

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

CAP 1470

A large decorative graphic at the bottom of the page consisting of overlapping, semi-transparent blue and teal shapes that create a gradient effect.

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Enquiries regarding the content of this publication should be addressed to: abigail.grenfell@caa.co.uk

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Chapter 1

Introduction

Purpose of this document

- 1.1 On 25 October 2016, the government announced that it was in favour of a new northwest runway and associated infrastructure at Heathrow. In light of this announcement, we propose to modify the economic licence of Heathrow Airport Limited (HAL), so as to allow HAL to recover up to £10 million per annum of costs associated with obtaining planning permission for a new northwest runway (i.e. Category B costs).
- 1.2 This document invites representations on the £10 million per annum proposal.
- 1.3 We are consulting separately on the treatment of Category B costs incurred over £10 million per year.¹

Views invited

- 1.4 Under the Civil Aviation Act 2012 (the Act) we may modify the conditions of a licence.² Before making modifications to a licence, we must publish a notice specifying the proposed modifications, giving our reasons for the proposed modifications, state the effect of the proposed modification and specify the period within which representations may be made regarding the proposed modifications. We must send a copy of the notice to the holder of the licence and such bodies representing airport operators or providers of air transport service as we consider appropriate.³ This document constitutes such a notice.

¹ Available at: www.caa.co.uk/CAP1469.

² Section 22(1) of the Act.

³ Sections 22(2) to (4) of the Act.

- 1.5 Any representations about the proposal in this document should be sent by e-mail to economicregulation@caa.co.uk no later than 6 December 2016. Alternatively, comments may be sent by the deadline above by post to:

Abigail Grenfell
Consumers and Markets Group
Civil Aviation Authority
CAA House
45-59 Kingsway
London WC2B 6TE

- 1.6 We expect to publish the representations on our website as soon as practicable after the period for written representations expires. Any material that is regarded as confidential should be clearly marked as such. Please note that we have powers and duties with respect to handling of confidential information under section 59 of the Act and the Freedom of Information Act 2000.
- 1.7 If you have any questions on this document please contact Abigail Grenfell (020 7453 6243, abigail.grenfell@caa.co.uk) or Stephen Gifford (020 7453 6279, stephen.gifford@caa.co.uk).

Next steps

- 1.8 Once we have considered the representations, we will decide whether, and if so, how to modify HAL's licence.

Chapter 2

Background and reasons for the proposed modifications

Background

- 2.1 On 13 February 2014 we gave notice that we were granting a licence to HAL that would come into force on 1 April 2014.⁴ This price control period from 1 April 2014 to 31 December 2019 is known as Q6.⁵ Condition C.1 of the licence contained a price control that lasts until 31 December 2019.
- 2.2 The CAA has published a series of discussion documents, consultations and policy updates on our approach to the economic regulation of new runway capacity over the past few years:
- Recovery of costs associated with obtaining planning permission for new runway capacity: policy update ([CAP 1372](#)), February 2016
 - Economic regulation of new runway capacity – Update ([CAP 1332](#)), September 2015
 - Economic regulation of new runway capacity ([CAP 1279](#)), March 2015.⁶
- 2.3 On recovery of costs in relation to new runway capacity, we identified three categories of costs.
- Category A costs – these are Airports Commission-related and associated lobbying costs, which in general would be incurred before a government decision.

⁴ Pursuant to section 15(5) and (7) of the Act. The notice is available at www.caa.co.uk/CAP1151.

⁵ Q6 originally expires on 31 December 2018. We consulted on extending Q6 for one year, so that it will expire on 31 December 2019. The notice of proposed modification to HAL's licence to that effect is available at www.caa.co.uk/CAP1459.

⁶ These documents are all available from www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/.

- Category B costs – these are costs directly connected with, and solely for the purposes of, seeking planning consent through the Development Consent Order (DCO) process and are, in general, incurred by an airport operator after a Government policy decision on the location of new capacity; and
- Category C costs – these are costs typically (but not exclusively) incurred after planning permission is granted and cover the construction of new capacity, up to entry-into-operation.

2.4 This proposal relates to recovery by HAL of Category B costs. We propose that up to £10 million per year of efficient Category B costs can be recovered by HAL, in the form of higher airport charges within the Q6 period. We propose that recovery of costs can commence from 25 October 2016 when the Government announced it had identified the Heathrow northwest runway as the preferred scheme.

2.5 This £10 million is an annual allowance and any underspend cannot be carried over into the following year. We consulted on this proposal in July 2016,⁷ having previously stated our policy intention in a number of discussion documents mentioned in paragraph 2.2 above.

2.6 The following section outlines our responses to stakeholders' views and reasons for the proposal.

Our response to stakeholders' views and reasons for the proposal

2.7 HAL argued that the £10 million per year threshold should be increased as it is substantially lower than the amount of costs they would incur each year for the planning application. We consider that the threshold should not be increased. We have previously stated⁸ that the £10 million per

⁷ CAA, Recovery of costs associated with obtaining planning permission for new runway capacity: initial proposals, July 2016, available at: www.caa.co.uk/CAP1435. We have considered the views put forward by the ten stakeholders who responded to this document.

⁸ CAA, Economic regulation of new runway capacity (March 2015), available at www.caa.co.uk/CAP1279.

- annum threshold has been intentionally set at a lower amount than the expected costs of the planning process, with the majority of these costs subject to separate risk-sharing arrangements. Our view remains the same.
- 2.8 Many of the responses from airlines and airline industry bodies argued that there should be no pass through of £10 million into airport charges, as it would mean pre-funding new capacity and that users should only pay for additional capacity when it comes into operation.
- 2.9 In our view, the retention of the £10 million pass-through is in the interests of users as it incentivises the airport operator to start work on securing planning permission immediately after a government announcement of its preferred location of new capacity and before a risk-sharing mechanism is put in place. We believe that additional runway capacity in south-east England will benefit current and future air passengers and cargo owners, and we consider that incentivising HAL to start the process of obtaining planning permission is an important first step in delivering new capacity.
- 2.10 The £10 million threshold will not reduce the incentive for the airport operator to act in an economical and efficient manner. Planning costs are expected to be significantly more than £10 million a year, and any costs above this threshold will be subject to a risk-sharing mechanism.
- 2.11 Some of the stakeholders questioned the use of the word “automatic”, stressing the need for all costs (including the £10 million) to be justifiable and subject to an efficiency test. We agree with respondents and made this efficiency point clear in paragraph 1.13 of our initial proposals:
“All Category B costs incurred will be subject to an efficiency test. An Independent Fund Surveyor (IFS) will provide ongoing assessment of the reasonableness of Category B costs incurred, and allow the airport, the airlines and the CAA to identify any expenditure that is inefficient.”
- 2.12 Our use of the “automatic” phrase in our initial proposals means that recovery of these costs will be quick and straightforward through higher airport charges in Q6, following scrutiny by an independent reviewer such

as the IFS to ensure that they are efficiently incurred. If HAL's efficient spend in any one year is less than £10 million but £10 million has already been passed through into airport charges, then a downward adjustment would be made to airport charges in later years.

- 2.13 Allowing a pass-through of £10 million per year has been our proposed policy since March 2015, as a means to ensure consistent treatment between HAL and GAL. The cost recovery of £10 million is similar to an allowance made in the licence issued to Gatwick Airport Limited (GAL) when we granted its licence on 13 February 2014.⁹ We consider that this is reasonable and necessary to ensure that HAL is treated in the same way as GAL had government favoured runway expansion at Gatwick.
- 2.14 This policy has been noted and consulted upon in various consultation documents (as set out above) but uncertainty and delay around the timing of a government announcement on runway expansion made it difficult to introduce the condition in a more timely manner.
- 2.15 In our view, where possible it is desirable to make licence modifications with prospective effect and we would only consider introducing a condition with retrospective application in exceptional circumstances where the particular facts in point mean that it would be necessary to do so. Having regard to the reasons given above, it is our view that the present circumstances justify a modification to HAL's licence with retrospective application (i.e. to be effective from 25 October 2016).
- 2.16 On the effect of the proposed modification, a high-level estimation shows that a pass-through of £10 million of Category B costs in a year brings about an increase in the maximum revenue yield per passenger by approximately £0.14. The pass-through will be limited to an overall cap of

⁹ The notice granting GAL's licence and an up-to-date version of the licence can be found at www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Gatwick-airport/. GAL's licence is based on a series of commitments made in its Conditions of Use (CoU) and which are also licence conditions. See Conditions C1.1, C1.5(b) and C1.8 of the Licence and paragraph 6 of Schedule 1 to the CoU.

£10 million in each year and any underspend cannot be carried forward to any subsequent year.

Chapter 3

The proposed licence modification

- 3.1 We propose to include a new term 'A' in the price control formula in Condition C1.2. 'A' is the pass-through of Category B costs (planning costs) for runway expansion defined in a new condition C1.12. In light of this proposed change, the original Condition C1.12 (Definitions) will become Condition C1.13.
- 3.2 'A' will be divided by the number of passengers in the relevant Regulatory Year¹⁰ in the calculation of the overall maximum revenue yield per passenger.
- 3.3 Condition C1.12 defines 'A' as allowing a maximum of £10 million in each Regulatory Year to cover the reasonable costs of applying for planning permission for runway expansion and associated infrastructure. These reasonable costs include capital, operating and financing costs and they will be subject to any policy guidance that we may issue, following consultation.
- 3.4 The mechanism by which HAL receives Category B costs up to £10 million in Q6 will depend on the requirements of the Airport Charges Regulations. Under the Regulations, HAL must consult with users at least four months before changing its charges and publish details of a change at least two months before the change takes effect.¹¹ As the time for consultation on airport charges for 2016 and 2017 has already passed, Category B costs for these two years can be recovered two years in arrears through the per passenger correction factor (K_i).¹² Category B

¹⁰ A Regulatory Year is defined in the Licence as the 12 month period between 1 January and 31 December in each of the four years from 2015 to 2019.

¹¹ Further information is available at: www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Competition-policy/Airport-charges-regulations/.

¹² As specified in Condition C1.5 of the licence.

costs for 2018 and 2019 can be recovered in the year they are expected to be incurred following the usual timetable of charges consultation.

- 3.5 In this case, we propose that the modification should have retrospective effect to allow up to £10 million pass through for Category B costs from 25 October 2016, the date of the Government announcement of its preferred location of new runway capacity.

Appendix A

Proposed modifications to Heathrow licence

C1.2 On each occasion on which the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in each of the four subsequent relevant Regulatory Years **starting on ~~beginning with~~ 1 January 2015 and ending on 31 December 2019**, the Licensee shall fix those charges at the levels best calculated to secure that, in each relevant Regulatory Year, total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the amount set in accordance with the formula below:

$$M_t = (1 + RPI_{t-1} + X + B_{t-2})Y_{t-1} + \frac{D_t}{Q_t} - \frac{T_t}{Q_t} + \frac{A_t}{Q_t} + \frac{BR_t}{Q_t} - K_t$$

Where:

- M_t is the maximum revenue yield per passenger using the Airport in Regulatory Year t expressed in pounds, where;
- RPI_{t-1} is the percentage change (positive or negative) in the Office for National Statistics (ONS) CHAW Retail Price Index between April in year $t-1$ and the immediately preceding April;
- $X = -1.5\%$;
- B_{t-2} is the bonus factor in Regulatory Year t , based on the Licensee's performance in $t-2$, as defined in condition C1.8;
- Y_{t-1} is the revenue yield per passenger in Regulatory Period or Regulatory Year $t-1$ defined in condition C1.3;
- D_t is the cumulative development capex adjustment in Regulatory Year t defined in condition C1.9;
- T_t is the capital 'trigger' factor in Regulatory Year t defined in condition C1.7;

- Q_t is passengers using the Airport in Regulatory Year t ;
- A_t is the cost pass-through for runway expansion in Regulatory Year t defined in condition C1.12;
- BR_t is the business rate revaluation factor in Regulatory Year t defined in condition C1.11; and
- K_t is the per passenger correction factor in Regulatory Year t defined in condition C1.5.

NEW:

A_t : pass-through of Category B costs (planning costs) for runway expansion

C1.12 A_t is the cost pass-through adjustment of up to £10 million in each Regulatory Year to allow for the recovery of the reasonable costs (capital and operating) of applying for planning permission for a third runway and associated infrastructure (Category B costs) since the Government announcement of its decision on 25 October 2016 to support the development of a third runway at the Airport. These Category B costs must, in the CAA's view, have been efficiently incurred. This adjustment shall have regard to any policy guidance that may be issued by the CAA, following consultation, in relation to the recovery of these Category B costs.

If: $t = 2016, 2017, 2018$ or 2019

Then: $A_t =$ eligible and efficient Category B costs up to £10,000,000

Otherwise: $A_t = 0$

Definitions

C1.123 In this Condition C.1: