Caroline Low
Director, Airport Capacity Directorate
Department for Transport
1/27 Great Minster House
33 Horseferry Road
London
SW1P 4DR

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Dear Caroline

Designated Airports National Policy Statement: the CAA's approach to economic regulation of capacity expansion at Heathrow aiport

We wrote to the Department in May 2016[1] and April 2018[2], outlining our initial views on the approach to the regulation of capacity expansion at Heathrow airport and the risks that were then apparent. We have also continued to develop our thinking on the regulatory framework for HAL through a series of consultations and working papers.

In parallel, we have been monitoring and reporting to the Secretary of State under section 16 of the Civil Avitation Act 1982, about how well HAL is engaging with and responding to the airline community on its plans for capacity expansion and whether this engagement is appropriately reflecting consumers' interests (the "Enhanced Engagement" reports). We sent our latest Enhanced Engagement report to the Secretary of State on 14 May 2019.[3]

You have asked for an update of the CAA's views on:

- the assessment of the risks the CAA is currently managing in relation to the economic regulation of capacity expansion at Heathrow airport; and
- our previous assessment of the adequacy of the CAA's powers – i.e. whether the previous conclusion that the CAA's powers are sufficient still holds.

We deal with these in turn below.

An update on risks

When we wrote to the Department in 2018, we highlighted the following risks and challenges:

(i) actual and potential investors and creditors have insufficient confidence in the expansion programme, creating a financing challenge;

(ii) cost efficient expansion cannot be achieved, including risks:
   - that consumers' interests are not properly reflected in the overall scheme design; and
   - the scheme design is not affordable and financeable.

(iii) airlines are not appropriately engaged during the process, including the related risks that:

[1] See link
[2] See link
[3] See link

- airlines have views that are not aligned with the interests of consumers;
- airlines (and potential third-party developers who are in discussions with them) may become frustrated by a lack of genuine engagement by HAL in considering alternative means of delivering expansion and attempt to obstruct further progress; and
- even if they are fully engaged, alignment is not possible between key stakeholders to produce a legitimate outcome, which might undermine delivery through public criticism or legal challenges.

(iv) HAL suffers financial distress;

(v) HAL or its shareholders might stop pursuing the development of new capacity; and

(vi) political support for expansion might be withdrawn.

While we have further developed aspects of our thinking on the regulatory framework (for instance see our consultations of October 2018[4] and March 2019[5]) and HAL's plans have developed significantly (it has produced its preferred masterplan for consultation) our present view is that the broad risks set out above remain appropriate. Nonetheless, HAL is also reviewing options for the level of its pre-DCO spending and this together with other pressures on the timetable increase the risk of delays to the delivery of an operational third runway at Heathrow compared to HAL's current target date of 2026. Bearing this in mind it is appropriate for us to supplement risk (ii) with a further consideration "that the timetable for opening of new capacity is unduly delayed and/or early expenditure is made prematurely given the wider risks to the programme".

Our approach to risk management and mitigation

As we noted in our letter of April 2018, our primary approach to managing **risks (i) to (v)** is to use our powers under CAA12. This is supported by our ongoing commitment to maintaining the stability of the regulatory regime where appropriate, for example, through our confirmation that we will continue to use the regulatory asset base and single till that are well understood by investors and airlines. We also noted that Government may have a role to play in the management of some of these risks.

We are also seeking to broadly align our work on the regulatory framework with the wider programme for capacity expansion to allow us to set HAL's next main price control on the basis of the best available information. Bearing this in mind we are working to put in place arrangements (taking account of the commercial deals that have been agreed between HAL and certain airlines) for a two year interim period to apply in 2020 and 2021. This should allow more time to develop the regulatory framework for capacity expansion and for the increased maturity of HAL's plans, and both these factors should help with the management of risks (i) to (v).

Nonetheless, this transitional period does not deal with all the uncertainty about the wider programme timetable and as we have noted above HAL is currently reviewing options for the level of its pre-DCO spending and the overall timetable. If it becomes clear that 2026 is no longer an appropriate target date for the openning of the new runway then we will need to consider whether the timetable for developing HAL's next main price control remains appropriate. There are advantages in avoiding a further transitional period and we may be able to retain an approach of setting the next main price control from the start of 2022 and deal with any uncertainty arising from delays to the wider capacity expansion programme through adjustment mechanisms in the price control. We will make decisions on these matters after HAL provides more information on the options for the timetable and following further discussions with stakeholders. In doing so, we will also be mindful of the advantages of being able to develop the regulatory framework in a way that allows us to best manage risks (i) to (v).

[4] See CAP 1722.

[5] See CAP 1782.

In relation to **risk (i)** our primary focus will be on developing an approach to financeability and the cost of capital that allows for the efficient financing of capacity expansion. This will involve identifying regulatory arrangements that provide for reasonable incentives on HAL's management to deliver capacity expansion efficiently but at the same time do not create undue risks that would jeopardise HAL's access to cost effective investment grade debt finance. In this way, we intend to develop a package of regulatory measures that provides for the delivery of capacity expansion at the most efficient level of overall costs – taking account of both financing and capital costs. This approach will be consistent with our statutory duties and should provide the best protection for the interests of consumers. We have appointed Centrus as specialist financial advisors to help us develop a robust approach to financeability that best supports the affordable delivery of the capacity expansion programme at Heathrow airport. HAL has an important role to play in relation to these matters and it is also important that it develops an efficient and affordable plan for capacity expansion, which will help support overall financeability.

For **risk (ii)**, we are continuing to consider appropriate roles for both *ex ante* incentives (i.e. incentives based on HAL bearing a pre-determined share of any variances from the forecast of costs made in setting the price control) and *ex post* incentives (i.e. incentives relying on subsequent review of HAL's spending).[6]

Although HAL has been able to retain an overall budget for enhancement expenditure of about £14 billion (in 2014 prices) for the period to its target date for the opening of the new runway in 2026, its forecasts of pre-DCO costs (which are an important component of the £14 billion) have risen significantly and in response to this, we have published a consultation on early costs and the regulatory timetable (CAP1819) in early July 2019 on these matters.[7] Pre-DCO spending creates particular risks and issues as it may both support timely delivery of capacity expansion, but if HAL were not to be granted consent for its DCO application, then this would be largely wasted expenditure. As noted above, we have asked HAL to review options for the level of this expenditure and the implications of these options for the overall programme timetable and for consumers. There are also other pressures on the programme timetable HAL's current target date for runway opening of 2026.

It is not uncommon for the target dates for the delivery of large infrastucture projects to be revised and these issues do not necessarily reflect issues with the framework for economic regulation. Nonetheless, the established approach to setting price controls and making licence modifications naturally involves a relatively extensive and time consuming process given the importance of both the issues and consultation. In the circumstances where new or modified licence conditions are required, these are likely to take time to implement and this may limit our flexibility in responding to developments in the wider programme. This may be the case with respect to the treatment of early costs in HAL's licence and these matters are discussed further in our July 2019 consultation on early costs and the regulatory timetable.

We have also continued work on the development of a licence condition to reflect consumers' expectations by requiring HAL to conduct its business so as to secure the economical and efficient: (a) operation and maintenance; and (b) timely and appropriate enhancement and development of the airport. The CAA's Board will consider in July whether formally to propose introducing this condition into HAL's licence in July 2019, with the intention that the new condition would come into effect in January 2020.

In June 2019, we also published our latest assessment of affordability and financeability[8]. This is initial analysis and significant uncertainties remain, nonetheless we were able to develop a base case informed by information from HAL's preferred masterplan, with additional illustrative scenarios. The analysis indicates that there are a range of credible scenarios that are both affordable and financeable. There are also scenarios where affordability and financeability would be more difficult and unsurprisingly lower costs and a lower cost of capital lead to greater affordability, but a lower cost of capital can also put pressure on financeability. These

[6] See the discussion of incentives for capital expenditure efficiency in chapter 2 our March 2019 Consultation.

[7] See link.

[8] See CAP 1812.

broad findings are consistent with the results of the assessment in our April 2018 Consultation of these matters. We will further develop our assessment of affordability and financeability as our work to develop the regulatory framework and price control arrangements for HAL continues.

We have also asked the Consumer Challenge Board (CCB) to review HAL's approach to consumer engagement and report on how well the interests of consumers are reflected in its preferred masterplan.

We are seeking to manage **both risks (ii) and (iii)** through:

- our ongoing monitoring and reporting[9] to the Secretary of State on how well HAL is engaging with and responding to the airline community on its plans for capacity expansion and whether this engagement is appropriately reflecting consumers' interests (Enhanced Engagement);
- the particular emphasis of our May 2019 Enhanced Engagement report on the importance of HAL delivering high quality and timely information to support the M5a gateway in early 2020, when airlines will have a formal opportunity to express their commercial views on the overall viability of the scheme, including in relation to operability, deliverability and affordability. We are working with HAL and the airlines to monitor information sharing leading to the M5 process to help ensure any issues with respect to the timely delivery of high quality information are properly addressed; and
- our continuing expectation that HAL will stand by its public commitment to engage in good faith with the airlines and third parties coming forward wishing to develop alternative commercial arrangements for the delivery of elements of the capacity expansion programme, and we will review any evidence that it has not done so (with a view to establishing whether this provides evidence of inefficiency).

We remain conscious that, given the scale and complexity of the capacity expansion programme at Heathrow airport, there will be risks to delivery, including the possibility of legal challenge to the regulatory and/or planning processes. Encouraging good quality engagement between all stakeholders should help manage these risks and HAL has a particularly important role to play in properly managing these risks. Nonetheless, the section below on enhancements to the regulatory framework notes some of the challenges arising from the proposals being brought forward by the Arora Group in relation to "Heathrow West".

In relation to **risk (iv)**, we have noted above our approach to taking account of financeability in developing the overall regulatory framework and we also intend to publish a working paper on the financial resilience and ring fencing arrangements applicable to HAL in the near future. Although we continue to regard the residual risks of financial distress of HAL as being relatively low, if it were to occur, the regulatory framework would only be able to provide limited mitigating actions and we or other stakeholders might request Government action to help protect the interests of consumers.

We have previously discussed our view that **risk (v)** includes a risk that HAL or its investors will "hold out" for a better regulatory settlement or Government support before continuing with capacity expansion. This could happen at any stage of the process, although once HAL has spent significant sums and we start to formulate proposals for a new price control, this becomes a riskier strategy for HAL to pursue. Our approach to the regulatory treatment of HAL's planning costs and other pre-DCO spending is discussed further in our July 2019 consultation on early costs and the regulatory timetable.

However, as we have said before, the CAA12 cannot be used to compel investors to make the scheme of capacity expansion happen. If the Government wishes to put the promoter under an obligation to deliver, it will need to rely on other levers, as in other sectors.

Finally, **Risk (vi)** will need to be mitigated by the Government, the successful promoter, the airlines and the CAA all working together.

[9] See link for our Enhanced Engagement/Section 16 reports.

Enhancements to the regulatory framework

As we have noted above, the CAA's work in relation to the economic regulation of new runway capacity at Heathrow airport is conducted in accordance with its primary duty under the CAA12 to further the interests of present and future consumers, as well as our other duties. Any decision that the CAA makes in relation to economic regulation will be subject to public law principles that ensure that the CAA must act within its powers.

While the CAA's licensing framework remains the primary tool for managing the economic risks around the development of new capacity, the licence conditions which could be used will mostly not be in place until the full price control for the development of new capacity is in place, currently anticipated to commence in 2022. As noted above, we have consulted on the possible introduction of a new licence condition from the start of 2020 requiring HAL to conduct its business in a way that is economical and efficient. Nonetheless, the framework presently contained in HAL's licence will be of only very limited direct assistance in managing the risks identified above.

While we continue to make significant progress with developing and consulting on policy, which is an essential stage in the licence modification process, we will need to go through the processes required by the CAA12 to put in place the licence modifications that are necessary or expedient to deal with the issues raised by the development of new capacity, and any such modifications will be subject to the rights of appeal held by HAL and materially affected airlines to the Competition and Markets Authority. As noted in the discussion above on the regulatory treatment of HAL's pre-DCO costs, in the circumstances where new or modified licence conditions are required these are likely to take time to implement and this may limit our flexibility in responding to developments in the wider programme.

We also note that the proposals being developed by the Arora Group in the form of its Heathrow West development may create additional uncertainty in relation to a number of the risks outlined above. It may also create the potential for additional legal challenges to the expansion programme more generally. In this context, we note that neither the regime under the Planning Act 2008 or CAA12 were designed to manage the issues raised by competing developments and this may raise relatively novel legal and procedural questions. As noted above, we have published a Technical Information Note[10] which seeks to give some guidance on our approach to these matters, but there remains significant uncertainty in this area, not least because our assessment is that the Heathrow West proposal is at a relatively early stage of development, as we noted in our March 2019[11] consultation.

As we have noted before, even if it were to become clear that there may be merit in amending CAA12 in the interests of consumers Government would need to carefully consider the impact of change, including whether it would delay capacity expansion and what the effect of those impacts would be on the interests of consumers. In any event, new powers may be contentious and difficult to implement in a timely way, all the more so as the programme for expansion progresses and given the current Parliamentary timetable and agenda. Bearing the above in mind (including the difficulties in making changes to primary legislation) we have not identified specific changes to the CAA12 that would better facilitate the timely delivery of capacity expansion at Heathrow airport.

Ongoing relationship with the Department

In the delivery of new runway capacity, we acknowledge that the Government's role is an enabler and that the designation of the NPS was a key step in the process. The CAA will continue its current approach of working closely with the Department throughout the development of the project. This will include continuing our dialogue with your team on the issues discussed in this letter as the programme for capacity expansion at Heathrow airport progresses.

[10] See link.

[11] See CAP 1782.

I am pleased to say that our teams have strengthened their solid, collaborative and open working relationships since we wrote to you in April 2018, while continuing to respect the different roles we play and I look forward to those relationships continuing. At the same time, the CAA is continuing to develop its working relationship with other relevant bodies, such as the Planning Inspectorate.

Please let me know if you would like to discuss any aspect of this letter, which we intend to publish in due course, consistent with the approach we adopted in relation to our April 2018 letter.

Yours sincerely

Andrew Walker
Chief Economist