The Recovery of Costs associated with Obtaining Planning Permission for a New Northwest Runway at Heathrow Airport: Final Proposals and Notice of Proposed Modification to Heathrow Airport Limited's Economic Licence to allow for an Annual Recovery of £10 million of Category B Costs for a New Northwest Runway

BACKGROUND

1. This submission is made by International Airlines Group plc (IAG) in response to the CAA's consultations of November 2016 on:

    - the recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: final proposals (CAP1469); and
    - the notice of proposed modification to Heathrow Airport Limited's economic licence to allow for an annual recovery of £10 million of Category B costs for a new northwest runway (CAP1470).

2. It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling and Aer Lingus.

3. IAG believes that the Government's decision to expand Heathrow was the right decision on the location of new capacity. However, we are equally clear that in order for the new runway to be successful it must be affordable. For the avoidance of doubt this means no increase in current charges. Consequently, we believe that *"a positive outcome of the planning process"* is not approval at any cost, but the delivery of efficient capacity, at a cost that users are willing to pay.[1] We believe that this is consistent both with the CAA's statutory duties and the CAA's policy position as laid out by its CEO.

4. The CAA has stated in Andrew Haines' letter to John Holland-Kaye dated 25 October 2016 (Haines' Letter):

    - *"… Government's aspiration that airport charges should remain close to current levels";*
    - *"… keeping charges flat in real terms is also an outcome that many of the airlines hope to secure in exchange for their support…";*

[1] CAP1469, paragraphs 1.17 and 5.13

- *"… you too have personally committed to keeping charges flat";* and
- *that this "… is potentially very helpful: if you committed to this now [meaningfully] it would help you build support…".*

5. We support the development of an affordable Heathrow, and were encouraged by the CAA's position set out in the Haines' Letter. Consequently, it seemed logical to expect that the CAA's proposals in CAP1469 and CAP1470, would be targeted at delivering additional capacity at no additional cost. We are therefore particularly disappointed by the CAA's proposals in two regards:
   - the CAA's proposals are excessively generous to Heathrow Airport Limited (HAL) (to the detriment of passengers), and effectively over-incentivise HAL to deliver capacity that they have already shown every willingness to deliver. This not only makes it harder to achieve expansion at no additional cost, but as this is the CAA's first formal action since the R3 announcement, sets a very unhelpful precedent on future cost discipline, and undermines the excellent sentiment in the Haines' Letter; and
   - the CAA's proposals, which IAG considers to be arbitrary and premature, appear to have been hurriedly drafted, are supported by assertion (rather than evidence) and do not appear to have been properly considered.
6. As a result, we consider that the CAA's proposals are based on factual errors and that CAA has erred in the exercise of its discretion. We also consider that the proposals are wrong in law.
7. Our concerns with the economic approach taken in CAP1469 and CAP1470 are as follows:
   - treating the development consent order (DCO) as an asset;
   - the "risk-sharing" methodology;
   - the timing and level of returns;
   - the issue of airline involvement; and
   - the relevant costs included.
8. We also have procedural concerns about the approach taken by the CAA, namely that:
   - it is inconsistent with the CAA's statutory duties;
   - it is inconsistent with the Haines' Letter; and
   - certain elements of the proposals are arbitrary and premature.
9. Rather than rigidly follow the format of CAP1469 and CAP1470, this response will focus on these important issues.

Treating the DCO as an asset

10. The CAA proposes to treat the DCO as an asset. From the point of view of HAL's shareholders, the DCO has value because, as is the case with any land, land with the benefit of planning permission for development is more valuable than the same land without planning permission.

11. However, from the perspective of the passenger, the DCO is not an asset. The perspective of the passenger is the perspective to which the CAA should have regard on the basis of its statutory duties. This is because in regulating HAL, the CAA is under a statutory duty to exercise its functions in a way which it considers will further the interests of users of air transport services.

12. For passengers and the airlines who serve them, the value of the DCO is only derived when capacity becomes available. The CAA has failed to identify in its proposals any benefit to current users of the DCO being granted. As a result, the CAA's approach is for current users, who derive no benefit from the grant of the DCO in the future, and who may not be future users, to subsidise those future users.

13. The CAA recognises that treating the DCO as an asset is at best questionable. The CAA undermines its own position by stating that the DCO is *"a quasi-intangible asset"*[2] and that its treatment as an asset is *"debatable and there is no firm precedent".* IAG submits that these comments highlight that the decision to treat the DCO as an asset is an arbitrary decision taken by the CAA without regard to any regulatory precedent or evidentiary basis. It is also illogical from a practical perspective. For example, the depreciation treatment of the "asset" becomes unworkable. IAG submits that it is impossible for the depreciation treatment to be fair in respect of an asset that does not exist.

14. The CAA's only argument for treating the DCO as an asset is that the alternative is worse. It says *"… some airlines argued that planning permission was not an asset. […] Our view is that if we did not treat planning permission as an asset, then we would need to treat Category B costs as opex (instead of capex). This would imply that costs should be recovered when they were incurred, which airlines were strongly against."*[3]

[2] CAP1469, paragraph 1.13
[3] Ibid, paragraph 4.37. This approach also ignores the totex approach adopted by other regulators.

15. Contrary to the approach taken in CAP1469 and CAP1470, there is ample precedent from industry on the treatment of these types of (potentially speculative) costs. That treatment is straightforward and, IAG submits, readily applicable in these circumstances:

    - where the development proceeds, it is normal practice for operating costs (such as those associated with obtaining planning permission) to be capitalised and recovered against the asset in question, once it comes into operation; and
    - where the development does not proceed, it is normal practice for such operating costs to be absorbed by the relevant company – potentially, with a reduction in returns to shareholders, who willingly bear this risk for the potential return.

16. These principles apply equally to large infrastructure projects, where there are numerous examples of planning costs having been at risk until the project becomes operational and produces benefits for consumers. The low carbon energy projects which are supported by contracts for difference ("CfDs"), such as new nuclear power stations and wind farm projects are clear examples. In each case, payments are only made to the developer under the CfD when the project delivers electricity. Until such time as the projects become operational and deliver benefits for consumers, planning costs are at risk.

17. The CAA is required to comply with certain statutory duties in performing its regulatory functions, including in relation to these proposals. Those duties are:

    - general duties (set out in the Civil Aviation Act 1982) to secure that airlines provide services to satisfy public demand at the lowest charges consistent with a high standard of safety and further the reasonable interests of users of air transport services; and
    - specific duties in regulating operators of dominant airports (set out in the Civil Aviation Act 2012) including HAL to further the interests of users of air transport services having regard to the need to promote economy and efficiency on the part of licence holders.

18. IAG submits that the CAA's proposals in relation to the treatment of the DCO as an asset are inconsistent with these duties. They demonstrate that the CAA failed to properly consider the interests of current users. This has led to the CAA's proposals unfairly favouring future users at the expense of current users.

Risk sharing methodology

19. We continue to be concerned by the CAA's position on risk sharing. We remind the CAA that the purpose of economic regulation is to protect the interests of consumers and deliver an outcome which approximates the outcome from a competitive market. It is

not to insulate the shareholders of the regulated business from risk. Indeed to do so would be detrimental as it reduces the incentive for the regulated business to rationally assess and mitigate risk. We are surprised therefore that the CAA continues to make proposals that have no precedent in competitive markets.

20. In competitive markets the investor makes an investment, knowing the risk in expectation of a return. If the investment fails, the investor makes no return. However, the CAA propose that HAL make excess returns (105%) if the DCO is granted and yet HAL is hugely insulated (85%) if it is not granted. Despite the absence of any parallel with normal commercial practice and the fact that this approach does not incentivise HAL to manage risk appropriately, the CAA has advanced no reason as to why this approach is in the passenger interest. The CAA effectively proposes to transfer all of the risk associated with applying for the DCO from HAL to the airlines but has entirely failed to explain why the airlines should bear the planning risk (a risk over which they have absolutely no control). This runs counter to principles of good governance and basic economics which dictate that risks be allocated to and borne by those best able to manage them.

21. A related issue is the approach that the CAA takes to setting the weighted average cost of capital (WACC). Considering a spread of potential cost outcomes to HAL of -15% to +5% (85% to 105%), if there is a 75% chance that the DCO will be granted, then the net aggregate risk to HAL is zero. Therefore, when the CAA is setting the WACC for Category B costs, it must take this into account and set equity/debt betas at an appropriate level – in this example, zero. If, of course, the CAA considers that the chances of the DCO being granted are greater than 75%, then the debt/equity betas should be negative.

Timing of returns

22. Linking HAL's returns to the granting of the DCO, rather than to new capacity coming into operation, means that current users (who may well not benefit) pay. The CAA will be aware that, choosing to fly, and indeed flying from Heathrow is discretionary for passengers[4], and therefore, unlike in other regulated industries, many future users may not be current users. As a result, the CAA's proposals are intertemporally inequitable.

23. The CAA fails to provide an explanation for its assertion that 15-year depreciation, for which there is no obvious precedent, ensures that future users pay the most. The CAA states *"… [e]xtending the depreciation period will attribute more of the costs of the planning process to future users of the airport, reducing the amount of Category B costs which are recovered before the new runway is open, which was a major concern from airlines in their responses. Approximately, two-thirds of the Category B costs above £10 million per annum would be recovered after the runway has opened, with the other third*

[4] But not hub airlines

recovered after planning permission and before the runway opens."[5] Modelling the CAA's proposed treatment, we come to a quite different outcome. The Appendix shows our model and is based on Davis Commission data, we would be happy to discuss.

24. Consider an example of £120m (be that 85% or 105%) in costs of obtaining the DCO spread equally over a four-year period between 2017 and 2020, subject to straight-line depreciation over 15-years and attracting a return of 5.35%. HAL would enjoy revenues of £120m through "return of the RAB" and £45m "return on the RAB", resulting in incremental user charges of £165m between 2017 and 2034.

25. The Airports Commission forecasts that by 2024 (before the delivery of new capacity) passenger traffic would have risen to 75.4 million people per annum (mppa). By 2034, passenger traffic, passenger traffic is forecast to have increased to 113.1 mppa, of which 37.6 mppa would therefore be future users. Consequently, of the 1,584 million passengers that are forecast to use the airport between 2017 and 2034, 1,347 million would be current users and 237 million would be future users.

26. On the basis of these numbers, the application of a RAB-based model of regulation (without profiling) demonstrates that of the £165m incremental airport charges, £147m (89%) would be paid by current users, with only £18m (11%) being paid by future users. If the CAA takes the view that future users are all users after the new capacity is available (a view with which we disagree), this ratio changes to £81m (49%) for current users and £84m (51%) for future users. In either case, this is not the one-third/two-thirds split as described by the CAA.[6]

27. Consequently, we do not understand how the CAA could reasonably assert that the majority of costs would be borne by future users, rather than current users or that this proposal is in the passenger's interest. We ask the CAA to be transparent, and adopt an open book process so that we may see the CAA's modelling to support its position.

28. In particular, we would like to understand the calculations the CAA has made and the following matters:

    - how any delays to the construction timetable and/or completion would affect the charges attributable to current and future users;
    - by how much does the proposal lower the overall cost, and whether it is less than the cost to current users who will not enjoy the benefits of expansion;
    - what discount rate between current and future users the CAA has used; and

[5] Ibid, paragraph 4.48

[6] Ibid

- the evidence upon which the CAA has relied to adopt a 15 year depreciation period, including how sensitive the proposal is to the length of the depreciation period.

29. In addition, we believe that the CAA has failed to address the potential for distortionary effects on competition of incumbent airlines subsidising new entrants.

Level of returns

30. The CAA's position is that Category B costs should attract a full WACC, because HAL is entitled to the full opportunity cost of capital. IAG disagree with this position in principle for the following reasons:

    - we do not accept that DCO costs are any different from R&D costs, and therefore in themselves should not attract a return. Rather it is the asset itself (in this case the runway capacity) that should attract the return;
    - it is not clear what use HAL's investors would have put their capital to and therefore what the baseline return would have been;
    - CAA has not pointed to any regulatory precedent to support this proposal; and
    - the return must be related to the risk borne. It is rare for DCO applications with supportive National Policy Statements (NPSs) and Government policy to be refused. Consequently, unless HAL fails to diligently apply for a DCO (in which case it should not be rewarded anyway) this "asset" is almost riskless, and so should attract a much lower return than other assets in the RAB.

Airline involvement and governance

31. We are concerned that the CAA's proposals are based on assertions about airline involvement in the planning process. We are particularly concerned that:

    - the CAA's assertions around airline involvement are wrong; and
    - the CAA relies on governance structures that do not yet exist, and even if they did would not have the effects that the CAA expects of them.

32. In terms of airline involvement, the CAA's rational for the 85% to 105% approach is partly that airlines need some financial "skin in the game" in order to participate. We would remind the CAA that it is ultimately the airlines and their passengers that will pay for the proposed expansion. The cost to airlines of an expansion that is not affordable is potentially catastrophic, and therefore there is already a huge incentive for airlines to become involved in any event. Airlines are therefore already under significant financial pressure to participate and do not need to be penalised further by the CAA.

33. The CAA also considers that airline involvement will add extra cost scrutiny to HAL and deliver a more efficient proposal. However, this is a flawed assumption for two reasons:

    - neither the airlines nor the independent fund surveyor (IFS) have any expertise or experience in airfield design and costing; and
    - the CAA relies on a governance process (namely the governance group that the CAA considers should be set up comprised of HAL, airline representatives and the IFS) that does not yet exist. Even if this governance structure were to be set up, the airlines would not have a veto right and HAL "consulting" with the airlines would not give the airlines any control over planning costs.

34. We are also concerned by what we see as a reluctance to regulate by the CAA. The CAA has proposed the current approach to costs (Categories A-C), yet on the most important issue of what constitutes a Category B cost, or an efficient spend, it refuses to take a decision. Instead, the CAA proposes to rely on "advice" from the IFS who is currently not qualified to provide an ongoing assessment of the efficiency of Category B costs (as proposed by the CAA). There is also no discussion in the CAA's proposals of on what grounds, when and how capex spend would be disallowed. Given the early part of the process, and the importance of cost control, this perceived lack of willingness to regulate is especially concerning to IAG.

35. We also question whether the CAA's focus on efficient spend (however that may eventually be defined) is adequate. If, for example, HAL commissions a study which it ultimately does not later rely on in its DCO application, IAG submits that those costs should not be passed through. There needs to be a mechanism for the CAA to prevent HAL commissioning studies, advice and analysis, however efficiently, that are not strictly required for a successful (and efficiently made) DCO application.

36. IAG submits that the CAA's proposals in relation to the proposed governance arrangements fail to discharge the CAA's statutory duty to promote economy and efficiency on the part of HAL, because they provide no incentive the for the DCO application to be made efficiently.

Relevant costs

37. We disagree with the CAA's proposals to treat NPS costs as Category B costs. We are not aware of any other regulator treating NPS costs as being costs associated with obtaining planning permission in the way proposed by the CAA. IAG favours the strictest definition of Category B costs, namely those that are ***solely*** incurred as part of the DCO application, rather than the broader concept of "costs related to the DCO" as the CAA now states.

38. In addition, the selection of the date on which the Government announced that it had identified the Heathrow northwest runway as the preferred scheme is arbitrary and

without logical justification. IAG submits that the selection of this date is flawed because it effectively allows for the premature recovery of costs associated with the DCO, as well as costs which are not associated with the DCO. In line with this analysis, IAG submits that the relevant date should be, at the earliest, the date of NPS designation.

39. We also disagree with the CAA's proposals not to establish a pRAB. The CAA has presented no evidence that such an approach would impose a significant regulatory burden above that involved in tracking Category B costs in the RAB. IAG submits that there is no discernible regulatory burden associated with the creation of a pRAB. It would be the simplest way to track Category B costs, as it would not only maintain the CAA's flexibility to treat these costs differently from other capex (such as Category C costs), but would remove any potential for these to be subsumed into the RAB (thereby attracting perpetuity returns).

40. The CAA's statement that *"… airlines seem to be more concerned about higher charges over a short period of time than stranded planning costs"* is disingenuous.[7] As ought to have been apparent from the scope and scale of responses to its consultations (as well as various other communication/engagement), airlines are engaged across a range of issues. One of these, as the CAA says, is that users ought not to be forced to pay for an asset from which they derive no benefit – a concern that should be shared by the CAA. However, we are concerned with the appropriate allocation of risk, and ensuring that HAL can earn an appropriate level of return and the timing of that return in delivering additional runway capacity.

41. Finally, it is not clear from the CAA's proposals how it proposes to amend the Q6 settlement. Presumably there are HAL resources, both opex and capex that were assigned to other purposes that are now assigned to the DCO application. The approach of the CAA will need to be clear and avoid any double payments. For example, current staff are included in the Q6 opex budget. If they are assigned and charged to R3 (and included in the RAB) the CAA will need to adjust the Q6 opex budget downwards. Similar adjustments would also need to be made for capex. The CAA has failed to address this point.

42. Again, IAG submits that the CAA's proposal in relation to the relevant costs recoverable is inconsistent with its statutory to promote economy and efficiency on the part of HAL.

[7] Ibid, paragraph 4.49

43. We object to the proposed amendment to HAL's economic licence, which is demonstrably not in users' interests. We have a number of concerns relating to the CAA's proposal.

Arbitrary and premature nature of the CAA's Proposal

44. The £10m pa "cost pass-through" of Category B costs is entirely arbitrary and the CAA has offered no explanation as to how it arrived at this figure. The only justification given is a reference to a term in Gatwick Airport's economic licence and a desire to incentivise HAL to obtain the DCO as soon as possible. The CAA simply states that *"[a] £10 million threshold had already been included in the licence for GAL as part of the Q6 settlement and we have said since our first consultation in March 2015 that we would propose a similar arrangement for HAL."*[8]

45. One of the cornerstone principles underpinning the Civil Aviation Act 2012 is to remove airports from "one size fits all" regulation, allowing the CAA to regulate according to the particular circumstances at each airport. We do not therefore understand the CAA's argument for consistency between the treatment of HAL and GAL. The CAA simply asserts that this is an appropriate outcome without providing any evidence why this is the case. We would like to see what analysis the CAA has undertaken to reach this conclusion.

46. We also think it premature for the CAA to be reaching a decision on these proposals at this time. The Haines Letter specifically refers to the development of a new economic regulatory framework to be the subject of a substantive consultation in June 2017. The recovery of planning costs is, IAG submits, an important part of the framework yet before there is the opportunity to engage with the CAA on the development of that framework, planning costs are arbitrarily being imposed.

47. There are practical issues associated with how the pass-through of costs will work in practice. For example, the CAA's proposals do not address whether the £10m would apply to the first £10m of Category B costs incurred in a year, or the last. If HAL has discretion, it will be incentivised to "bury" or apply its least efficient spend to the pass through. It is also not clear how the CAA proposes to monitor and control HAL's spend, nor is any detail provided as to the criteria it will use to determine what spend is efficient.

48. In addition, the mechanism for pro-rating cost recovery is not clear. This applies in respect of 2016 year (where the proposed start date for cost recovery is 25 October

[8] Ibid, paragraph 4.1

2016). The CAA's proposals do not refer to the pro-rating of the £10m pa pass through for 2016, although we assume that this must be the intention.

Requirement to incentivise HAL to proceed with the DCO application

49. We disagree with the CAA's argument that HAL needs to be incentivised to proceed with the DCO application. The returns to HAL's shareholders resulting from the grant of the DCO are potentially very large indeed. These returns would certainly be enough to encourage HAL to apply for the DCO. Indeed, this fact is evidenced by HAL's behaviour thus far, as it has already invested heavily in engaging with the Airports Commission and the Department for Transport when the likelihood of being able to build an additional runway was much less certain, and when the CAA was clear that such Category A costs would not be remunerated.

50. We also note that the CAA argues that the £10m pa pass through was to "*incentivise Hal to start work on securing planning permission immediately after the Government announcement of its preferred location for new capacity and before a risk sharing mechanism is in place*"[9]. Consequently, the following questions arise:

    - if the £10m is intended to be an incentive to start work, there is no logical justification for it to subsequently be paid on annual basis; and
    - the CAA considers the pass through to be an incentive between the Government announcement of the preferred scheme (on 25 October 2016) and a risk sharing mechanism being put in place (on which the CAA expects to publish its decision in January 2017). The proposal for a £10m pa pass through to cover a three month period seems excessive and disproportionate.

51. The CAA does not explain the basis for its view that it is in the interests of current users for HAL "*to start work on securing planning permission immediately*". IAG submits that the CAA's proposals will mean that current users face increased costs, but will not benefit from increased choice, new capacity or increased resilience.

International Airlines Group plc

2 December 2016

[9] CAP1470, paragraph 2.9

APPENDIX

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	
Opening RAB	£0m	£28m	£54m	£78m	£100m	£92m	£84m	£76m	£68m	£60m	£52m	£44m	£36m	£28m	£20m	£12m	£6m	£2m	
CapEx	£30m	£30m	£30m	£30m															**£120m**
Depreciation	£2.00m	£4.00m	£6.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£8.00m	£6.00m	£4.00m	£2.00m	**£120m**
Closing RAB	£28m	£54m	£78m	£100m	£92m	£84m	£76m	£68m	£60m	£52m	£44m	£36m	£28m	£20m	£12m	£6m	£2m	£0m	
WACC	£0.69m	£2.14m	£3.48m	£4.72m	£5.15m	£4.72m	£4.30m	£3.87m	£3.44m	£3.01m	£2.58m	£2.16m	£1.73m	£1.30m	£0.87m	£0.49m	£0.22m	£0.06m	**£45m**
User Charges	£2.69m	£8.14m	£9.48m	£12.72m	£13.15m	£12.72m	£12.30m	£11.87m	£11.44m	£11.01m	£10.58m	£10.16m	£9.73m	£9.30m	£8.87m	£6.49m	£4.22m	£2.06m	**£165m**
Current Users	72.5m	73.2m	73.6m	73.9m	74.3m	74.7m	75.0m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	75.4m	**1,347m**
Future Users									4.5m	9.3m	17.8m	27.1m	27.1m	27.1m	27.1m	27.1m	32.2m	37.6m	**237m**
	72.5m	**73.2m**	**73.6m**	**73.9m**	**74.3m**	**74.7m**	**75.0m**	**75.4m**	**79.9m**	**84.7m**	**93.2m**	**102.5m**	**102.5m**	**102.5m**	**102.5m**	**102.5m**	**107.7m**	**113.1m**	**1,584m**
	£0.04	**£0.08**	**£0.13**	**£0.17**	**£0.18**	**£0.17**	**£0.16**	**£0.16**	**£0.14**	**£0.13**	**£0.11**	**£0.10**	**£0.09**	**£0.09**	**£0.09**	**£0.06**	**£0.04**	**£0.02**	
Current Users	£2.69m	£8.14m	£9.48m	£12.72m	£13.15m	£12.72m	£12.30m	£11.87m	£10.79m	£9.80m	£8.56m	£7.47m	£7.16m	£6.94m	£6.53m	£4.78m	£2.96m	£1.37m	**£147m**	**89%**
Future Users									£0.65m	£1.21m	£2.02m	£2.69m	£2.57m	£2.46m	£2.35m	£1.72m	£1.26m	£0.68m	**£18m**	**11%**
																			£165m	**100%**
Current Users	£2.69m	£8.14m	£9.48m	£12.72m	£13.15m	£12.72m	£12.30m	£11.87m											**£81m**	**49%**
Future Users									£11.44m	£11.01m	£10.58m	£10.16m	£9.73m	£9.30m	£8.87m	£6.49m	£4.22m	£2.06m	**£84m**	**51%**
																			£165m	**100%**