land¹. In certain limited circumstances the justification for compulsory acquisition may be assisted by early agreement to facilitate an extended notice period or the offer of financial support for early relocation to ensure business continuity. All costs associated with facilitating and securing these preliminary works should be considered Category C costs (including the costs of obtaining planning permissions and making acquisitions).
21. We would like to highlight to the CAA the importance of clearly defining blight and hardship as Category C costs. These costs are the first enablers for future construction costs and thus fast, efficient delivery of capacity. It is important for Heathrow, and ordinary local people in our community, that there is clear policy guidance on these particular elements. It is Heathrow's intention to expand while ensuring that our community is fairly treated and compensated. A clear policy guidance would help to facilitate both ambitions.
22. We note the CAA wishes to better understand the detail of these pre-construction costs before developing a specific policy to cater for them. The CAA's intention is to consider the regulatory approach to these costs shortly after the Government decides the location of new runway capacity.
23. Heathrow would like to engage with the CAA on the detail of the Category C costs as soon as practicably possible. We consider that regulatory certainty over the recovery of Category C costs is essential for the success of capacity expansion and that the CAA needs to be ready to publish its *Initial Proposals* on these costs as soon as the Government confirms the location of new runway capacity. To that end, Heathrow is keen to initiate a number of meetings with the CAA throughout September to ensure that the CAA has all the detail that it needs to set policy.
24. Regarding the recovery of Category C costs, the CAA is clear in asserting that these costs are not subject to the proposed risk-sharing arrangements and outlines that these costs could be treated in a similar fashion to the capital projects handled in Q6. We support this general principle, more work clearly still needs to be done by the CAA to propose a formal framework for the approval and recovery of these costs, especially those incurred before planning consent is granted.
25. Heathrow would like to draw the CAA's attention to the significant scale of these costs and highlight the need for regulatory certainty when considering them.

¹ Section 122(3), Planning Act 2008

Category B costs

Background

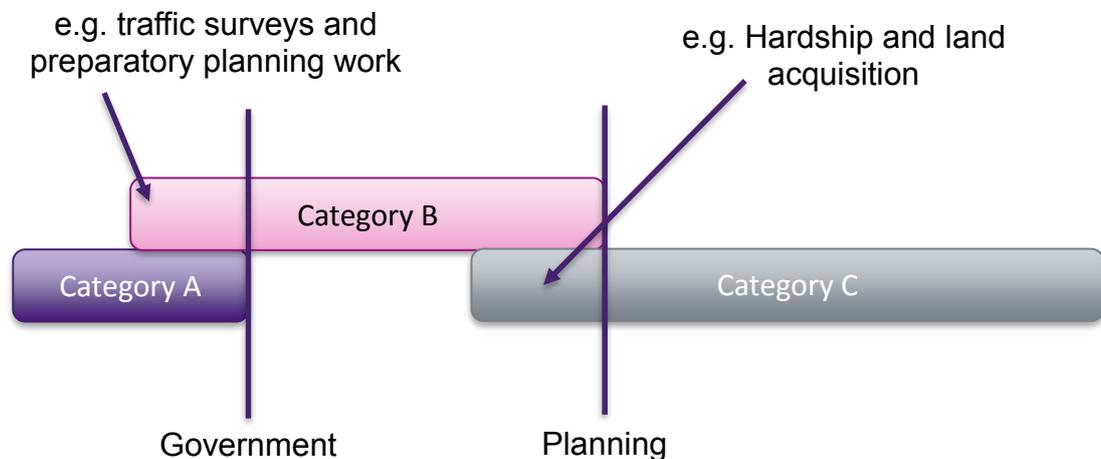
26. A Government decision on the location for new runway capacity is expected by October 2016. Early clarity on cost recovery of planning costs (Category B costs) is necessary to ensure that investment proceeds in a timely way, as well as reducing uncertainty to Heathrow and its investors it will also reduce uncertainty faced by passengers and airlines of the impact on airport charges.
27. Following publication of the CAA's policy update in September 2015, Heathrow attempted to enter into commercial discussions with our airline customers on risk sharing arrangements around Category B costs. In addition to attempting to engage the airline community at the Joint Steering Board, our senior strategic airline governance forum, we wrote to the LACC/AOC, British Airways, Virgin Atlantic and easyJet inviting them to enter into commercial discussions. Only one airline took up the offer of even exploratory discussions before the CAA's deadline of spring 2016.

Cost definition

28. The CAA has previously defined Category B costs as "capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision on the location of new capacity and are associated with seeking planning permission". This phrasing should form the basis of the new Licence condition. Including a prescriptive list of cost categories within the Licence should be avoided. A prescriptive list will generate an unnecessary rigidity within Heathrow's Licence since at this stage not all expenditure related to the planning permission is fully understood by Heathrow, airlines or the CAA. It is also highly likely to result in costly and excessive bureaucracy in defining costs. If there is a desire to exclude certain costs, at a minimum there should be a "negative" list of costs excluded to help certainty and simplicity.
29. All costs post-Government announcement associated with obtaining planning permission (not already included in the Q6 allowance) need to be considered Category B costs. In addition to the example cost categories set out by the CAA, and without intending to define a prescriptive list of items, Heathrow would like to bring the CAA's attention to a number of costs items that should be considered Category B costs; staff costs for Heathrow colleagues and consultants working on the planning application; communication costs associated with maintaining support for Heathrow expansion; additional security costs to maintain operations during this period; cost associated to responding to the National Policy Statement (NPS); planning fees and examination costs; third party costs (e.g. legal costs and planning performance costs or fees); and costs of Heathrow participating in the defence of any legal challenge of the Government location decision, the NPS or the Development Consent Order (DCO).
30. The definition of Category B and Category C costs should be complementary. Costs associated with delivering planning permission incurred post-Government announcement and before the DCO is made by the Secretary of State should be Category B costs if they are not Category C costs.
31. Heathrow supports the IFS providing an on-going independent assessment of costs within Category B expenditure. All cost should meet an efficiency test and be fully transparent to the CAA and the airlines, and only costs actually incurred would be recovered (as opposed to forecast expenditure). We make further observations on the IFS in paragraph 55 below.

32. The CAA has acknowledged that there are some costs associated with securing planning permission that are being incurred ahead of a Government decision on location of new runway capacity. Heathrow agrees with this view and will take all reasonable endeavours to demonstrate to the IFS, the CAA and the airline community how expenditure that has occurred prior to a Government decision will be used for planning application purposes and therefore qualify as Category B costs. Figure 1 below, illustrates the actual profile of investment for each type of costs category.

Figure 1 – cost categories and timing



Scenario definition

33. Heathrow welcomes the CAA's decision to simplify the number of scenarios that need to be considered. The scenarios, as defined by the CAA are linked to a clear milestone; success or failure of planning consent. Heathrow considers that this generates regulatory predictability and therefore the right incentives to achieve planning consent in a timely and efficient manner. Above all it creates an objective test of success or failure avoiding future subjective debates as to stakeholders' merits or faults.
34. Although in principle Heathrow supports the scenarios as defined by the CAA, it has significant concerns regarding the following paragraph: "5.14. *That said, in order to fulfil our primary duty to users, we consider it necessary to safeguard users from a scenario where the airport operator unilaterally withdraws from the planning process. If there is clear and compelling evidence that GAL/HAL were responsible for the failure to obtain the DCO, then we reserve the right to decide that GAL/HAL will be able to recover less than 85% of the Category B costs incurred*". This paragraph could override the objectivity and certainty generated by defining two outcome based scenarios and therefore jeopardise the balance achieved by them.
35. Heathrow understands that it is right that an efficiency test should apply, as applies to all capital investment at the airport, and that an IFS will provide an assessment of cost

efficiency. However, the CAA's proposal to additionally reserve its right to reduce the amount that Heathrow is entitled to recover has a number of unintended effects. It would:

- a. reduce the deliverability of the project if investors perceive that the regulatory framework is highly subjective;
- b. by definition increase the uncertainty about total recovery, which would directly affect the perceived risk of the proposal, and trigger a higher (than otherwise) cost of financing. Ultimately this will be reflected in prices paid by Heathrow airlines and passengers. It is not at all clear how this proposal can then be in the interest of passengers if passengers could be paying more than they would otherwise do, and;
- c. foster a culture of allocating fault and blame between the airlines, the airport and the CAA. This would run counter to the aim to generate a collaborative framework between all interested parties. The focus should be placed on fostering collaboration to ensure efficiency.

36. For the avoidance of doubt, Heathrow supports the scenarios as defined by the CAA, either success or failure of planning consent. However, it is essential that the CAA reconsiders paragraph 5.14 to align it with its duties.

Automatic recovery of up to £10m each year

37. The CAA proposal allows for the automatic recovery of the first £10m of Category B costs spent by the airport. These costs will directly transition into airport charges and not be subject to the risk sharing arrangements proposed by the CAA in this paper.

38. Heathrow considers the rationale for allowing £10m of automatic recovery for Heathrow is simply that Gatwick already has this allowance within its licence. We do not think the CAA's stated rationale for not varying the £10m automatic recovery on the basis of efficiency to be particularly well founded and that £10m is an arbitrary amount. However, it does ensure a fast start for planning work which is valuable.

39. Heathrow therefore considers that in the round an automatic recovery of £10m each year in the form of airport charges to be a reasonable compromise.

Risk sharing mechanism

40. Heathrow welcomes the CAA's recognition that risk and reward should not be decoupled from a regulatory perspective.

41. Heathrow nevertheless disagrees with asymmetric ranges proposed by the CAA. Heathrow considers that the ranges should be symmetric, in particular when the CAA's initial proposals do not allow for the recovery of efficiently invested Category A costs. We believe that the risk sharing parameters should be large enough to have an impact and stand by our proposal of an 80%/120% range. We feel this provides the appropriate incentives to all parties and is a fair balance of risk given the level of control each party has. For these reasons Heathrow considers that the CAA should reassess its risk sharing ranges.

42. Relatedly, the CAA asserts in paragraph 5.10 that *"the airport operator will be able to generate additional value as a result of planning permission being secured and the*

capacity expansion which follows, notwithstanding the fact that it will remain subject to our economic regulation". Heathrow strongly disagrees with this statement for two reasons.

43. Firstly, the fact that Heathrow will be able to generate additional value on the planning permission asset as a result of planning permission being secured cannot be considered in isolation. The opposite will happen if planning is not secured. Therefore, this cannot be an argument for the asymmetric nature of the mechanism.
44. Secondly and more fundamentally, the CAA states that the airport would generate additional value as a result of the expansion that will follow - albeit subject to economic regulation. There is absolutely no certainty and less than normal commercial visibility of the value creation of expansion. Value creation will depend on both the risks and management of those risks inherent in expansion (e.g. volume traffic and construction risk) and economic regulation. The assertion the operator will generate value is an important misinterpretation of how economic regulation is applied by the CAA. The CAA is not concerned about value, but the costs of providing airport services coupled with a level of return that should represent the risks faced by Heathrow.
45. Heathrow would urge the CAA to reconsider the statement in paragraph 5.10 since it is inconsistent to how the current regulatory framework works. Therefore, it should not carry any weight when defining the risk/reward ranges.

Planning RAB and timing of the remuneration

46. Heathrow recognises and supports the CAA's intention to balance the interests of current and future passengers. A way to achieve this is by assessing the relative amounts paid by current and future passengers.
47. Heathrow agrees with the CAA that a balance between capitalisation/slow money and pay as you go/fast money is the best solution to ensuring that the CAA's primary duty is properly implemented.
48. Heathrow agrees with the CAA that Category B costs over £10m per annum should be added to the RAB and recognises the importance of providing transparency around the costs of the planning process.
49. While these costs should be transparently accounted for it is important that the pRAB terminology is avoided as this could create the impression of investments not being included in the RAB. This would have the unintended consequence of negatively impacting the financeability of the airport. This does not impact the CAA's proposal on the timing of remuneration. Keeping Category B costs as a line item in the existing RAB is also far simpler than establishing a new methodology.
50. We believe that planning costs should be included in the airport RAB and agree that, from an accounting perspective, it is important that these costs can be clearly understood.
51. We fundamentally disagree with a move to an Assets in Operation (AIO) approach as proposed in the consultation document. This does not align with how we are remunerated or how our financing takes place. We see no reason to move away from Assets in the Course of Construction (AICC) so long as Category B costs remain sufficiently separable in the normal airport RAB. This will ensure that any future additions or subtractions can easily take place to account for the risk sharing parameters.

Depreciation and net present value neutrality

52. Heathrow considers that applying a 10-year asset life is a reasonable compromise in the event that planning permission is achieved, it balances generating a predictable cash flow, and ensuring that passengers will not be paying for the planning process for longer than needed while ensuring a contribution from future passengers to costs that benefit them. We also believe 10 years is the appropriate timeframe for the outcome in which planning permission is not granted. This would ensure a smoother charging profile compared to the 3/4 years proposed by the CAA. We are concerned that 3/4 years cause a spike in charges for consumers, counterintuitively in the scenario where consent is not given. This does not seem to be in consumer interest.
53. We agree with the CAA intent that Category B costs are treated in the same way as any other projects undertaken in Q6 in that it will ensure that net present value neutrality is maintained.

Use of an IFS

54. The introduction of an IFS at Heathrow to provide an on-going assessment of the reasonableness of decisions on key capital projects and that capital is being used effectively to deliver the outcomes determined by the business case has been a successful innovation in the Q6 period.
55. Heathrow supports the use of the current IFS to provide an independent assessment of the efficiency of Category B costs incurred. We would urge that rather than establishing a separate IFS for a single project (which is smaller in expected costs than some ongoing projects at Heathrow), we use the existing IFS. Of course this is provided that the current IFS is deemed to have the right expertise to accomplish the task. This is a sensible approach in the interest of efficiency and simplicity for ourselves, the airlines and the CAA. It also ensures we are ready to implement the right review framework, in order to ensure efficient expenditure is guaranteed, as soon as the Government makes a decision.

Transparency around planning materials produced

56. It is good commercial practice for Heathrow to consult with its airline customers. Moreover, extensive pre-application consultation with local communities and a wide range of stakeholders which would include airlines is required under the Planning Act 2008. Consultation ensures that decisions are informed by input from airlines and other relevant parties, and that the airline community have every opportunity to input to decisions made by Heathrow. We will share as much material as practicably and legally possible as part of (but not limited to) the high quality consultation that will need to be undertaken before the planning application is submitted.
57. We welcome an assumption that airlines will have access to planning and design, including cost estimate data during the planning phase. Indeed, we would like to go further and seek full-time airline participation, in a collaborative way, as full members of the planning and consent application team. Similar collaborative development has paid great dividends for example in the T2 project. We have respectfully sought to discuss engagement options with the airline community and would welcome discussions to define the right structures, resources and processes for expansion.
58. It is disappointing therefore that to date despite efforts made by Heathrow, the Heathrow airline community has chosen not to engage on matters associated with Heathrow expansion, including risk sharing arrangements. We would urge that airline access to data

and information be conditional only on one thing, their active engagement in the consultation process and their input to a jointly designed programme of work. That will need to be supportable given airlines resources priorities, but we are certain only a collaborative effort will design a successful airport of the future.