

## Consumers and Markets Group

Bernadette Kelly CB  
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Great Minster House  
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30 April 2018

Dear Bernadette

### **Airport National Policy Statement: the CAA's approach to economic regulation of the expansion of airport capacity at Heathrow**

I understand that a package of material will be provided to Ministers in advance of a Government decision, subject to Parliamentary process, to designate an Airports National Policy Statement (NPS) for the purposes of the Planning Act 2008. To assist the DfT in preparing that package, your team has requested that we provide our views on the risks that the CAA is currently managing in relation to the economic regulation of new capacity at Heathrow.

We remain firmly committed to our longstanding view that additional runway capacity will benefit air passengers and cargo owners (together, "consumers") avoiding the higher airfares, reduced choice and lower service quality that would come if capacity is not increased.

#### This letter in context

We wrote to the Department in May 2016 outlining our initial views on the approach to the regulation of new capacity and the risks that were then apparent. We have since developed our thinking through a series of consultations, with a view to managing those risks. Our latest thinking, to be included in our April 2018 consultation and update on the regulatory framework for HAL (our "April Consultation"), among other things, sets out:

- our initial analysis of the affordability and financeability of the new capacity at Heathrow;
- proposals intended to ensure that alternative commercial and delivery arrangements for aspects of capacity expansion are properly considered; and
- how we will align the regulatory timetable to the wider development and planning timetable.

In parallel, our report to the Secretary of State under section 16 of the Civil Aviation Act 1982 in relation to airport-airline engagement on the development of the Heathrow expansion scheme (the "Section 16" report) sets out our approach to ensuring that HAL:

- builds on the successes of the existing airport-airline engagement process; and
- engages to best effect with airlines and other stakeholders in the period up to submitting its Development Consent Order (“DCO”) application.

### Expansion and airport charges

While the range of plausible outcomes with respect to airport charges per passenger remains relatively wide, our initial assessment suggests that there are credible scenarios in which capacity expansion can be delivered affordably and financeably, with airport charges per passenger remaining close to current levels in real terms and line with the ambition expressed by the Secretary of State on these matters in 2016.

For instance, our April Consultation illustrates a possible scenario based on HAL’s assumptions for the costs of its Westerly Option, combined with a mid-range estimate for the cost of capital based on PwC’s early and preliminary work on these matters (which was published alongside our December 2017 consultation) that gives airport charges per passenger that are broadly consistent with 2016 levels in real terms. This is only initial analysis and is subject to further consultation, assessment, development and change. Of course, this is only one scenario and all stakeholders will need to work constructively together to ensure that capacity expansion is delivered efficiently (and no unnecessary costs are incurred) to support the delivery of affordable levels of airport charges. We will seek to develop and improve our initial assessment of affordability and financeability as further information on the preferred expansion scheme becomes available during 2018 and 2019. We will continue to model scenarios as the scheme is refined and we obviously cannot rule out the need to address scenarios where airport charges per passenger vary significantly from our initial analysis, not least given the considerable uncertainties that relate to HAL’s current cost estimates. The detail of our approach to conducting this initial analysis and a fuller presentation of the results are set out in our April 2018 Consultation.

### Clarifying the risks we are managing

When we wrote to the Department in 2016, we noted that we were, in discussion with the Department, managing a number of risks and challenges. These risks were that:

- (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;
- (iii) airlines are not appropriately engaged during the process;
- (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.

Since then, we have been able to refine our analysis. In this light, we consider that risk (ii) above includes risks:

- that consumers’ interests are not properly reflected in the overall scheme design; and
- the scheme design is not affordable and financeable.

Our interactions with stakeholders through the Section 16 and regulatory processes suggest that risk (iii) also has the following related risks, that:

- that airlines have views that are not aligned with the interests of consumers;
- that 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.

### Our approach to risk management and mitigation

Our management of risks (i) to (v) will be rooted in our work to develop a robust and evidence based regulatory framework for HAL based on our powers under the Civil Aviation Act 2012 (CAA12). We also recognise that Government may have a role to play in the management of some of these risks.

In developing the regulatory framework we will seek to:

- set an appropriate cost of capital (including taking account of market based evidence on the appropriate returns for debt and equity finance) that will incentivise investors to provide finance to HAL over the long term;
- lever on competitive forces by promoting the exploration of alternative commercial and delivery arrangements that are in the interests of consumers;
- develop a balanced package of incentives and other regulatory tools to encourage HAL to deliver new runway capacity efficiently and in a timely way, including incentives for timely delivery and appropriate consequences for non-delivery;
- oversight of HAL's proposals as they develop, including through observing and facilitating the airport-airline engagement process, the role of the Independent Funds Surveyor and through appropriate benchmarking; and
- the publication of a consultation and update paper on the licensing tools to promote both delivery and the financial resilience of HAL later this year.

In relation to **risk (i)** our primary focus will be in setting the cost of capital and testing the path of prices for both financeability and affordability. In relation to the cost of capital, we aim to build investor confidence in the robustness of our decision making by transparently building the evidence base for our decisions in consultation with stakeholders. To this end, we have commenced this process by publishing an independent report we commissioned from PwC on HAL's cost of capital for the next price control period. Investors can also gain comfort from the availability of the appeal process under CAA12 to the Competition and Markets Authority, which allows for an independent determination of our decisions on the licence modifications that will be required to put changes in the regulatory framework into effect.

Our approach to financeability is also supported by our ongoing commitment to maintaining the stability of the regulatory regime where appropriate, for example, through confirming that we will continue to use the regulatory asset base and single till that are well understood by investors and airlines. Further, we will also consider the overall impact of our incentive package and risks on investor returns and we have a continuing dialogue with credit rating agencies to help ensure we understand the perspective of debt investors.

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, with any spending that can be shown to fail an efficiency test being disallowed from recovery through HAL's charges). We are also considering strengthening the role of other elements of the regulatory regime (including the capital expenditure governance) which promote efficient capital expenditure. Our initial analysis suggests that some degree of *ex ante* incentives could operate as part of a balanced package of incentives and we are now considering the practical issues that would support implementation.

To manage **both risks (ii) and (iii)**, we:

- have set out in our final Section 16 report the approach we expect to see to ongoing and enhanced engagement between HAL and airlines on scheme design. This should include further opportunities for airlines to explain their position on the affordability of the proposed scheme and, if they were to be of the view that the scheme should not proceed because of their concerns about affordability, to fully justify their views on these matters;
- expect HAL to stand by its public commitment to engage in good faith with airlines and third parties coming forward wishing to develop commercial and delivery arrangements. We will review any evidence that it has not done so to determine whether it provides evidence of inefficiency and would guard against the recovery of inefficient costs from consumers;
- have written to HAL's Chief Executive recently to reinforce our expectations around HAL developing a robust evidence based approach to developing cost estimates and ranges;
- have set clear expectations that all parties need to engage effectively to ensure that efficiency is "designed in" to the expansion project;
- expect HAL's approach will remain subject to ongoing scrutiny by the Independent Funds Surveyor, reporting to both HAL and airlines and we will keep the effectiveness of this process under review; and
- will consider using both *ex ante* and *ex post* incentives, as discussed above.

Our April Consultation sets out clear expectations for HAL to develop an effective process for engagement with airlines and others bringing forward credible proposals for alternative means of delivering elements of new capacity, including terminals. We will continue to look at what lessons can be drawn from the approaches taken by other regulators, for example, in relation to driving competitive forces into the procurement of capital projects and, absent such arrangements, the regulation of monopoly assets (such as Ofgem's Competition Proxy model).

We will monitor HAL's response to our proposals for engagement on alternative commercial arrangements in the coming months to help us determine whether we should prioritise consideration of licence enforcement or the bringing forward of new obligations. Nonetheless, we are conscious that, with an infrastructure project of this scale and complexity, there will be risks to delivery, including the possibility of legal challenge to the regulatory and/or planning processes. We consider that driving good quality engagement and a thorough process, coupled with seeking to strike an appropriate balance between the affordability and financeability of the programme in the round will be the best means of seeking to minimise the risk of such disruption.

In relation to **risk (iv)**, we are progressing work on possible enhancements to financial ring fencing obligations (including that HAL should retain an investment grade credit rating and to strengthen HAL's reporting on financial resilience) and as noted above we intend to publish an update and consultation paper on licence issues in later this year. We will also take account of financeability in developing the overall regulatory framework. Although we regard the residual risks of financial distress of HAL as 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 consider that **risk (v)** includes a risk that HAL or its investors could unreasonably "hold out" for a better regulatory settlement or Government support before continuing with capacity expansion. We do not expect HAL to adopt such an approach but if it were to do so it could happen at any stage of the process. If this were to happen soon then HAL would risk not recovering all of its planning costs, but otherwise the regulatory framework would appear to provide relatively little protection for consumers. Once HAL has spent significant sums and we start to formulate proposals for a new price control, hold out would become a

riskier strategy for HAL to pursue. In particular HAL may have incurred significant early construction and compensation costs and not completed the regulatory approvals process (that will test whether HAL is pursuing a commercially financeable plan for capacity expansion that is in the interests of consumers) for these costs. Our intention is also that the new price control will include balanced incentives for the timely delivery of capacity expansion. The ability of HAL (and materially affected airlines) to challenge our decisions under CAA12 by appealing to the Competition and Markets Authority provides certain checks and balances as such an appeal would provide for an independent determination of the terms of the regulatory settlement.

Our consultation and update paper on licensing issues to be published later this year will also address risk (v) through considering obligations on HAL to reflect consumers' expectations that new runway capacity will be delivered in their interests and whether there should be links between them and the financial resilience rules. Other incentives on HAL to deliver capacity include our approach to regulating planning costs and we are also considering the possible development of price control incentives that could include consequences for non-delivery. Nonetheless, Government action might also be appropriate if the circumstances were to arise such that HAL stopped pursuing capacity expansion.

**Risks (i) to (v)** will also be managed, in part, by the CAA's approach in seeking to align the price control and planning timetables, so that the price control can be set using the latest information on the costs that HAL will need to incur in order to meet planning obligations arising from the NPS and DCO. To this end, our April Consultation will set out our proposal to implement an interim price control for a period of two years from the end of 2019 to allow greater alignment between the regulatory and planning processes, while, at the same time, protecting the interests of consumers by enabling them to benefit from HAL's performance since the existing price control was set.

**Risk (vi)** will be best mitigated by Government, HAL, airlines, other stakeholders and the CAA all working together.

#### Interdependencies with the planning DCO consent process

In general, the CAA's policy is for costs (or an appropriate contribution to them) required by planning consents to be allowed where they are efficiently incurred. Nonetheless, in overall terms, capacity expansion needs to be both affordable and financeable if capacity expansion is to be viable and so even if costs have statutory drivers, the overall cost envelope needs to be consistent with these constraints if capacity expansion is to proceed.

Detailed assessment of these costs will only be possible when significant progress has been made by HAL in the DCO process, including in relation to surface access costs, community compensation and the treatment of particular existing facilities. Much more work will be required by HAL in these areas.

For example, in relation to surface access, where schemes are essential for airport operation or development and user funding has been optimised it is CAA's policy is to allow an appropriate contribution to surface access costs from airport charges, detailed scheme level assessments will be required to identify the appropriate package of schemes and measures that will be appropriate. In this context, we note the contents of the revised draft NPS and welcome the statements in paragraph 3.39 that:

*"[t]he majority of the surface access costs where a split of beneficiaries is expected (for example, where multiple businesses and the public at large benefit from a new road junction or rail scheme) are likely to be borne by Government, where the schemes provide greater benefits for non-airport users. The airport contribution would be subject to a negotiation, and review by regulators."*

Clearly, we will need to engage closely with the DfT in the coming months to understand better the funding issues on the the schemes that are likely to support the development of a robust package of proposals and the overall price control settlement. As noted above, we have taken steps to align the price control timetable with that for wider capacity expansion and expect to be in a position to make final price control proposals in 2021.

### Developing the regulatory framework

The CAA's work in relation to the economic regulation of new runway capacity at Heathrow will be 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, at present the licence conditions which could be used are largely not in place. In the short term, therefore, the framework presently contained in HAL's licence will be of only very limited direct assistance in managing the risks identified above.

We have made considerable progress with developing and consulting on policy, which is an essential stage in the licence modification process. Nonetheless, we will need to go through the processes required by the CAA12 to put in place the licence conditions that are necessary or expedient to deal with the issues raised by the development of new capacity. While any modifications that the CAA directs to HAL's licence will be subject to appeal by HAL and materially affected airlines to the Competition and Markets Authority, stakeholders will already be able to determine the areas in which the CAA is considering taking action, and this may assist in managing their expectations as to how the regulatory rules may change. Once any conditions are in place, if enforcement action is required, this would bring with it a degree of uncertainty.

### Suitability of the CAA12 framework to accommodate expansion

When we wrote to the Department in 2016, we noted that capacity expansion at Heathrow has no direct regulatory precedent, that the regulatory process was at an early stage and that we would need to consult stakeholders further on the development of the regulatory framework, consistent with our statutory duties under the CAA12. We also said that we had no grounds to believe that the existing statutory basis for economic regulation must be changed to accommodate economic regulation of new capacity.

It should be recognised, however, that, in line with other regulated sectors, while the CAA12 enables the CAA to develop licensing tools to promote, encourage and incentivise investment in new capacity, the CAA12 cannot be used to compel investors to make capacity expansion happen. Even if HAL's licence were to be amended to introduce conditions to promote, encourage and incentivise delivery, the CAA cannot force investors to finance or develop a scheme, though we may be able to seek to penalise economically irrational behaviour by the regulated entity by new licence conditions and price control incentives.

Similarly, while the CAA:

- is in favour of competitive arrangements (for example to help deliver new capacity or to manage demand risks) where they are in the interests of consumers; and
- considers that the regime under CAA12 is flexible enough to accommodate a wide range of commercial structures at Heathrow;

the CAA12 does not permit the CAA to force HAL to divest part or parts of its business in order for a third party to develop new capacity.

Having considered the CAA12 again, we have not currently identified any areas where we consider that the existing statutory framework for the regulation of HAL must be changed to support capacity expansion at Heathrow. At least in part, this reflects the nature of the challenge associated with designing a statutory framework to govern the introduction of alternative commercial arrangements in that this is best done by a regime that targets a specific set of alternative arrangements. A good example is in the energy sector where there are bespoke processes governed by statute for competitive provision of offshore electricity transmission, but these statutory provisions do not provide more general powers that would allow Ofgem to force the introduction of competition on a wider basis. In the case of Heathrow focused proposals for the development of alternative commercial proposals have only recently started to emerge and we are still in the process of facilitating discussion so that they can be properly evaluated.

While the case is not currently made for change, even if it were to become clear that there may be merit in amending CAA12 in the interests of consumers, for example to introducing new powers, such as, to compel divestment or force the introduction of competition, Government would need carefully to consider the impact of change, including whether it would delay capacity expansion. New powers may be contentious and difficult to implement in a timely way. In any event, given the current Parliamentary timetable and agenda, it appears that primary legislation could be several years away and such delays may not be in the interests of consumers.

#### Future relationship with the Department

In the delivery of new runway capacity, we acknowledge that the Government's role is as an enabler and that the designation of the NPS is a key step in the process. As a result, the CAA will continue to work closely with the Department throughout the development of the project.

We are keeping the risks outlined in this letter under review alongside the scope of our powers and whether there may be areas in which development of the regulatory regime may benefit from formal guidance from the Secretary of State under CAA12. We expect to continue a dialogue with your team on these issues as the programme for capacity expansion at Heathrow progresses.

I am pleased to say that our teams have strengthened their solid, collaborative and open working relationships since the Government's decision to bring forward the NPS was announced in October 2016, while continuing to respect the different roles we play. I look forward to those relationships continuing throughout the development of new runway capacity. This will be especially important given the high level of lobbying that we expect both the CAA and the Department will experience throughout the process, not least because of the inevitable commercial tensions between stakeholders.

At the same time, the CAA is developing its working relationship with other relevant bodies, such as the Planning Inspectorate, to ensure that the interfaces it has with them are as effective as possible.

I hope that this provides you with clarity on how we intend to proceed once the NPS has been designated. You will appreciate that it is difficult at this stage to set out the full detail of our approach as much work remains to be done to gather the evidence base to support our decisions.

Finally, we would note that an expanded Heathrow will require significant change to the airspace design in the south east of England and beyond. The CAA has two separate but related roles on airspace:

- making decisions on proposals to change airspace design; and
- developing a strategy and plan for the use of UK airspace for air navigation up to 2040, including for the modernisation of such airspace.

As you know the CAA does not have any powers to require collaboration between airports to facilitate airspace change and we welcome the ongoing dialogue with the Department regarding the best way to manage the risks that this implies.

The airspace strategy and plan is being reviewed during 2018 prior to submission to the Secretary of State and will, of course, take into account the contents of the NPS, if designated.

Please let me know if you would like to discuss any aspect of this letter, which I do not object being published at the appropriate time. I will leave that decision to you given it is intended to be part of your decision making process.

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

A handwritten signature in black ink, consisting of a series of fluid, connected strokes that form a cursive-style name.

**Richard Moriarty**  
Director, Consumers and Markets Group