

# **Economic regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion**

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's consultation of December 2019 on the early costs of capacity expansion by Heathrow Airport Limited (HAL) (CAP1871). It sets out the views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus and LEVEL.
2. It does not seek to comment on every point raised in CAP1871 - rather, it focuses on key issues; however, we may subsequently comment on others. For ease of reference, it broadly follows the structure of CAP1871. Emphasis is added, throughout.

## **Executive summary**

### Regulatory treatment of HAL's early costs

3. The bulk of this paper was written ahead of the announcement of the Court of Appeal's judgement issued Thursday 27 February 2020 which found the designation of the Airports National Policy Statement unlawful by reason of a failure to take into account the Government's commitment to the provisions of the Paris Agreement on climate change. In the light of this judgement the risks to the scheme have substantially increased as have the timescales to DCO and therefore the pre-DCO timescales. These need addressing and we have added some thoughts to this paper on how to do that.
4. At the same time, pre-DCO costs under the CAA's preferred timetable have ballooned from £265m for Category B costs and £650M for early Category C costs as at April 2018 to £500m and £1.6bn respectively.
5. The fact that the risk to the scheme has now increased as have the pre-DCO timetables means that the CAA should revisit its recommendation on its preferred scenario as clearly some of the key parameters have now changed. We are of the view that the original judgement was flawed in the first place and these changes further exacerbate the situation. A new plan is needed with further reductions in pre-DCO costs to protect the consumer from increased risk.
6. Of particular concern are the extended pre-DCO timescales caused by this judgement and the temptation for HAL to continue spending at the current rate and add more pre-DCO costs which will burden the consumer further. In the light of the recent judgement

the CAA should stop Heathrow spending on expansion (or if they want to continue to do so, it should be at their own risk) during the period where reviews/appeals are going on.

7. If plans do eventually progress the only sensible means of managing the uncertainty and rising costs is to establish a regulatory framework which provides for reasonable, necessary, and defined pre-DCO expenditure in a manner that does not expose airlines or passengers to significant development risk or rewards HAL for unnecessary early expenditure. We propose to do this with a regulatory reward scheme which provides the right incentives for HAL to only engage in necessary pre-DCO expenditure coupled with much tighter planning, governance and control.
8. If pre-DCO construction costs are to be payable to HAL then they should be kept to the set timeframe and budget that justifies early expenditure. It also means it is imperative to put in place appropriate and effective measures for monitoring and control of pre-DCO expenditure.
9. In light of this, we disagree with the CAA's preferred policy approach for the regulatory treatment of Category B and early Category C costs. The approach is flawed and does not further the interests of passengers.
10. In particular, we do not agree with the CAA that passengers pay scarcity rents to airlines; although, we see that in consequence of its view, the CAA is committed to pre-DCO expenditure. At the same time, so long as the CAA maintains its generous approach to WACC, HAL is encouraged to increase the RAB – and so to maximise what it spends.
11. It is HAL's (not the CAA's) responsibility to finance capacity expansion, while it is in passengers' interests neither to pay for stranded assets, nor to bear the risks of DCO failure. Passengers' interests can be defined by the relationship between the likelihood of DCO success, HAL's significantly increased forecasts of pre-DCO costs and the CAA's approach to financeability.
12. Increased expenditure factored by an increased risk of stranded assets is driving up the costs and risks of pre-DCO investment. This is likely to only increase in light of the recent Court of Appeal decision. It cannot further passengers' interests for them to be forced to pay to HAL more than HAL itself pays for pre-DCO expenditure, particularly when in normal circumstances such investment would not be made without prior DCO approval.
13. Because the CAA proposes to remunerate HAL's pre-DCO expenditure at an inflated WACC, while HAL is financing it with cheap debt, HAL's shareholders benefit from a wide differential – and so it suits HAL to propose unnecessary pre-DCO expenditure. If it

was remunerated at the Cost of Debt (CoD), this would remove HAL's incentive for unnecessary early expenditure; HAL would become ambivalent and would only incur pre-DCO expenditure that was necessary to protect agreed delivery of capacity expansion.

14. In this way, HAL's interests would be best served by being reimbursed at what it naturally assumes will be an inflated WACC for post-DCO expenditure – and so it would be incentivised to defer any unnecessary pre-DCO expenditure, in anticipation of DCO approval. This approach would also further passengers' interests, because necessary pre-DCO expenditure would be financed at the lowest possible cost, but they wouldn't be forced to finance post-DCO expenditure, until the benefits were guaranteed.
15. The CAA's objectives for its regulatory treatment of pre-DCO costs ought to be to protect passengers, to ensure timely delivery of capacity expansion and to balance returns to HAL's shareholders with benefits to passengers. HAL should be rewarded by WACC for pre-DCO expenditure only in the event of both DCO success and delivery of capacity expansion.
16. In light of these comments, we set out at paragraphs 55 to 59 below what we consider to be the most appropriate regulatory framework for managing early Category C costs.

#### Implementation

17. Principally, we agree with the introduction of a draft licence condition to regularise early construction costs associated with expansion. However, we do not agree with the draft condition as proposed. We expand on this further below at paragraphs 60 – 66.

### **Introduction & context**

18. The CAA has a number of statutory duties, one of which is the so-called '*financeability duty*', which it recently defined as having to '*... ensure that each licensee is able to finance its licenced activities*'.<sup>1</sup> In fact the particular statutory duty is that the CAA: '*... must have regard to 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...*'<sup>2</sup> That it has artificially expanded its financeability duty has been repeatedly put to the CAA, without meaningful response.<sup>3</sup> In particular, the issue was

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<sup>1</sup> CAP1832, Appendix A, paragraph 5

<sup>2</sup> Civil Aviation Act 2012, section 1, paragraph (3)(a)

<sup>3</sup> The expansion of both scale and scope of the CAA's financeability duty is illustrated at Appendix A

set out in detail in our submissions to the CAA's 'major consultation' of March 2019 (CAP1782)<sup>4</sup> and its 'working paper' of June 2019 (CAP1812).<sup>5</sup>

19. The CAA's commitment to early delivery of capacity expansion is predicated on a mistaken understanding that passengers are currently paying scarcity rents to airlines at LHR – and that this would dissipate on arrival of new airport capacity.<sup>6</sup> We (and others) have been at considerable pains to demonstrate that this is an entirely false premise; however, to no avail. The CAA's position remains that where demand outstrips supply, there must be scarcity rents - and these cannot flow to HAL, because it is regulated by the CAA, so airlines must get them.
20. The demand in question is, of course, for aircraft seats, while the supply constraint is on airport infrastructure; however, the CAA runs the one directly into the other. We have repeatedly explained why any correlation is mitigated by airlines' activities; for example, increasing aircraft size and consolidating onto routes where demand is greatest. This position was confirmed by RBB Economics who, on behalf of IAG, produced a critique of the reports by Frontier Economics and FTI Consulting and found that: *'RBB considered that there is no evidence to suggests [sic] that there are scarcity rents being earned at Heathrow.'*<sup>7</sup>
21. The CAA has failed to substantively respond to the points raised by RBB or IAG. The consequence of the CAA's mistaken view as to scarcity rents and its willingness to underwrite the costs of pre-DCO expenditure (that is, to force airlines and passengers to pay for it) means that should the DCO application fail, passengers will pay the costs of whatever assets it allows into the RAB, even if those assets become stranded by DCO failure. The CAA's proposed approach will expose passengers to very significant development risks and is entirely contrary to the CAA's duties to further the interests of users of air transport services as set out in the Civil Aviation Act 2012 (CAA 2012).
22. Few neutral commentators would dispute that the odds of DCO failure are shortening – and HAL understands that this has become a distinct possibility; arguably, the greatest threat it faces, particularly in light of the Court of Appeal decision. HAL (like all businesses) seeks to mitigate threats. Aside from promising whatever those with power and/or influence over a DCO decision may wish to hear, HAL's best strategy (for its shareholders) is to narrow the gap between the NPV of DCO success and failure. So, it is

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<sup>4</sup> Economic regulation of capacity expansion at Heathrow: policy update and consultation

<sup>5</sup> Heathrow expansion – affordability and financeability update

<sup>6</sup> The CAA's view of the market is illustrated at Appendix B

<sup>7</sup> CAP1871, Appendix C, paragraph 9.

in HAL's interests to spend as much as possible before a DCO decision – and this is reflected in its spiralling pre-DCO cost estimates.

23. If it is that early expenditure is so very much in passengers' interests, then there ought to be regulatory tools to ensure HAL sticks to its proposed development schedule so to ensure such early expenditure does not go beyond what passengers' can reasonably be expected to pay for. However, we are unaware that CAA has considered or developed any. Instead it is proposing to underwrite pre-DCO expenditure in its entirety – and at a rate of return far exceeding HAL's actual cost of capital. This creates a scenario whereby HAL may be motivated spend as much as it can as quickly as it can and are not incentivised to seek a DCO decision as soon as possible.<sup>8</sup> In light of the uncertainty around the DCO application (exacerbated by the Court of Appeal decision) this is not appropriate and contrary to the interests of users of air transport services.
24. Rather than set out what it required, the CAA: *'... asked HAL to consider a range of options...'* with the result that customers and the regulator must choose from a palette offered by the regulated firm.<sup>9</sup> Since April 2018 HAL's forecasts of Category B costs have escalated from £265m to £500m+, while those of early Category C costs have snowballed from £650m to £1.6bn, yet the CAA has to date failed to interrogate or restrict these project increases by HAL in any sense. The CAA says that it will act: *'... with a view to avoiding further unexpected increases in these costs [but] we do not rule out further changes to the treatment of Category B costs [...] in response to the representations we receive from stakeholders...'*<sup>10</sup> We are concerned that this will be perceived by HAL as weakness – or at least, a lack of resolve.
25. The CAA says that it: *'... recognised the importance of robust forecasts [and] there have been some important changes to the scope of HAL's programme.'* This is true; the £14bn HAL is now quoting covers far less infrastructure than when that number was forecast and, in our estimate, on a like-for-like basis, the forecast is now £32bn+. The CAA acknowledges that: *'... HAL's forecast of the element of these costs that it plans to spend ahead of obtaining a DCO has increased significantly.'*<sup>11</sup> It does not, however, appear to have asked HAL why - or at least, suggests no explanation; although, it implies a recognition that HAL's behaviour is predictably and entirely in its own interests. The CAA is reminded of its duty to have regard to the need to promote economy and efficiency by licensees.

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<sup>8</sup> HAL's strategy is illustrated at Appendix C

<sup>9</sup> CAP1871, paragraph 3

<sup>10</sup> Ibid, paragraphs 4 & 5

<sup>11</sup> Ibid, paragraph 8

26. There is a trade-off to be made between the cost of any given investment and its impact on the timing of delivery of capacity expansion, factored by the likelihood of DCO success and the costs of DCO failure. In its deliberations, the CAA does not appear to have taken into account the potential for DCO failure and/or stranded assets. In preferring Scenario 2a, it simply says: ‘... *we have considered the trade-offs between higher early Category C costs and later delivery of runway opening.*’<sup>12</sup> HAL is doubtless emboldened by the CAA’s leniency, (for example) when it says: ‘... *if there is more certainty [...] we can consider whether there is a case for accelerating early spending.*’<sup>13</sup>
27. Even if you take the CAA’s view of scarcity rents (which we don’t), then it must at least be clear that passengers are best served by pre-DCO investment being made only where essential for early delivery of R3 and at the lowest possible cost.

## Analysis of scenarios

28. For the reasons that follow, we disagree with the CAA's conclusion that Scenario 2a is likely to result in the best outcome for consumers.
29. The CAA says that: ‘... *[HAL] outlined four principal scenarios [to the CAA and then] engaged with airlines...*’<sup>14</sup> The engagement undertaken by HAL to date has been largely ineffective as there has been little serious consideration of consultation responses and very little consequential changes to their proposals. Any reasonable supplier would be engaging with its customers well before finalising its plans to ensure consultees have a real opportunity to influence those plans. Also, it is hard to understand what the CAA means when it says: ‘... *[it] should not be construed as setting a budget for early Category C costs, nor are we endorsing particular levels of expenditure or particular construction activities.*’<sup>15</sup> In our view, this is precisely what the CAA is doing. HAL will consider whatever the CAA allows into the RAB as its budget and so will invest no more than this amount on the specified projects allowed by the CAA.
30. In dismissing Scenario 4, the CAA has relied upon its erroneous understanding that the costs of waiting for DCO approval outweigh those of the £0.9bn to £2.5bn annual scarcity rents that it says airlines at LHR are getting from passengers. For the reasons already explained, this is incorrect. Of the remaining three scenarios, the CAA did not

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<sup>12</sup> Ibid, paragraph 10

<sup>13</sup> Ibid, paragraph 12

<sup>14</sup> Ibid, paragraph 1.1

<sup>15</sup> Ibid, paragraph 1.5

commission its own, but asked HAL to undertake a risk assessment, which can be summarised as follows:

- Scenario 1 is restated as HAL's preference, with maximum pre-DCO expenditure (although the IFS had already said this was unrealistic);
- Scenario 2 describes a high level of pre-DCO expenditure (£1.6bn) and a promise to meet the NPS deadline of 2030; and
- Scenario 3 has a less aggressive level of pre-DCO expenditure (£1.0bn) and a promise to miss the NPS deadline.

31. The CAA has selected Scenario 2, but it is difficult to see how it had much choice in circumstances where the alternatives proposed by HAL were the 'impossible' or the 'unacceptable', in order to position its preference at the mid-point of a 'range' appear more reasonable. The CAA summarises by saying: '*... the views of stakeholders diverge significantly.*'<sup>16</sup> They do and this needs to be properly taken into account by the CAA.
32. Of the options put forward by HAL, and subject to our comments below regarding the appropriate regulatory treatment of early Category C costs, IAG maintains that Scenario 3, with the lower cost and slower rate of £1.0bn, will result in the best outcome for users of air transport services. It recognises the trade-offs between benefits that (the CAA says) would accrue from early delivery and the costs and risks of DCO failure. It is the only option that makes any concession to passengers' interests – and as such, it is better than the other options put forward by HAL.
33. The CAA acknowledges and repeatedly refers to the risk of 'sunk costs', in the context of the potential for DCO failure, but it would be much worse than the CAA appears to anticipate.<sup>17</sup> The main risk to passengers' interests from DCO failure is that of 'stranded assets'.<sup>18</sup> It is not that HAL would at some point realise it was in a bad investment and consequently decide not to 'throw good money after bad'. It is that HAL would be stopped from continuing a bad investment, with the capitalisation of whatever assets

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<sup>16</sup> Ibid, paragraph 1.15

<sup>17</sup> "The Sunk Cost Dilemma is a formal economic term that describes the emotional difficulty of deciding whether to proceed with or abandon a project when time and money have already been spent, but the desired results have not been achieved. A Sunk Cost Dilemma, when attempted to be resolved, requires an evaluation of whether further investment would just be throwing good money after bad. The purely rational economic person would consider only the variable costs, but most people irrationally factor the sunk costs into our decisions. The Sunk Cost Dilemma is also called the Concorde Fallacy." *Investopedia*

<sup>18</sup> "Stranded assets are 'assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities'. Stranded assets can be caused by a variety of factors and are a phenomenon inherent in the 'creative destruction' of economic growth, transformation and innovation, as such they pose risks to individuals and firms and may have systemic implications." *Wikipedia*

had already entered the RAB, whether or not passengers derived any value from them. Depreciation of and returns on RAB assets are fully remunerated by airlines and passengers, so unlike in a commercial situation, where good investments are preferred to bad, this does not directly affect HAL!

34. Further, the CAA's justification for its preferred scenario is unclear and unsound. The CAA explains that: '*... it is not practicable to for us to develop a robust estimate of this probability [of DCO success]*'.<sup>19</sup> We understand the difficulty, but not the CAA's '*stylised analysis*', which attempts to identify a: '*... break even probability [which would] make consumers indifferent between the choice of Scenario 1 and the scenario under consideration*'.<sup>20</sup> It seems to us that in order to undertake this exercise, it is essential to know the cost to passengers of delay (the essential difference between scenarios), as well as the cost to passengers of DCO failure (which is directly correlated to the amount of pre-DCO expenditure and therefore greatest in Scenario 1) and the likelihood of DCO failure (the unknown quantity). So, the argument appears to be circular: you can't get to '*the probability of DCO success*' without knowing the '*likelihood of DCO failure*' – and once you do, you don't need to do the exercise, because the two numbers add up to 1.
35. We agree with the CAA's list of '*very significant limitations*' in its chosen approach.<sup>21</sup> It worryingly says that: '*... if there is greater certainty about the programme later [...] issues of timing and spending can revisited...*'<sup>22</sup> Instead, if pre-DCO construction costs are to be allowed, the CAA should be seeking to hold HAL to a set timeframe (i.e. the early delivery that justifies the costs) and budget. Critical to this is establishing meaningful governance arrangements which enable not only the CAA but also airlines as key stakeholders to monitor and manage that pre-DCO expenditure spend.

## **Regulatory treatment of HAL's early costs**

### Regulatory treatment of Category B costs

36. The CAA sets out its: '*... near final decision on the regulation of Category B costs [and] proposals on the regulatory treatment of early Category C costs...*'<sup>23</sup> It goes on to describe its '*broadly settled view on the regulatory treatment of Category B costs*'.
37. We disagree that: '*... [there are] advantages of not reopening the treatment of expenditure already agreed...*'. The quantum of proposed expenditure has changed so

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<sup>19</sup> CAP1871, paragraph 1.25

<sup>20</sup> Ibid, paragraph 1.28

<sup>21</sup> Ibid, paragraph 1.30

<sup>22</sup> Ibid, paragraph 1.34

<sup>23</sup> Ibid, paragraph 2.3



radically and the implications for passengers is far beyond that which was originally anticipated that it would be unreasonable for the CAA not to give due regard to these change in circumstances. We consider that the new circumstances themselves warrants a complete reassessment of the regulatory treatment of both Category B and C costs. .Further, in our view, the CAA ought not to be conferring benefits on HAL as a result of inaccuracies in its forecasts. On the contrary; the CAA should pause to reflect on and re-evaluate the entire programme, with a view to further passengers' interests, in accordance with its duties as set out in the CAA 2012.

38. Given its erroneous views on scarcity rents and (in consequence) what it must believe may follow in the event of DCO failure, the CAA's objectives ought to be to maximise the value to passengers of DCO success and minimise the cost of its failure consistent with the duties it owes under the CAA 2012. It is hard to see how creating a scenario whereby HAL is effectively encouraged to spend as much as possible, as soon as possible, whilst making passengers pay more than HAL's costs for assets from which they may potentially not benefit does this. Nevertheless, the CAA has said:

- for £10mpa of Category B costs, passengers will pay 100% of HAL's unscrutinised costs, (through the k-factor, so @ Y+2 & RPI-X);
- for the next £265m (less £10mpa) of Category B costs, passengers will pay 105% of HAL's costs, compounded by an inflated WACC, provided '*... [HAL] can demonstrate it used appropriate endeavours...*'; or
- passengers will pay 85% of HAL's costs, compounded by an inflated WACC, in the event that HAL cannot demonstrate it used appropriate endeavours; or '*in certain limited circumstances*';
- passengers will pay <85% of HAL's costs, compounded by an inflated WACC, in the event of '*clear and compelling evidence that HAL had unilaterally withdrawn from the planning process*'; and
- for a newly allowed tranche of £235m of Category B costs, passengers will pay 100% of HAL's costs, compounded by an inflated WACC, in the event of DCO success; or
- passengers will pay 85% of HAL's costs, compounded by an inflated WACC, in the event of DCO failure, in the event that HAL cannot demonstrate it used appropriate endeavours.<sup>24</sup>

39. The CAA has also made clear that it does not preclude allowing Category B costs over and above £500m cap, but has clarified neither what is meant by '*reasonable*

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<sup>24</sup> Ibid, paragraph 2.6 & table 2.1

*endeavours’ nor ‘certain limited circumstances’.* It is critical such clarification is provided now so that the potential for costs to be passed on to airlines and ultimately passengers is fully understood and can be regulated accordingly.

40. There can be little doubt that HAL will finance pre-DCO costs with debt, obtained from capital markets at favourable rates, which are much lower than those the CAA proposes to force onto passengers.
41. It is strange to note that HAL’s forecasts of cost and timing have changed so radically, yet the CAA has done nothing in response. The result is that HAL becomes increasingly brazen in its requirements, while the CAA is continuously accommodating - and passengers stand to pay ever-increasing costs.

#### Scrutiny and reporting of Category B costs

42. The CAA sets great store by what it describes as *‘scrutiny and reporting’*, but should recognise that they are not the same thing. Scrutiny requires the sharing of information by one party for its interrogation by another, whereas reporting is just what it says: the first party tells the second only what the first wishes it to know.
43. We do not share the CAA’s *‘concerns that HAL was not monitoring these costs closely enough’*.<sup>25</sup> In our view, it is likely that HAL was monitoring its Category B costs very closely indeed, but what it wasn’t doing was reporting them. Increased frequency of reporting, of itself, achieves nothing. What is needed (at a minimum) is some good reporting, not more bad reporting. In any case, even if increased reporting delivers transparency benefits, it does nothing to control HAL’s spending. Whilst HAL may be uncomfortable reporting ever-increasing costs, unless the CAA puts a break on it, then the current trend seems destined to continue.

#### Recovery cap for Category B costs

44. The CAA’s description of how it intends to control Category B costs is perplexing. First it recognises that: *‘... a reporting cap [...] would not provide a sufficient incentive for HAL to control costs [so] for any recovery cap to be a “fixed cap” beyond which no recovery costs will be allowed [...] would unreasonably expose HAL to risks that may be out of its control [and therefore] retaining scope to adjust the recovery cap [...] would be in the interests of consumers.’*<sup>26</sup> We disagree and would make the following points:

- if a *‘reporting cap’* is insufficient (we agree) then the CAA ought to be setting a price cap – or something that is sufficient to control early construction costs;

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<sup>25</sup> Ibid, paragraph 2.31

<sup>26</sup> Ibid, paragraphs 2.33 & 2.34

- the CAA is demonstrably more willing to expose passengers to risks which are wholly outside their control than it is to expose HAL to risks over which it enjoys (at least) a degree of control, contrary to its duties under the CAA 2012; and
- an ‘*adjustable recovery cap*’ (as described by the CAA) isn’t a cap.

It seems from the CAA’s language that it anticipates further retreating on the question of Category B costs. It describes: ‘... *initially setting the recovery cap at £500m [and then that it does] not expect to change the level of the cap unless there is a material change in circumstances...*’<sup>27</sup>.

#### Risk sharing arrangements for Category B costs above £265 million

45. IAG’s proposal for regulatory arrangements for Category B costs above £265m are shown at paragraph 59.

#### Regulatory treatment of early Category C costs

46. Alignment between the regulatory treatment of Category B and early Category C costs ought not to be made on the basis of removing from HAL an incentive to categorise costs as one or the other, presumably depending on which would attract the better treatment from the CAA. It is a question of economics, but nevertheless illuminating that the CAA sees the potential for HAL to engage in regulatory gaming (and presumably, win) as sufficient reason to adjust its regulatory approach and consequently the costs it puts onto passengers.

47. The CAA goes on to discuss the potential for where: ‘... *a significant proportion of the costs can be recovered (for example, through the resale of assets) in the event of an unsuccessful DCO application.*’<sup>28</sup> Before it sets a policy, we would urge the CAA to carefully examine what happened at STN, following BAA’s unsuccessful application to build a second runway. To our understanding – and in summary:

- BAA purchased a large number of domestic properties, in anticipation of the granting of planning permission, which in the end was not forthcoming;
- these properties had been incremented to the RAB and costs recovered through airport charges, buildings depreciating and land appreciating, in the normal way:
  - depreciation on buildings through ‘*return of the RAB*’; and

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<sup>27</sup> Ibid, paragraph 2.35

<sup>28</sup> Ibid, paragraph 2.50

- costs of capital of depreciated buildings and appreciated land through *'return on the RAB'*;
  - after it withdrew its planning application, BAA was unable to recover its costs, because it owned such a large proportion of the local property portfolio, which would have flooded the market had all (or a significant number) of BAA's properties been released for sale; so
  - most were put into the rental market, which further damaged the sales market - and while rental incomes were put into the single-till, revenues fell a long way short of the level needed to offset costs; so
  - passengers were forced to pay for BAA's failed planning application and stranded assets.
48. Doubtless with an eye on local support for capacity expansion, HAL has offered domestic property owners what is essentially an option to sell at a considerable premium to value, which would be available as soon as HAL makes its DCO application. The proffered justification is that HAL will need time to acquire all the necessary properties, which must be available by the time planning permission is granted. The risks associated with this strategy are huge and unnecessarily borne:
- the problems encountered at STN would be magnified in scale, due to the relative size of HAL's proposals and values of properties in question; and
  - crucially, the premium that HAL is offering owners of domestic properties would be irrecoverable and thus, forever capitalised into the RAB, meaning that passengers would be forced to pay for early delivery of R3 forever.
49. Instead of giving owners of domestic property what amounts to a *'put option'*, the best strategy would be for HAL to take out a *'call option'*, allowing it to buy the properties over a short space of time, in the event of a successful DCO. This way should the DCO be unsuccessful, HAL won't be left with an unmanageable property portfolio, for which passengers will be forced to pay – partly (at least, the premium) in perpetuity. Of course, BAA's experience will have been passed down to HAL – and neither have ever been averse to the inclusion of stranded assets in the RAB.

#### Scrutiny and Reporting of early Category C costs

50. As outlined in paragraphs 38 and 39 above, we support the CAA's proposals for enhanced reporting arrangements for early Category C costs but stress that reporting alone will not provide sufficient control over HAL's spending.

#### Recovery cap for early Category C costs

51. In its approach to setting a recovery cap for early Category C costs, surprisingly the CAA mentions what it describes as: ‘... *the challenges in developing regulatory incentives for efficiency...*’<sup>29</sup> The primary purpose of regulatory incentives is precisely to incentivise efficiency, so these are challenges to which the CAA must rise.

#### Wider governance arrangements

52. IAG’s view on wider governance arrangements is set out at paragraphs 60-66

#### Risk sharing arrangements for early Category C costs

53. We disagree with the CAA’s statement that: ‘... *if we develop regulatory arrangements that allocate all the risk of failure to obtain planning consent to HAL, this would require investors to be compensated for the risks HAL would face, which would lead to higher airport charges and so would not be in the interest of consumers.*’<sup>30</sup> HAL is financing pre-DCO expenditure through low cost debt and so provided HAL is able to service its debt, then there is no risk to investors and no requirement for airport charges to increase.
54. The CAA seems to acknowledge the point, when it says: ‘*in circumstances in which HAL is not granted a DCO], allowing a lower return (for instance at the cost of debt) should provide greater longer term protection for consumers...*’<sup>31</sup> In our view, the point holds true equally in the event of DCO success. The CAA should be seeking to protect the interests of passengers in case of either eventuality in accordance with the duties it owes to users of air transport services pursuant to the CAA 2012.

#### Recovery of early Category C costs

55. In light of the above comments, we set out below our preferred approach to the regulatory treatment of early Category C costs.
56. The CAA’s objectives for its regulatory treatment of pre-DCO Category B and early Category C costs ought to be:
- to protect passengers from the risks of stranded assets, by incentivising HAL to incur only as much pre-DCO expenditure as is necessary;
  - to protect passengers from excessive costs, by incentivising HAL to deliver efficient development and obtain DCO in a timely manner;
  - to ensure a balanced approach, by tying returns to HAL’s shareholders to the delivery of benefits to passengers.

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<sup>29</sup> Ibid, paragraph 2.57

<sup>30</sup> Ibid, paragraph 2.62

<sup>31</sup> Ibid, paragraph 2.63

57. The CAA must recognise that the pre-DCO costs of concern exist in a pre-Final Investment Decision environment and this should be reflected in their regulatory treatment. HAL will at some point in the future make a Final Investment Decision whether or not to go ahead with Expansion. Pre-DCO construction costs should therefore be appropriately controlled to reflect the risk of HAL not proceeding. In addition, in the event that HAL decides against Expansion, which could occur even after a successful DCO grant, HAL should not be rewarded for the pre-DCO expenditure at an inflated WACC. Any such pre-DCO expenditure must be rewarded at CoD in these circumstances otherwise airlines and passengers will be left paying for assets deliberately stranded by HAL with zero return. For pre-DCO expenditure HAL must only be rewarded at WACC in the event of both DCO success and the delivery of capacity expansion.
58. It is therefore essential that HAL is able to differentiate between pre-and post-DCO expenditure, just as would a normal developer, which would stand to lose any investment in stranded assets. The regulatory approach should be to reward pre-DCO costs at CoD and post-DCO costs rewarded more generously than CoD. In this way, HAL should prefer post-DCO expenditure and so will not incur unnecessary pre-DCO expenditure, because the rewards for delivering any given asset will be greater, if it waits for DCO approval. Nevertheless, pre-DCO expenditure will remain protected in case of DCO failure, because it would be remunerated at CoD – and so there is no risk to HAL. However, this needs to be coupled with clear plans, justifications, governance and caps to ensure the objectives in paragraph 55 are met.
59. IAG proposes an alternative regulatory treatment for Category B and early Category C costs as outlined in the table below:

Timing/quantum of efficient early Category B and C costs incurred	Scenario		
	1. DCO application is successful and approved by Secretary of State; and: 2. HAL/investors decide to proceed	DCO application is unsuccessful or is not approved by Secretary of State	1. DCO application is successful and approved by Secretary of State; and: 2. HAL/investors decide <u>NOT</u> to proceed
Up to the recovery cap	H7 Cost of New Debt applied to Expansion additions to the RAB (until R3 open; then full WACC)	H7 Cost of New Debt applied to Expansion additions to the RAB	
Above the recovery cap but below any adjusted recovery cap (if such an adjusted recovery cap is agreed by the CAA and airlines)	H7 Cost of New Debt applied to Expansion additions to the RAB		
Above any recovery cap	Cost incurred disallowed from being an addition to the RAB		

*\* All RAB additions subject to ex-post efficiency tests*

## Implementation

60. Principally, IAG supports the introduction of a new licence condition as a means of controlling early construction costs in respect of expansion. However, we have strong concerns about the draft condition as proposed.
61. As an overall comment, it is unclear what the purpose of this condition is as drafted. It is not the appropriate mechanism to control timing of the development and it is toothless in terms of controlling the programme of works or costs because in the event development goes beyond either, the CAA will have no choice but to change the condition. It would be more appropriate if the condition sought to govern how the costs were arrived at given the development is supposed to be delivered by a certain date and at a certain cost. The condition should seek to define a programme of works or what is meant by construction costs, which are justified as necessary to meet the stated commencement date and require the Licensee to consult with airlines on any delays or increase in such costs.
62. We believe that the licence condition should provide detailed provisions for governance arrangements. Whilst Condition F of HAL's licence in theory addresses this (albeit not

explicitly regarding expansion), in practice HAL's engagement with stakeholders to date has not been sufficient and detailed guidelines regarding governance need to be in place to give confidence going forwards.

63. We do not agree with the CAA's statement that their approach *"avoids the potential 'chilling effect' of codifying a detailed description of a programme of early Category C costs and associated governance arrangements"*. In order to maintain control over early Cat C costs, the condition needs effective governance arrangements and also some sort of definition of what those early Cat C costs can be.
64. We are concerned that in proposing a *'relatively simple modification to HAL's licence'* the CAA is moving/blurring the boundary between:<sup>32</sup>
- the *'airport operation services in the area for which the licence is granted'*;<sup>33</sup>
  - HAL's *'licenced activities'*;<sup>34</sup> and
  - *'[allowing] capacity expansion to proceed'*.<sup>35</sup>
65. As the CAA rightly says: *'... [there is] potential for relatively large amounts of expenditure in 2020 and 2021...'* It seems to us that if the CAA is wedded to this approach, then it must at least balance off HAL's demands for flexibility against airlines' and passengers' requirements for efficiency, certainty and the duties it owes pursuant to the CAA 2012. The CAA's description, with *'a high level description of the programme'*, *'a baseline with the flexibility to allow for changes and variations'* and only *'principles for the governance arrangements'* does not appear to fulfil this requirement.<sup>36</sup>
66. HAL appears to understand the CAA's proposal perfectly; as it says: *'... a targeted licence condition could be beneficial but should only include the content needed to codify the treatment of expenditure and ensure that the appropriate regulatory treatment can be enforced...'*<sup>37</sup> Unsurprisingly, HAL did not support the inclusion of *'detailed definition of the programme'*. In other words, HAL likes the CAA's proposal, so

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<sup>32</sup> Ibid, paragraph 3.1

<sup>33</sup> Civil Aviation Act 2012, section 1, paragraph (3)(a)

<sup>34</sup> The CAA misquoted its *'financeability duty'* under the Civil Aviation Act 2012 as being to: *'... ensure that each licensee is able to finance its licenced activities'*

<sup>35</sup> The CAA said it would: *'... help ensure [HAL] can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed...'* CAP1782, paragraph 6

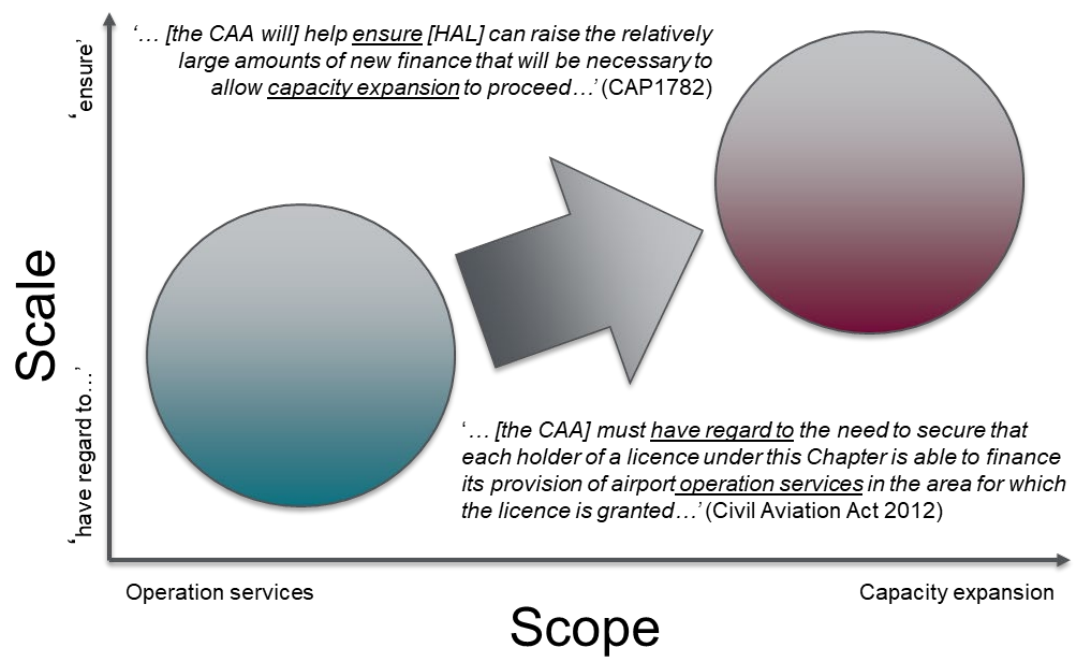
<sup>36</sup> CAP1871, paragraph 3.4

<sup>37</sup> Ibid, paragraph 3.6

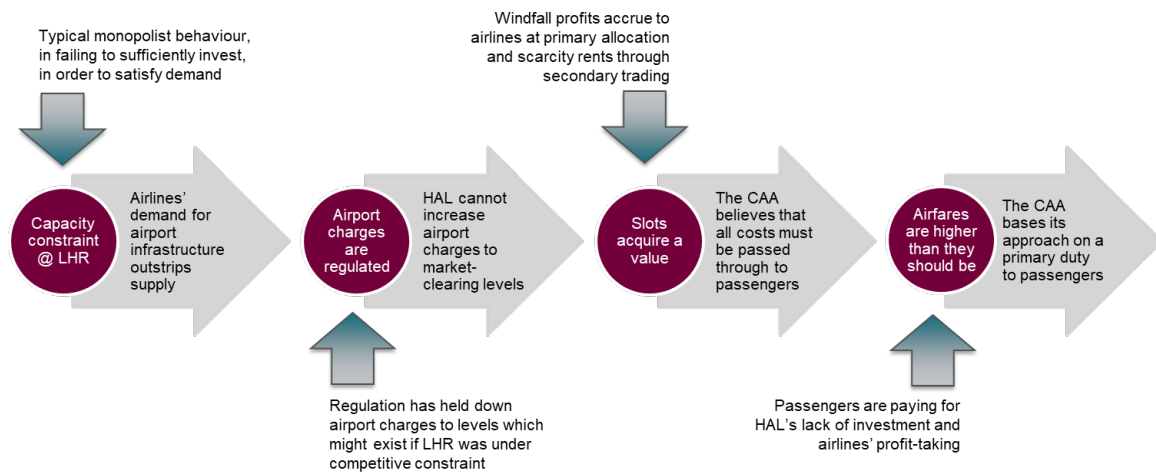


long as a licence condition guarantees it will be remunerated for capacity expansion,  
but does not say that it must do any.

## Appendix A: the CAA's financeability duty



## Appendix B: the CAA's view of the market



Appendix C: NPV of DCO success & failure, to HAL

