

The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: Policy statement

CAP 1513



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About this document

This document sets out our policy in relation to the recovery of costs associated with obtaining planning permission for the new runway and capacity expansion at Heathrow Airport. These costs are termed Category B costs.

We have developed this policy following two rounds of public consultation: an initial proposals consultation published in July 2016 ([CAP 1435](#)) and final proposals published in November 2016 ([CAP 1469](#)). In addition we had consulted on the principle of risk sharing arrangements for planning costs in earlier public consultations in March 2015 ([CAP 1279](#)) and September 2015 ([CAP 1332](#)).

This Policy Statement is complementary to our decision to modify Heathrow Airport Limited's (HAL's) licence¹ to permit up to £10 million per year of efficient Category B costs to be recovered. It deals with Category B costs that are in addition to the £10 million of efficient costs already allowed for in the licence modification.

We are issuing this Policy Statement now in order to give reasonable certainty with respect to the regulatory treatment of this important category of costs. We will make proposals to modify HAL's licence to put these proposals into effect later in the process, as part of a full package of amendments to support the development of the capacity expansion.

¹ Available from this page: <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/>.

Chapter 1

Executive summary

- 1.1 This Policy Statement sets out our decisions on the regulatory treatment of the costs Heathrow Airport Limited (HAL) will incur in seeking planning permission to develop a new northwest runway and capacity expansion at Heathrow Airport. These are termed Category B costs (or planning costs).
- 1.2 The Government has identified the north-west runway at Heathrow as its preferred option for airport capacity expansion in the South-East of England. Our starting point is that consumers' interests would be furthered by the timely development of additional capacity and that we should put in place regulatory arrangements to incentivise efficient and timely delivery.
- 1.3 We have made it clear in our January consultation on our priorities and timetable for developing the regulatory framework for HAL² that it must, as a matter of priority, develop a scheme design that furthers the interests of consumers and that it must do so by engaging in a transparent and effective way with airlines and others stakeholders on the potential options, their costs and value for money. This emphasizes the importance of planning and thoroughly exploring an appropriate range of options to ensure that the final design is affordable and fit for purpose. Nonetheless, the planning costs associated with this process are substantial and so it is also important to encourage efficiency in this category of spending and to avoid wasteful expenditure.
- 1.4 We are also mindful that HAL, the airlines, and Secretary of State have all recently expressed support for making sure that future airport charges are maintained as close to current levels as practicable during and after the capacity expansion programme. HAL has committed as an early priority to work with the airlines and other stakeholders to explore whether there are

² See [CAP 1510: Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable](#).

design options that would see future charges rise by no more than inflation in any year. As we explained in our January consultation, it is important that HAL's business plans are both affordable and financeable, and that we develop the regulatory framework in a way that supports affordability and financeability as far as possible in accordance with our duties.

- 1.5 In finalising our policy on Category B planning costs, we have considered carefully the above factors, responses to our November 2016 proposals on the treatment of these costs, and our statutory duties.

Changes made to our November 2016 proposals

- 1.6 We had four responses to our final proposals. These were from HAL, International Airlines Group (IAG), London (Heathrow) Airline Consultative Committee/Airport Operators Committee (LACC/AOC) and Virgin Atlantic Airways (VAA).
- 1.7 The primary concerns of airlines were:
- the timing of the recovery of allowances for costs (with the airlines expressing the view that cost recovery should not commence until the capacity expansion is in place); and
 - the incentives for efficiency and allocation of risks created by our proposals for regulatory incentive mechanisms.
- 1.8 HAL expressed concern about the calibration of the regulatory incentive mechanisms and that we had said in our proposals that “we reserve the right to decide that HAL will be able to recover less than 85% of Category B costs, if there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process”.
- 1.9 In addition to reaffirming the importance of HAL planning carefully and thoroughly, exploring an appropriate range of options to ensure that the final design is affordable, financeable and fit for purpose, we are making the following changes to our earlier proposals:

- in deciding on how regulatory depreciation should be recovered, to focus on an approach which will enable us to ensure consistency with our wider decisions on the appropriate path of HAL's charges in the future (which should encompass both affordable charges for airlines and the financeability of HAL's forecasts of efficient expenditures). Recovery will not commence until after the outcome of the DCO process is known, the risk sharing adjustments have been applied and the amount to be recovered (in excess of the £10 million per year) is known;
- to address concerns that our risk sharing mechanism might incentivise HAL to spend excessively, to introduce a review point if cumulative efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million (including the £10 million per year already included in charges). This figure represents the estimate for planning costs that HAL has shared with the airlines. If efficiently incurred Category B costs approach this level, we may conduct a review of our policy for the recovery of Category B costs in excess of £265 million. The CAA's decision whether to conduct any review of this policy, and the scope of any review, will have regard to the expected materiality of any Category B costs in excess of the £265 million and any emerging evidence on the efficiency of spending;
- to reduce any inappropriate regulatory uncertainty which might undermine investor confidence, we are clarifying our statement on what happens to cost recovery in the event that HAL withdraws from the planning process. We want to make clear that we would seek to reduce the amount that HAL can recover below the 85% threshold set out in the risk sharing arrangements only in certain limited circumstances where there was compelling evidence that HAL had unilaterally withdrawn from the planning process. We would not expect to reduce planning cost recovery below the 85% threshold where HAL could demonstrate that it had used all reasonable endeavours to continue with the capacity expansion programme; and

- we have refined our proposals for governance arrangements as explained in Chapter 5 to complement the evolving arrangements between the airport and airlines on the role of the Independent Funds Surveyor (IFS) in the planning processes.

1.10 As noted below and in the following chapters, there are also a number of areas where we have kept our position largely unchanged from our final proposals.

Summary of the CAA's policy

1.11 Our final policy decision is that Category B costs should be defined as costs which are directly associated with, and solely for the purposes of, seeking planning consent for the delivery of new runway capacity, including through the Development Consent Order (DCO) process.

1.12 Category B costs incurred over £10 million per year should be capitalised and rolled into HAL's existing Regulatory Asset Base (RAB). These costs should be clearly identified as they are added to the RAB in order to allow the CAA and stakeholders to track and scrutinise the level of costs incurred.

1.13 Category B costs over £10 million per year should be subject to the following cost recovery arrangements:

- a 105/85 risk-sharing mechanism, which allows a 5% addition to costs incurred if a DCO is granted, but limits recovery to 85% of the costs incurred if a DCO is not granted;
- the starting date for, and profile of, regulatory depreciation for Category B costs in the RAB will be set consistently with broader considerations on the affordability of charges and the financeability of HAL's expenditure programmes; and
- HAL should receive a return on planning costs included in the RAB to cover its weighted average cost of capital (WACC) at the level determined in its price control settlements from time to time.

- 1.14 Category B costs incurred, including those recovered through the licence modification that we made on 21 December 2016, will be subject to ongoing governance processes and efficiency tests. To complement the existing IFS arrangements, where appropriate, a planning-focused Independent Planning Cost Reviewer (IPCR) will provide advice to the CAA on the efficiency of Category B costs. The CAA will make a final decision on the level of planning costs to be added to the RAB.
- 1.15 As noted above, we have clarified our position on the unilateral withdrawal of HAL from the planning process.
- 1.16 HAL should make the materials and reports produced for the planning process available to the CAA, the airline community and other stakeholders as soon as practicable. HAL should consult with the airline community at the outset on the rules and principles for classifying any such information as confidential and how this should be shared with stakeholders.
- 1.17 Our policy on Category B costs may be reviewed if efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million. The CAA's decision whether to conduct any review of this policy, and the scope of any review, will have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of spending.
- 1.18 Full details of our policy on Category B planning costs are set out in the following Chapters. We will deal with wider incentives in our June consultation.
- 1.19 We are issuing this Policy Statement now in order to give reasonable certainty with respect to the regulatory treatment of this important category of costs. We will make proposals to modify HAL's licence to put these proposals into effect later in the process, as part of the full package of amendments to support the development of the capacity expansion.

Our duties

- 1.20 In developing this Policy Statement, we have had full regard to our statutory duties under the Civil Aviation Act 2012 (CAA12) which are summarised in Appendix 1.

Structure of this document

- 1.21 The structure of this Policy Statement is as follows:
- Chapter 2: Recovery mechanism for eligible costs
 - Chapter 3: Definition of eligible costs
 - Chapter 4: Risk-sharing arrangements
 - Chapter 5: Promoting efficiency and transparency
 - Appendix 1: Our duties under CAA12

Chapter 2

Recovery mechanism for eligible costs

- 2.1 This Chapter sets out our policy decisions on how efficient planning costs incurred by HAL will be recovered. It sets out a summary of our November 2016 proposals, a summary of respondents' views, our thinking and final policy decisions.
- 2.2 Specifically, it covers our decisions in relation to:
- adding planning costs to the RAB, requirements relating to transparency, and the period over which these costs should be recovered;
 - the time from when these costs will be recovered; and
 - how we will adjust for the time value the money.
- 2.3 These matters are dealt with in turn below.

Adding planning costs to the RAB, transparency and the period over which these costs should be recovered

- 2.4 In our November 2016 proposals, we said that efficient Category B costs above £10 million per year should be capitalised and rolled into HAL's existing airport RAB. These costs would need to be identified clearly and transparently, as they may need separate treatment (including the application of risk sharing arrangements) from other capital projects. We also said that efficient Category B planning costs added to the RAB should be recovered over a 15 year period.

Stakeholder responses

- 2.5 Stakeholders had mixed views:
- while not all respondents agreed that planning costs should be included in HAL's overall RAB, the main concerns were to ensure

transparency and allow flexibility of treatment. Nonetheless, IAG said that our approach was inappropriate and that potentially speculative planning costs should not be treated as an asset;

- in relation to the cost recovery period, HAL considered our proposals to be a reasonable compromise between regulatory predictability and ensuring that a wider group of passengers who will benefit from the new capacity will pay for the costs incurred;
- there was some consensus among airlines that a depreciation period of fifteen years was not appropriate and it would be more appropriate to depreciate planning costs consistently with the expected life of the assets constructed for capacity expansion; and
- airlines expressed concern over prefunding and considered that the CAA's approach placed too great a burden on "existing users" and might distort the market between incumbent and new airlines. They suggested alternative approaches such as adopting unitised depreciation.

Our views

2.6 We note the different views about whether planning costs should be capitalised and added to the RAB and discussion as to whether this inappropriately infers that the Development Consent Order (DCO) is an asset. Adding these costs to the RAB will facilitate their recovery over an appropriate period that should allow for both affordable prices and financeable expenditure. We have also developed (as discussed in Chapters 4 and 5) incentives and processes to encourage and incentivise HAL to develop a high quality approach to its planning application and ensure costs are efficiently incurred. We regard this broad approach as entirely consistent with our statutory duties.

2.7 It will not be appropriate to create a separate RAB for planning costs, as this would be unnecessarily complex and would have no clear benefits. Nonetheless, the amount of planning costs added to the RAB should be clearly identified to maximise transparency. On this basis, HAL must ensure that these costs are reported separately in its regulatory accounts.

- 2.8 We have considered our approach to cost recovery periods further in the context of our January consultation on priorities and timetable, and the importance of ensuring that the development of new capacity remains affordable for airlines and the consumers they serve, as well as being financeable.
- 2.9 This suggests that we set the profile of regulatory depreciation and the timetable for recovery in line with these broader principles rather than a mechanistic approach based on a fixed recovery period or unitised depreciation. We hope that during this year we will make progress with both HAL and wider stakeholders (including airlines) on an appropriate profile for regulatory depreciation, including the portion relating to planning costs.
- 2.10 As the overall regulatory package is developed, this should allow us find an appropriate balance between existing and future users³ and help address concerns about the premature recovery of costs.

CAA policy decision

- 2.11 The CAA's policy decision is that Category B costs above £10 million should be capitalised and rolled into HAL's existing RAB. These will need to be transparently identified and separately reported in the regulatory accounts.
- 2.12 Category B planning costs added to the RAB should be recovered over a period which is consistent our broader approach to affordability and financeability.

³ For the avoidance of doubt, the CAA considers that it should interpret "future" users in line with the ordinary meaning of words and that this was the intention when CAA12 was enacted. We consider that this approach is supported by the fact that, as the airport will be a single operation once the new capacity opens, any user may use parts of the new capacity when using the airport (especially the new runway).

Cost recovery when planning permission is secured

- 2.13 Our November 2016 proposal was that cost recovery (via depreciation and the WACC) should start only when the result of the DCO process is known.⁴ Returns earned before this time would be tracked into the RAB and recorded in the regulatory accounts, rather than immediately added to airport charges.

Stakeholder responses

- 2.14 Respondents had a range of views on cost recovery:
- HAL suggested that recovery should be done consistently with the assets in the course of construction (AICC) approach, and that this would help stabilise the price profile; and
 - Airlines said that recovery should commence when the new capacity comes into use. They said this would be consistent with what happens in other sectors.

Our views

- 2.15 Because of the operation of the risk sharing mechanism described in Chapter 4, there are advantages in not starting cost recovery until the quantum of costs to be recovered from the RAB is known. This militates against using the AICC approach for recovering these costs. Therefore, we do not consider that it is appropriate to commence the recovery of the financing element of these costs as they are incurred.
- 2.16 We note the examples of other sectors provided by airlines and we agree that there are other plausible approaches to cost recovery. However, in the circumstances of capacity expansion, we consider that there are advantages in setting out now the approach to cost recovery to encourage HAL to engage in comprehensive discussions on the design of the capacity expansion (which should ultimately benefit airlines and consumers) and to reduce any unnecessary uncertainty which may tend

⁴ In practical terms, recovery of costs will start in the accounting year after the result of the planning process is known.

to increase its financing costs (that would ultimately be passed on to airlines and consumers).

- 2.17 We intend that the recovery of these costs will start after the decision on the DCO is known, but with the exact profile of regulatory depreciation to be determined as part of our broader approach to affordability and financeability. We consider that this will enable us to ensure, as the overall regulatory package is developed, that there is an appropriate balance between existing and future users. It will also help address concerns about any impact on the balance of charges between consumers using the airport both before and after any new capacity opens.

CAA policy decision

- 2.18 Our policy is that Category B costs added to the RAB should be recovered after the outcome of the DCO process is known with the profile of regulatory depreciation taking account of our broader approach to affordability and financeability.

Adjustment for the time value of money

- 2.19 Our November 2016 proposals were that HAL should be able to earn the WACC on Category B planning costs added to the RAB, with this being tracked into the RAB ahead of the decision on the DCO. The WACC would be consistent with that used in the Q6 settlement.

Stakeholder responses

- 2.20 Stakeholders expressed a variety of views:
- HAL and LACC agreed that it was appropriate to reflect investors' time value of money. LACC considered that this should be done retrospectively taking into account the value created by the planning permission; and
 - IAG and VAA took the view that no return should be applied: IAG considered that the costs were analogous to speculative R&D costs.

Our views

- 2.21 Given that we are not allowing the recovery of these costs until after the outcome of the DCO is known, we need to reflect the time value of money by applying a WACC to Category B planning costs added to the RAB.
- 2.22 Because we expect future charges to be regulated, the grant of the DCO should not generate a windfall gain for HAL, although it would benefit from the risk sharing arrangements discussed in Chapter 4. In the absence of a prospective windfall gain, we do not consider it appropriate to disallow recovery of the WACC or to set a different WACC for these costs.
- 2.23 On this basis, the CAA considers that it is appropriate for HAL to be able to recover a WACC return on its investment in Category B planning costs.

CAA policy decision

- 2.24 Our policy is that HAL should be able to earn the WACC on any Category B costs that are added to the RAB from the date they are incurred. The level of the WACC will be the same as that level determined for the price control settlement in force from time to time. The WACC will also be applied to the Category B costs in the RAB irrespective of whether the DCO is successful or not.

Chapter 3

Definition of eligible costs

- 3.1 This Chapter sets out our policy decisions on which costs will be recovered as Category B costs. It sets out our November 2016 proposals, a summary of respondents' views, our thinking and our final policy decision.
- 3.2 Specifically, it covers our decisions in relation to:
- the definition of Category B costs; and
 - the circumstances in which Category A costs may be reclassified as Category B costs.

Definition of Category B costs

- 3.3 We proposed to use the date of the Government policy decision on the preferred location of new runway capacity to distinguish between Category A costs (which are not recoverable) and Category B costs.
- 3.4 We proposed to define Category B costs as capacity expansion costs that are, in general, incurred by HAL after the Government policy decision on the location of new capacity (i.e. 25 October 2016) and are associated with seeking planning permission.
- 3.5 We provided a non-exhaustive list of these costs and proposed that they should be monitored by a governance group. The CAA would be advised on the efficiency of these costs by an Independent Fund Surveyor (IFS) before deciding on whether particular costs should be included in Category B or deemed inefficient.

Stakeholder responses

- 3.6 There was broad agreement on the definition of Category B costs across the respondents, although:

- HAL considered that the scope should be widened to include security costs and costs it had incurred prior to the Government announcing its preferred location for capacity expansion in the South East of England; and
- IAG considered that the scope should be narrowed to allowing recovery only of costs incurred after designation of the National Policy Statement (NPS) in relation to the new capacity.

Our views

- 3.7 The policy that the CAA has been developing through this series of consultations has been clearly focussed on costs relating to the grant of planning permission for the expansion project. We see no convincing reason to revisit what we have said on the definition of Category A costs. In terms of Category B costs, we will only allow additional security costs to the extent that HAL can clearly and persuasively demonstrate that they are directly associated with HAL seeking planning approval.
- 3.8 We do not agree that costs in relation to the preparation of the NPS should be automatically excluded from Category B, because the NPS is a key precursor to the DCO process.
- 3.9 It is important to note that we do not consider that Category B costs should include existing corporate costs that have been taken into account in the existing (Q6) price control settlement. We consider that only the incremental costs (for example in relation to staff costs) incurred by HAL associated solely with seeking planning permission should be included in Category B. Chapter 5 sets out further details on what transparency, supporting information and justifications we expect HAL to provide.

CAA policy decision

- 3.10 The CAA's policy decision is that we will permit costs to fall within Category B if they are:

- in general, incurred by HAL after the Government policy announcement on its preferred location for new capacity (25 October 2016); and
- associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow.

3.11 The November 2016 consultation listed the categories of costs which the CAA regards as directly associated with seeking planning permission and falling within Category B. These include:

- planning advice and consultants for master planning;
- environmental and sustainability advisory and consultancy;
- legal and professional advice;
- architectural, structural and engineering design;
- surveys on land, surface access and the environment;
- public consultations for the DCO processes;
- preparation of material for the Government's NPS; and
- costs incurred by the IFS in relation to planning matters.

3.12 This list is not exhaustive and should be used as guidance.

3.13 We consider that it is important that HAL takes a thorough approach to exploring options at the planning stage (in conjunction with the airlines and other stakeholders) and that the best option for consumers is developed. HAL should not have costs disallowed for reasonably exploring options, provided expenditure is not wasteful or inefficient.

3.14 There are existing governance arrangements involving HAL, airline representatives and the IFS that should assist in the monitoring of Category B costs. We will supplement this, where appropriate, with the appointment of an IPCR. These matters are discussed further in Chapter 5.

3.15 The CAA will make the final decision on whether any planning costs should be included in the RAB.

Reclassification of Category A costs

- 3.16 We proposed that some Category A costs could, in principle, be re-categorised as Category B costs if a strong and clear case is made by HAL that the information submitted for the planning process is not materially different from that submitted to the Airports Commission. At the same time, we said that we did not expect any Category A costs would be reclassified as we expected the design of the scheme to be significantly refined over time.

Stakeholder responses

- 3.17 HAL considered that Category A costs were part and parcel of, and essential for, the successful development of new runway capacity and that it had continued to incur these costs in the period between the Airports Commission final report and the Government decision. As they would not be recoverable from higher future returns, it considered that efficient Category A costs should be recoverable or reclassified much more readily as Category B costs.

Our views

- 3.18 We acknowledge that HAL has incurred costs in the period between the Airports Commission's final report and the Government's policy decision. However, we consider that costs incurred before the Government policy decision are analogous to bid costs which have been incurred by HAL to win the opportunity to build a new runway. Similar costs would also have been incurred by Gatwick Airport Limited, which are also not recoverable from users. The CAA does not, therefore, consider that these costs fall within the definition of Category B costs.
- 3.19 If HAL is of the view that any costs incurred before 25 October 2016 were, in fact, solely associated with seeking planning permission, rather than directed towards securing the Government's backing to build a new runway, then it must make a clear and compelling case to demonstrate that they should be included within Category B. We expect that it is likely

that it will be a demanding test as we expect that the scheme design will have evolved over time.

CAA policy decision

- 3.20 Category A costs are costs which were incurred by HAL during the Airports Commission process, or before Heathrow was named as the preferred location for new runway capacity on 25 October 2016. These costs are not generally recoverable.
- 3.21 On an exceptional basis, some Category A costs may be re-categorised as Category B costs if HAL can provide a strong and clear case that the information submitted as part of the DCO planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016.

Chapter 4

Risk-sharing arrangements

- 4.1 This Chapter sets out our policy decisions on how the risks relating to the investment made by HAL in seeking planning permission for the new runway capacity should be shared between HAL and consumers (via charges to airlines). It sets out our November 2016 proposals, a summary of respondents' views, our thinking and our final policy decisions.
- 4.2 Specifically, it covers our decisions in relation to:
- the principles and design of the risk sharing arrangements; and
 - cost sharing scenarios and possible further adjustments.

The principles of the risk-sharing arrangement

- 4.3 Our November 2016 proposal was that Category B costs should be subject to a risk-sharing mechanism on the basis that this would incentivise cost efficiency, encourage stakeholders to monitor the project and incentivise stakeholders to seek a positive outcome from the planning process.
- 4.4 Our final proposal was that a 105/85 risk-sharing mechanism should be put in place for efficient Category B costs incurred above the £10 million per year to be passed through into charges that has already been allowed through a modification to HAL's licence.

Stakeholder responses

- 4.5 Stakeholders expressed different views about the risk sharing proposals:
- HAL agreed with the principles of the risk sharing arrangements but objected to the asymmetric ranges for the risk sharing mechanism set out in the November 2016 proposals;

- IAG remained concerned because it considered that the purpose of economic regulation is to protect the interests of consumers, not to insulate the shareholders of the regulated business from risk in a way that they would not be in competitive markets;
- VAA said that some form of risk-sharing might be appropriate but had concerns that the calibration unduly favoured HAL; and
- LACC suggested there were two options regarding risk-sharing prior to DCO consent: (i) HAL bears all risk; or (ii) HAL and airlines jointly agree on cost expenditures.

Our views

- 4.6 We have consistently said that both HAL and airlines should face reasonable incentives in respect of planning costs to provide incentives for constructive stakeholder engagement and to provide incentives for efficiency. A risk-sharing mechanism should help deliver these objectives and so is consistent with furthering the best interests of users.
- 4.7 We consider that the present proposals represent a reasonable sharing of risk between stakeholders and expose HAL to a significant element of risk. Our approach represents an evolution from policy for previous large airport infrastructure projects (e.g. Terminal 5 at Heathrow and the second runway at Stansted), where airport investors enjoyed 100 per cent protection from the risk of stranded planning costs. In this sense, it offers better protections for airlines than in previous capacity expansion programmes.
- 4.8 We recognise that respondents to the November 2016 proposals had very different views about the appropriate calibration of risk sharing factors. As we set out in our November 2016 proposals, we consider that a 5% additional return balanced against a 15% financial detriment is proportionate and reflects the likelihood that the grant of a DCO is more likely than not (although it is not certain).
- 4.9 We are not persuaded by HAL's argument that the asymmetry may impact financeability as Category B costs are forecast to comprise a relatively

small percentage of the overall project costs. Even in the event that the DCO is not granted, HAL would be able to recover 85% of these costs.

- 4.10 We are also not persuaded by airline suggestions that the majority, or all, of the risk is transferred to HAL, as this might be interpreted as signalling a significant increase HAL's risk profile and could have a consequent adverse impact on the cost of capital. This would be inappropriate ahead of wider decisions due later in the process on how we can develop the overall regulatory framework to support efficient financing and affordability. In addition, it is not appropriate to compare the project to an unregulated commercial development because HAL's charges will continue to be subject to economic regulation.
- 4.11 Nonetheless, we are mindful of the need to retain a balance in the incentive arrangements. In particular, we remain at the early stage of the planning process and there is uncertainty about the future level of costs.
- 4.12 To address concerns that our risk sharing mechanism might incentivise HAL to spend excessively, we have introduced a review point into our policy, if cumulatively efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million (including the £10 million per year already included in charges).
- 4.13 This figure represents the estimate for planning costs that HAL has shared with the airlines. HAL has stressed this is an initial high level forecast for the period to DCO consent, which was originally created in summer 2016, and the actual level of costs will evolve with time. It has also said that the estimate is lower than the costs incurred ahead of planning consent by other major infrastructure programmes, including Thames Tideway and Hinkley Point C.
- 4.14 If efficiently incurred Category B costs approach or exceed this level, we may conduct a review of our policy for the recovery of Category B costs in excess of £265 million. In taking any decision whether to conduct any review of this policy, and on the scope of any review, the CAA will have

regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of these costs.

CAA policy decision

- 4.15 Our view remains that Category B costs should be subject to a risk-sharing mechanism. The risk sharing factors will be 105/85 for Category B costs incurred above £10 million per year.
- 4.16 If efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million, we may conduct a review of our policy for the recovery of Category B costs in excess of £265 million. In taking any decision whether to conduct any review of this policy, and on the scope of any review, the CAA will have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of these costs.

Cost sharing scenarios and possible further adjustments

- 4.17 Our November 2016 proposal was to apply a simple approach to the risk-sharing scenarios, namely either success or failure.
- 4.18 We also said we would reserve the right to decide that HAL will be able to recover less than 85% of Category B costs, if there were to be clear and compelling evidence that it had unilaterally withdrawn from the planning process.

Stakeholder responses

- 4.19 HAL continued to support the scenarios defined by the CAA. It said they create an objective test of success or failure and generate appropriate incentives to achieving planning consent in a timely and efficient manner.
- 4.20 It was, however, concerned by the possibility of recovering less than 85%, and described this as arbitrary and subjective, potentially creating uncertainty and potentially giving rise to an impact on financeability.

Our views

- 4.21 We would seek to use our discretion to reduce recovery below the 85% threshold set out in the risk sharing arrangements only in certain limited circumstances where there was compelling evidence that HAL had withdrawn from the planning process. We would not expect to reduce planning cost recovery below the 85% threshold where HAL could demonstrate that it had used all reasonable endeavours to continue with the capacity expansion programme. For example, we do not consider that HAL would have unilaterally withdrawn from the process if the Government withdrew its support (for example if the NPS were not to be approved).

CAA policy decision

- 4.22 Our policy decision is to apply a simple approach to the risk-sharing scenarios, namely either success or failure.
- 4.23 To reduce any inappropriate regulatory uncertainty which might undermine investor confidence, we are clarifying our statement on the withdrawal of HAL from the planning process. In particular, we want to make clear that we would seek to use our discretion to reduce recovery below the 85% threshold set out in the risk sharing arrangements only in certain limited circumstances where there was compelling evidence that HAL had withdrawn from the planning process. We would not expect to reduce planning cost recovery below the 85% threshold where HAL could demonstrate that it had used all reasonable endeavours to continue with the capacity expansion programme.

Chapter 5

Promoting efficiency and transparency

- 5.1 This Chapter sets out our policy decisions that provide extra assurance that HAL will only recover efficient planning costs from airlines. It deals with the governance to be put around HAL's expenditure, requirements for transparency and the provision of supporting information. It sets out our November 2016 proposals, a summary of respondents' views, our thinking and our final policy decisions.
- 5.2 Specifically, it covers our decisions in relation to:
- the creation of a planning IPCR and associated governance; and
 - ensuring transparency around the planning materials produced.

Creation of an Independent Planning Cost Reviewer at Heathrow and associated governance

- 5.3 Our November 2016 proposals involved setting up a planning-focused IFS to provide an ongoing assessment of the reasonableness of the Category B costs incurred. The intention was that this would provide an independent view on cost efficiency, to drive good behaviours and provide advice on the processes being followed.

Stakeholder responses

- 5.4 There was broad support for arrangements building on the existing capital expenditure governance structure that sought to ensure efficiency and transparency to facilitate the passing through of efficient costs.
- 5.5 Nonetheless, respondents expressed concerns that:
- these governance structures were not yet in place and did not give airlines a veto or full control over Category B costs;

- neither the airlines nor the IFS had the skills or experience to ensure cost efficiency;
- more detail was required on how inefficient cost would be disallowed;
- the CAA should use a range of tools, drawing on examples from other sectors, to ensure transparency and accountability; and
- the CAA should take a more active role in ensuring economy and efficiency in the DCO process.

Our views

- 5.6 We note the broad support for having a process to scrutinise Category B costs modelled on the existing IFS. In the notice to modify the HAL licence to allow annual recovery of £10m of Category B costs⁵, we said that a clear governance structure or protocol should be set up as a matter of urgency to ensure that the IFS can work and advise effectively on the efficiency of Category B costs. A draft governance protocol was described in that notice and we said that this would be required under Condition F1 of the licence. That notice said the protocol should cover the pass through of the £10 million of Category B costs each year and should be developed in such a way that it could be extended and amended to complement our final policy decision on the Category B costs incurred above the £10 million threshold.
- 5.7 We remain of this view and are pleased to note that HAL and the airlines have made progress in expanding the role of the current IFS to address planning issues. We understand the IFS will offer real time views to HAL and the airline community on the reasonableness of the development of HAL's master plan and DCO submission.
- 5.8 However, in order to address airlines' concerns, in addition to the valuable role of the IFS, to complement the existing IFS arrangements, where appropriate, we will also seek further independent advice (to be provided

⁵ This is available at: <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/>.

to us, rather than to HAL or airlines) on the Category B costs that HAL incurs. To avoid confusion with the current role and activities of the IFS, we will refer to this role as the IPCR. The CAA will make a final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.

- 5.9 As noted earlier, HAL should not have costs disallowed for reasonably exploring options, provided expenditure is not wasteful or inefficient. However, it should not be able to recover corporate costs that have been taken into account in the existing (Q6) price control settlement. We consider that HAL should put in place robust arrangements that demonstrate that costs are genuinely incremental to its business as usual activities.
- 5.10 In the light of these considerations, we have clarified our expectations in our policy decision below.

CAA policy decision

- 5.11 We will appoint an IPCR in a role that is separate from, and complementary to, the IFS to scrutinise and advise the CAA on the inclusion of Category B costs in the RAB. Activities undertaken by the IPCR may include providing:
- advice to the CAA on Category B costs (including whether particular costs should be included within Category B, whether Category B costs have been efficiently incurred and scrutinising staff costs and other costs to ensure that they are incremental to those included in the current Q6 settlement); and
 - periodic reports to the CAA (copied to HAL and the airlines) at key decision points in the planning process.
- 5.12 The CAA will make a final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.

- 5.13 HAL is required to develop a governance protocol on Category B costs to support the role of the IFS and IPCR under Condition F1 of the licence, for agreement with the airline community by 1 April 2017. This governance protocol should be based on the following procedures:
- HAL must produce a 12 month indicative budget and supporting information, within a reasonable time in advance of each new Regulatory Year (as that term is defined in HAL's licence under CAA12), broken down into sufficient detail to allow for *ex ante* scrutiny by the IFS and airlines;
 - planning costs incurred will be scrutinised in a governance group comprised of HAL, the airline representatives and the IFS (which should meet at least quarterly);
 - where the airlines or IFS raise issues of substantial concern, these may be investigated further by the IPCR and/or CAA;
 - the CAA may also independently investigate issues relating to the efficiency of planning costs (with the assistance of the IPCR where appropriate) where it considers this is warranted;
 - HAL must record the expenditure on planning costs on a monthly basis (with any items over £100k itemised individually) together with a reconciliation against the budget;
 - HAL must provide an annual statement of the planning costs that it has incurred within four months of the end of each Regulatory Year in sufficient detail to allow effective scrutiny by the IPCR and/or the CAA; and
 - The CAA will make a final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.
- 5.14 If agreement on the governance protocol cannot be reached, the matter should be referred to the CAA to make a determination under Condition F1.7, which the CAA would make by 1 July 2017.

Transparency around planning materials produced

- 5.15 Our November 2016 proposals were that HAL should make materials and reports prepared for the planning process available to the airline community, the CAA and relevant stakeholders as early as practicable. Stakeholders should agree in advance the rules around the timing of when information should be shared and how to handle confidential information.

Stakeholder responses

- 5.16 HAL noted that it had set up an online portal for the airlines to get access to the latest data and documents as part of recent airport-airline engagement.

Our views

- 5.17 We agree that an online portal is useful tool that could be used to share planning materials and reports and will enhance transparency. We look forward to seeing stakeholders working together to agree on the timing of sharing information and on handling confidential information.

CAA policy decision

- 5.18 Our policy decision is that HAL should make materials and reports prepared for the planning process available to the airline community, the CAA and relevant stakeholders as early as practicable.
- 5.19 Stakeholders should agree in advance the rules around the timing of when information should be shared and how to handle confidential information. In the absence of such agreement, the CAA will consider further regulatory action to ensure that the objectives of this policy are met.

Appendix A

Our duties under CAA12

1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (AOS), including capacity expansion, are set out in the Civil Aviation Act 2012 (CAA12).
2. CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 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 AOS.
3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of ‘consumers’.
4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
5. In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These secondary duties include:
 - the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the Better Regulation principles.

6. In relation to the capacity expansion at Heathrow airport, these duties relate to the CAA's functions concerning the activities of HAL as the licence holder at Heathrow.
7. CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and Gatwick Airport Limited are subject to economic regulation.
8. We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.