

Chief Executive's Office

Philip Rutnam

Permanent Secretary
Department of Transport,
Great Minster House,
London
SW1P 4DR

26 May 2016

Dear Phillip,

Economic Regulation and Expansion of Airport Capacity

I understand that a package of material will be provided to Ministers in advance of a possible Government decision this summer on the expansion of airport capacity in the South East of England. To assist you in preparing that package, your team has requested that the CAA sets out its position on the economic regulation of any new capacity.

The CAA agrees with the conclusion of the Airports Commission that there is a clear case for new runway capacity in the South East of England before 2030. Without an additional runway, consumers will suffer from higher prices, reduced choice and lower service quality. Given our primary duty under the Civil Aviation Act 2012 (CAA12), the CAA will be a strong supporter of a Government decision in favour of construction of a new runway capacity, respecting that the choice of location is a matter for Government.

We acknowledge the Government's role as an enabler of runway capacity expansion, for example, through the publication of a National Planning Statement (NPS). We also recognise that there will be interactions between the regulatory frameworks applying to airports, roads and railways. The CAA will continue to work closely with DfT and other relevant bodies, including the Office of Road and Rail and Highways England, throughout the development of the project. I'm pleased to say that our teams have a solid collaborative and open relationship while respecting the different roles we play.

Context

It is important to acknowledge the context that underpins the regulatory framework that will apply to any new runway capacity:

- whichever promoter is chosen by the Government to deliver the capacity, the nature of this project is unprecedented in economic regulation;
- the CAA's work in relation to the economic regulation of new runway capacity will be conducted in accordance with its primary duty, which is to further the interests of passengers and cargo owners ('consumers') as well as our other duties under CAA12;

- any decision that the CAA makes under CAA12 will be subject to public law principles (so that, for example it cannot by this letter, or otherwise, fetter its discretion) and, in relation to licence modifications, will be subject to a right of appeal by licence holders or providers of air transport services whose interests are materially affected by the CAA's decision; and
- the regulatory process is at an early stage; the CAA will need to consult extensively with all relevant stakeholders to ensure that our economic regulation policy furthers the interests of users in accordance with our duties under CAA12. It should be noted that the airport promoters have only just started to share with the CAA their high level plans for the design, cost, and financing of new runway capacity.

Regulatory architecture

We have considered whether the current regulatory framework provided by the CAA12 is appropriate to deliver new runway capacity. In doing so, we have approached this review on the basis that the existing airport owner will promote and deliver the new capacity. Bearing in mind DfT's understandable desire to avoid unnecessary uncertainty and delay once the Government has made its decision, we have no grounds at present to believe that the existing statutory basis for economic regulation must be changed to accommodate airport capacity expansion. Given we are, however, at such an early stage, we will keep this position under regular review, and will inform the DfT at the earliest opportunity if it becomes apparent to us that changes to the existing regime are required.

We will continue to learn from others to help us to develop an effective regime for the economic regulation of new airport capacity. We have reviewed the tools used in other contractual and regulatory regimes for major infrastructure projects. Whilst we consider that the structures used for the Thames Tideway Tunnel and Hinkley Point C projects do not appear to be directly transferable to airport expansion, there are still some relevant lessons that we can learn from them. These include the importance attached to long-term certainty, clarity around risk allocation, and the benefits of competitive tension to establish efficient financing and construction costs.

We understand that a Government support package was developed for the Thames Tideway Tunnel to manage certain risks and that a package has also been developed for the Hinkley Point C project, to cater for a change in Government policy. We note, however, that a Government support package is not currently your preferred approach for new runway capacity.

We have identified a number of key strategic risks that have the potential to affect the delivery of new runway capacity that will require ongoing monitoring and mitigation. These include:

- (i) insufficient confidence of actual and potential investors and creditors creates a financing challenge for expansion;
- (ii) the failure to achieve cost-efficient expansion;
- (iii) the failure to engage airlines appropriately during the process;
- (iv) a preferred promoter enters into financial distress;
- (v) a preferred promoter perceives a strategic interest to improve its financial position by forcing the re-opening of a regulatory settlement through refusal to develop new capacity (a 'hold up' scenario); and
- (vi) withdrawal of political support for expansion.

The CAA has the ability to develop a range of regulatory tools under CAA12 to help manage the first five risks. In mitigating the first risk we appreciate that we may need to consider augmenting our standard economic regulatory model to reflect the scale and complexity of the project. Our ability to mitigate the second and third risks will be enhanced if there is a clear expectation from both the CAA and the Government that the successful promoter must engage collaboratively with the airline community and other stakeholders on the precise design for new capacity so that the right type of scheme is designed and built at

the right cost. There should also be an expectation around transparency and harnessing the benefits of competitive tension wherever appropriate.

We are keen that we and DfT continue our current work on considering whether there may be other mechanisms that might help us address the fourth and fifth risks to ensure that delivery should continue, if we were faced with an extreme scenario. The sixth risk will need to be mitigated by Government, the successful promoter and the airlines all working together.

Process

The CAA recognises the desirability of providing greater certainty around its policy on the extent to which the costs of new runway capacity might be recoverable from airport users. We envisage a similar process and timetable for the three shortlisted options selected, with some specific changes to recognise the differences in the licensing arrangements currently in place at Heathrow and Gatwick.

We have already published a number of policy documents for consultation including in March 2015, September 2015 and February 2016. We expect to issue a number of further consultation documents in the coming months on different elements of our regulation of new airport capacity, starting with a consultation on the treatment of planning costs. We will then publish our policy conclusions on these issues and implement (subject to appeal) any licence modifications required. More details on our current thinking on these issues are set out below.

With a location decision in favour of either option at Heathrow, we could bring the economic regulation of new runway capacity into our work on the new price control for the 7th regulatory period for Heathrow Airport Ltd (HAL), referred to as 'H7'. Work on the new price control commenced in March 2016, with the revised licence required from 1st January 2019.

Recent consultation with the industry, however, suggests some support for extending the existing price control (Q6) by one or more years, to enable airports and airlines to focus on new runway capacity from the outset. Under such an extension, we could still complete the regulation of new capacity by the end of 2018, but elements of the H7 price control (such as service quality) could be completed in the following year. We would need to consult with interested parties on this extension option.

Following discussions with the successful promoter and airlines after a Government location decision, we would expect to issue a consultation document focusing on the overall architecture or economic regulation framework. This would cover issues such as:

- the long-term nature of capacity expansion and whether this should be reflected in the length and structure of the price control; and
- the importance of issues such as prefunding and the overall timetable for the regulatory process.

Subsequent consultations would cover incentives and efficiency in more detail, and might include:

- delivery obligations and incentives, where an airport operator is required to use best endeavours to develop its airport infrastructure/capacity in an economic and efficient manner to meet the reasonable requirements of users for additional capacity; and
- approaches to driving cost efficiency, such as the use of capital expenditure triggers and incentives, clawback provisions and increased scrutiny of costs by independent parties.

The process and timetable in response to a location decision in favour of a Gatwick runway would be similar, but we would first of all assess, and then consult on, the most suitable form of regulation. This is because, in 2014, the CAA changed the way that it regulates airport charges and services at Gatwick, moving from calculating a price cap to a more "deregulatory" approach, relying on specific licence-backed commitments given by Gatwick

Airport Limited. Should Gatwick be chosen as the location for new runway capacity, the CAA would need to make a decision whether this form of regulation was suitable for new runway capacity, or whether we would need to return to a more “traditional” Regulatory Asset Base (RAB) model (or, indeed, some other methodology). A revised GAL licence and price control conditions could also be in place by the end of 2018.

We are mindful that there will be significant interactions and dependencies with the NPS and DCO processes and that we may need to adjust our timetable as a result. Given the scale and complexity of this project, we are conscious that we may also need to adjust our timetable if the successful airport promoter requires more time to work constructively with the airlines, local communities, etc on its scheme design and cost. We are mindful that the Thames Tideway Tunnel and Hinkley Point C structures both took a considerable amount of time to develop, agree and implement and that trying to give regulatory certainty prematurely may not be in the interests of consumers.

Treatment of planning costs (or ‘Category B’ Costs)

We have previously recognised that the treatment of Category B costs needed to be addressed separately and more quickly than that of the overall economic regulation framework. With that in mind, we published in February 2016 a document setting out principles and issues related to the recovery of planning costs and encouraged discussions between airport operators and airlines on the subject. Since then, some preliminary discussions have taken place and views exchanged between parties and with the CAA.

As indicated above, assuming a Government decision is made in the summer, we plan to publish a consultation shortly thereafter setting out our initial views on the regulatory mechanism for the recovery of costs associated with obtaining planning permission for new runway capacity. The consultation will consider the definition of eligible Category B costs, which are (so far) defined as the costs associated with seeking planning consent. After suitable consultation, implementation of our policy will follow and deal with any planning costs incurred by the airport operator from immediately after the Government location decision.

Mitigations

We have previously recognised that spending on mitigations may be significantly higher than has been the norm in the UK due to the level of potential detriment to those affected by new capacity. In relation to any proposed mitigations, the CAA has a secondary ‘environmental duty’ that is aimed at ensuring economic regulation is consistent with an airport’s environmental obligations (resulting from both environmental and planning law) where the measures are:

- in the interests of users; and
- designed, implemented and delivered in an economic and efficient manner.

Where mitigations are referred to in an NPS and/or are backed by legal requirements, it would be easier for the CAA to have regard to the efficient costs of meeting these mitigations as being part of the ‘price’ of the promoter being able to develop the successful airport. We should also keep under review whether there is at any time the scope or need for ministerial guidance under the CAA12 in relation to the treatment of mitigations and community compensation measures.

Surface Access

The CAA recognises that significant investment in surface access infrastructure may be required to enable expansion to proceed and to accommodate the additional journeys that will be generated by expansion. This includes investment that might otherwise have taken place at a later date, but needs to be brought forward because of the additional journeys generated by airport expansion.

The CAA has previously stated its willingness to allow some of the costs of surface access investment to be recovered from airport passengers and cargo owners. Any such recovery would be subject to criteria including the delivery of net benefits to airport users, cost minimisation, the maximum practicable direct contributions from users of surface access facilities, and a sharing of the remaining net costs based on the share of benefits going to airport users and non-airport users. Costs in such cases should be measured against a base case that includes planned future upgrades by Government that would be carried out absent any further airport growth.

The CAA's current policy¹ is to allow the efficient cost of surface access investments to be recoverable from airport users where these principles are met or where these investments are required by the 'planning process' and are deemed either necessary to facilitate an expanded airport or essential to the design and operation of an expanded airport.

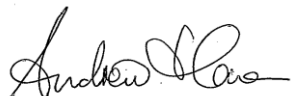
I hope that this provides you with clarity on how we intend to proceed. You will appreciate that it is difficult at this stage to set out further detail given there has not been a Government decision on location and the two airport operators are now only beginning to engage with us on their plans and financial programmes pending conclusions of their discussion with Government.

I do not have any objections to this letter being published at the appropriate time, but I will leave that decision to you given it is intended to be part of your broader policy making process.

Please let me know if you would like to discuss any aspect of this letter. In any event, can I suggest that we aim to meet in July when the landscape may be clearer.

Finally, can I take this opportunity to place on record thanks to your team for the collaborative and constructive way they have engaged with us to date.

Yours sincerely



Andrew Haines
CHIEF EXECUTIVE

¹ See Annex D of 'Airports review - policy issues: consultation paper' CAA Dec 2005.

http://webarchive.nationalarchives.gov.uk/20140713054907/http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportsreview_dec05.pdf