CAA Discussion paper on the regulatory treatment of issues associated with airport capacity expansion, CAP 1195

Response from Heathrow Hub Ltd/Runway Innovations Ltd July 2014

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1. Heathrow Hub Limited and Runway Innovations Ltd (HHL) are the private companies that have developed an independent proposal for expanding Heathrow airport, one of three options shortlisted by the Airports Commission (AC).

2. HHL welcomes the opportunity to respond to the CAA's Discussion paper on the regulatory issues associated with airport capacity expansion. HHL also welcomes participation in the preceding stakeholder workshop, which informed the CAA's discussion paper. It is apparent that there are many fundamental issues that would benefit from further consideration by the CAA and further engagement with airport operators and developers, airlines, investors and other stakeholders. HHL looks forward to contributing to such engagement in the coming months, in parallel with the ongoing dialogue with the Airports Commission.

3. HHL welcomes the fact the CAA is examining the implications of all the options currently under active consideration by the AC. HHL's proposals for (i) additional runway capacity, (ii) a new integrated transport interchange and passenger processing facility ("Heathrow Hub") and (iii) wider rail enhancements are the most innovative of the three options which the AC is examining. It therefore requires a broader consideration from the CAA on the regulatory opportunities and implications of this proposal, compared to the regulatory treatment of the more traditional proposals from Heathrow Airport Limited (HAL) and Gatwick Airport Limited (GAL). The CAA's discussion paper represents a welcome first step in this consideration.

4. The CAA rightly highlights in its discussion paper its statutory duty to protect the interests of airport users (passengers and cargo owners). It posits a range of regulatory options to deal with a number of regulatory challenges, such as ensuring that the capital costs of airport capacity expansion are as low and efficient as possible and risks are managed effectively. HHL considers that its proposal has a number of fundamental characteristics which would assist the CAA in achieving its regulatory goals, and thereby ultimately benefit passengers:
   - The HHL proposal uniquely is capable of enabling competition in airport services and facilities, should that be the regulator's decision, which would provide a strong and enduring incentive on both HHL and HAL to deliver airport capacity cost efficiently and tailored to users' needs.
   - The low capital cost of HHL's proposal results in only a very small increase in user charges, which could facilitate new entrants, potentially including low cost carriers, thereby enhancing competition with established carriers in the airline market at Heathrow.
   - HHL's masterplan allows highly efficient airline operations, with aircraft stands arranged in a 'toastrack' layout between the runways, facilitating the fast turn-round times and short taxiing distances required by low cost carriers, but benefiting all airlines. This would again benefit competition and ultimately passengers.

- The fact that HHL is privately funding all of its development costs from its own resources, without the expectation that some or all of these costs would be remunerated through regulated airport charges in advance of the new airport facilities coming into operation, provides the strongest possible incentive on HHL to ensure that such costs are efficiently occurred.

5. In the following table, we provide comments against specific issues raised by the CAA in its Discussion paper:

Paragraph	Comment
2.19	We agree with the CAA that "increased capacity could increase the prospects of terminal competition". HHL's proposals uniquely facilitate such an outcome, with the real prospect of competing passenger processing facilities, providing an alternative and a complement to the terminal facilities operated by HAL within the airport's current boundary. In developing its thinking on regulation to enable airport expansion, we would encourage the CAA to consider further how and when it would determine whether a separately owned and operated transport interchange and passenger processor, adjacent and connected to HAL with its existing terminals and additional runway capacity (as per HHL's concept), would be an airport operator with significant market power, and thus subject to CAA economic regulation, in parallel with the CAA's continuing regulation of HAL.
4.2	The CAA draws a sharp distinction between a long-lived runway and other airport assets, which leads it to consider possible alternatives for regulating the former. There is a risk of overstating the difference (e.g. runways might typically have a regulatory depreciation profile over 40 years, compared with terminals at 25 years), and thereby seeking novel regulatory techniques when established practices would suffice (and would also have the advantages for investors of regulatory stability).
4.51	We welcome the CAA's recognition of the need to consider the effect of any Government financial assistance that might be required to support airport expansion or development, and if so if it would be compliant with European State Aid requirements. The CAA also recognise the effect of these issues on the profitability of any investment and their fundamental importance to the airport operator undertaking that expansion. We suggest that it would be helpful for the CAA to consider these issues in parallel with the Airports Commission's work, as they are fundamental to the Commission's decision making process and the CAA's in principle assessment of whether the effect could be to create a high level of risk to delivery of the project and/or an unacceptable level of cost and/or risk to the airport operator/investor. These could be fundamental to project feasibility and/or viability and in our view would benefit from at least an in-principle assessment prior to the Commission's recommendation to Government.
Q4.14	The CAA asks whether there is a role for Government in providing financial assistance for any capacity development. HHL is firmly of the view that airport expansion at Heathrow could and should be fully financed by the private sector. In the past, Government has typically been called on to fund complementary road and rail investments to facilitate airport surface access. This appears to be similarly assumed by HAL and GAL in their alternative proposals for increasing airport capacity.

Paragraph	Comment
	HHL have instead developed a surface access strategy capable of delivery with as close as possible to a neutral impact on public finances. This is possible as a result of the potential offset costs of circa £1.1bn for rail projects which would not be required if HHL's proposals are implemented, e.g. Western Rail Access to Heathrow (WRAtH). HHL have secured in-principle agreement for their rail proposals from Network Rail, the holder of the Network Licence granted by the Secretary of State. The result is that HHL's rail enhancement proposals are both deliverable and could effectively be cost neutral to the public purse, whilst delivering much greater benefits (to both airport and non-airport passengers) and additional fares revenue compared to alternative proposals. HHL's proposals also avoid the potential issue of state aid where alternative proposals rely on public funding of new or enhanced road and/or rail infrastructure necessary to support airport expansion, but where these fail to deliver any wider benefits to non-airport traffic. HHL propose that the Heathrow Hub interchange itself would be privately developed, and funded either through airport charges or by adopting the existing successful model of privately developed and operated railway stations. We are currently developing a financial model for this element of our proposals, which we would be pleased to discuss with the CAA. In view of the inevitable inter-relationship between airport and surface access infrastructure necessary to support airport expansion, we suggest that the CAA might consider a co-ordinated approach to the economic regulation of airport and rail facilities and infrastructure, for example through the development of a joint regulatory approach with ORR.
7.25	The CAA notes that, were HAL to seek to acquire, whether through purchase, licence or some other commercial arrangement, the HHL concept for additional runway capacity, following approval by the AC and Government, then *"in the event that the expenditure was efficiently incurred, there would be an assumption that it would be added to HAL's RAB"*. HHL welcomes this statement. We also note, as above, that because all of HHL's development costs are funded 'at risk' from its own private financial resources, the CAA should be reassured that these costs are being tightly managed and thus efficiently incurred.
7.31	The CAA appears to reject the option of allowing a firm Government decision in favour of a particular airport expansion proposal to act as a trigger for allowing development costs thereafter to be remunerated through airport charges. We would suggest that the CAA reconsider this conclusion. Moving from Government support to securing planning permission can take many years and hundreds of £millions in reasonably incurred costs. This would include for example compensation for properties affected by the proposed new runway and associated facilities, (although we note that HHL's proposals minimise the extent of land and properties affected). For as long as there is Government support for a development, it would seem more reasonable to allow development costs to be partially remunerated via a return on assets in the course of construction, as the CAA favours at 5.29. If such Government support were to be withdrawn sometime prior to planning permission being obtained, then the CAA could protect users from any subsequent costs. This was the case in the CAA's 2008 price control decision for HAL, in which it stated that: "the CAA would also expect to apply a further

Paragraph	Comment
	ex post test to capital expenditure associated with Heathrow expansion, namely, to review whether the expenditure was necessary at the time it was incurred".
Q7.6	We suggest that a trigger based approach could also recognise that new capacity might be provided in phases, matching as far as possible the rate of increase in aircraft movements following completion of new capacity. For example new runway capacity might be provided ahead of stand, apron, satellite and terminal infrastructure. HHL's proposals are particularly suitable for a phased approach to development, with the consequent benefit of reducing the cost and risk of expansion.
7.34	We note that: *"The CAA has not developed an option by which HH is compensated directly for any efficient costs that it incurs in Q6 should it proceed with developing its proposal itself. In the event that HH does wish to proceed with developing its proposal the CAA would need to consider this issue more closely".* We welcome the CAA's acknowledgement that the regulatory treatment of HHL proceeding with the development of the Heathrow Hub and possibly also the expansion of runway capacity would require further detailed consideration.
7.47	The CAA raises the question of *"whether or not a licensed SPV [special purpose vehicle] could charge anything for infrastructure that it builds (as it might be difficult to define it as an airport operator)".* We would welcome further analysis and clarity from the CAA on this point, as per our comment on 2.19 above.
7.49	The CAA comments that: *"only allowing some of the* costs [of any purchase by HAL of the HH concept intellectual property and/or land options] *to be added to the RAB would ensure that there was an incentive on HAL to engage in robust negotiations with Heathrow Hub Limited, which would help ensure that any costs that are incurred are efficient".* We would argue, as above, that HHL's development costs face the strongest competitive pressures to efficiency, as all of our costs are at risk and not backed by any explicit or implicit support from an established regulatory framework. Therefore, the CAA could expect costs incurred by HAL in any purchase of intellectual property from HHL to be reasonably efficient and therefore expenditure allowed into the HAL RAB.
Appendix A	We note that the cost estimate of £12.1bn shown in Figure A.1 for Heathrow Hub's proposals assumes the construction of two additional runways, whereas HAL and GAL's costs are for one additional runway. In December 2013, the Airports Commission shortlisted an alternative HH proposal to provide only one additional runway, the capital cost of which we currently estimate as £9.4bn (£10.7bn including phasing allowance and professional fees). This includes amendments requested by the Airports Commission at the time of writing. We would be grateful if this table could be amended in future documents.

We trust that these comments are helpful. Please contact Steven Costello, Director, Heathrow Hub Ltd/Runway Innovations Ltd (steve@heathrowhub.com) should any further information be required.