The Recovery of Costs associated with Obtaining Planning Permission for New Runway Capacity: Initial Proposals

1. This submission is made by International Airlines Group plc (IAG) in response to the CAA's consultation of July 2016 on its initial proposals for the recovery of costs associated with obtaining planning permission for new runway capacity (CAP1435). It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling and Aer Lingus.

2. Recognising that the CAA has taken into consideration airlines' views on pre-financing, in our view the proposals do not go far enough in addressing this fundamental issue for two important reasons:

    a. in allocating Category B costs to a pRAB and then applying WACC indexation, the benefit of subsequent returns to GAL/HAL is unchanged; and

    b. in proposing that indexed Category B costs are recoverable at {105%*(total-£10mpa)}+10mpa if a planning application is successful or at {85%*(total-£10mpa)}+10mpa if not, the CAA does not share planning risks, but instead transfers the majority from GAL/HAL onto airlines.

3. This response will address only those issues where IAG's views and those of the CAA differ. For ease of reference, it broadly follows the same structure as CAP1435.

4. Unless otherwise stated, references are to CAP1435.

The CAA's Duties

5. Incentives to invest in scarce new capacity in SE England are clear and present: the briefest brief review of Heathrow Airport Limited (HAL) and Gatwick Airport Limited (GAL) engagement with the Airports Commission and the media, as well as their lobbying activities, demonstrates that both are highly incentivised. Neither airport operator has shown the slightest reluctance in advancing their respective cases in a number of arenas.

6. In listing its duties with respect to expansion, the CAA refers only to its secondary duties – emphasising returns to airport operators. There is no mention of the CAA's primary duty to consumers, while efficiency is relegated to being the last item mentioned.[1]

[1] Paragraph 2.4

7. The CAA contradicts itself, in relation to its finance duties: an airport operator must be able to finance its investment, but this does ***not*** mean that it has to be able to earn additional returns.[2]

8. Given this attractiveness and the likelihood (or certainty) that planning permission for additional development would not be granted for many years, the rewards of ownership of what will likely be the only available capacity in SE England, will be very significant. Consequently, there is no requirement for the CAA to offer additional incentives to either GAL or HAL, as it suggests would be consistent with its duties.[3]

9. Although diversification of risk is a welcome principle, the structure subsequently proposed by the CAA is not a risk-sharing mechanism. The manner in which risks would be borne mainly (or entirely) by airlines will be discussed, under 'Risk-Sharing Arrangements', below.

10. It is worth noting the CAA's dichotomy of views, regarding costs. On one hand there is acceptance that airlines will have to pay higher charges to HAL, but on the other, the CAA suggests that passengers will benefit from lower airfares.[4] The only way both hypotheses can be true, is if the CAA anticipates airline profitability being squeezed at both ends. This will ultimately result in passenger dis-benefits.

11. The CAA will not need reminding that the air-transport market is competitive and that the airport owned and operated by HAL and GAL are not; hence, they are economically regulated. If the CAA allows airport charges to increase, this will inevitably have an impact on downstream markets, with passengers ultimately bearing the consequences, through less choice, higher airfares and diminished service quality.

Definition of Eligible Costs

12. We broadly agree with the CAA, regarding the definition and timing of Category B costs; however, to remove any ambiguity, we consider that its drafting should be tightened.[5] In our view, the CAA should make it clear that Category B costs ***cannot*** be incurred by

[2] Paragraphs 2.4 & 4.17

[3] "… it is important to maintain incentives to invest [and so the CAA will] send a positive signal to potential investors [and ensure they get] a reasonable return…" paragraph 2.4

[4] "… it is important to protect users from ***unnecessarily high charges*** [in financing new capacity, which will] deliver considerable consumer benefits including more choice, ***lower airfares*** and higher service quality…" Paragraphs 2.4 & 2.5 (***emphasis added***) "… higher airport charges will not be entirely borne by existing users…" Paragraph 4.7

[5] "… capacity expansion costs that are, in general, incurred by an airport operator after a Government policy decision on the location of new capacity and are associated with seeking planning permission" and "[the definition] will need to be very clear and precise…" Paragraphs 3.1 & 3.2

an airport before a Government policy decision and are ***strictly limited*** to those costs related only to seeking planning permission through the DCO process.

13. We note that the CAA states that Category B costs must be efficiently incurred and over and above costs already allowed into the Q6 regulatory allowance. We agree completely.[6] We are nevertheless concerned about the vagaries of the CAA's language defining Category A costs - and that airport operators will seek to exploit this to their own advantage, to the detriment of airlines and passengers. In particular, the CAA does not exclude all Category A costs from recovery and offers airport operators an opportunity to lobby for reclassification of Category A cost as Category B costs.[7]

14. In our view, this is an enticement to HAL and/or GAL to seek to have unrecoverable costs associated with engagement with the Airports Commission (i.e. Category A costs) reclassified as Category B. There is therefore, considerable risk that either or both airport operators will seek to do this. This risk is exacerbated by the CAA's proposal that Category B costs would not only be fully recoverable but would earn a substantial premium.

15. We note that the CAA is yet to develop a specific policy for Category C costs and consider that such a policy should not allow either airport operator to recover against these, until such time as assets come into operation.

Recovery Mechanism for Eligible Costs

16. As a matter of principle, we do not consider that ***any*** costs should be automatically recoverable; rather, ***all*** costs should need to be justified, before being charged to airlines and passengers. Furthermore, we do not understand why the CAA has the view that this would not reduce incentives on airport operators and so would appreciate an explanation of how the CAA came to this conclusion.[8] In our current view, it is likely that either airport operator would simply categorise those costs it thought were ***least*** efficient as being below the £10mpa threshold, in order to avoid the CAA's scrutiny.

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[6] "… Category B costs must be strictly additional to any costs already included in the Q6 allowance as well as being efficiently incurred, so that the same expenditure will not be remunerated more than once." Paragraph 3.4

[7] "… the recovery of *most* Category A costs will not be permitted; [however] some costs could be re-categorised as Category B provided HAL/GAL can make a strong case [that] information submitted for DCO application is not materially different from that submitted to the Airports Commission." Paragraph 3.6 & footnote 3.

[8] "We continue to consider that Category B costs up to £10 million per year should be automatically recoverable [and this] will not reduce the incentive for the airport operator to act in an economical and efficient manner." Paragraphs 4.1 & 4.2

17. It could be construed that the CAA's position results from a desire to achieve some kind of equivalence between HAL and GAL, because GAL has a £10mpa threshold built into its licence, whereas HAL does not. There are many differences between regulation at LHR and LGW and we see no obvious reason to amend just one in isolation – but in any case, there will be no equivalence once a Government decision is announced.

18. As far as it may be possible to separate current and future users, then current users are an (initially large, but relatively declining) subset of future users. Consequently, it is illogical to seek to somehow divide the cost burden between the two. In our view, this simply means that current users will bear more of the costs and for longer than will future users (who are not current users).

19. The CAA is effectively saying that current users should pay for an asset that future users will enjoy. Unlike utilities, for example, in the case of such a significant airport capacity expansion, a large number of future users will not be current users. The only solution to this intertemporal consumption problem, is to start charging when capacity becomes available, so that future users bear the cost of capacity from which they are benefitting.

20. Whilst agreeing with the concept of a separate account for category B costs (the pRAB), we disagree with the CAA's proposed treatment.[9] Specifically, we do not consider planning permission to be an asset – at least not for passengers and airlines; albeit, we understand that it would be for shareholders. For passengers and airlines, value is only derived when a runway is built and operational. The CAA is confusing a project milestone (like completing foundations or steelwork) with the flow of benefits; even more so, if approval of a planning application (as opposed to knowledge of its outcome) is not required.

21. The pRAB (as the CAA describes its use) is not an appropriate mechanism for recovering Category B costs. Moreover, given that airlines and passengers are expected, over time, to reimburse category B costs, the reports, opinions and so forth which have been paid for in this way, should be transparently made available to current and future users of the airport. Should either airport operator wish to keep these reports and opinions confidential for competitive reasons, then the costs should be treated as a normal development risk, paid for out of the eventual returns on the asset, not charged directly to end users, and not charged to the pRAB.

22. Under a scenario in which HAL or GAL shares material with airlines, it is entirely possible that third parties may bring forward competing development plans, which may be

[9] "… [returns] should only start when the asset (planning permission) comes into use, that is when the result of the planning application is ***known***." Paragraph 4.11 (***emphasis*** added)

chosen in preference to those proposed by either airport operator. This scenario is explicitly envisaged in HAL's licence.[10]

23. In our view, should DCO not be granted, then (as would be the case for stranded R&D costs) Category B costs should not be recoverable from airlines and passengers. We do not understand why the CAA would ask a question as to whether these should be recoverable over 10 years or less. As the CAA points out, competitive businesses write off such costs, so we would welcome an explanation from the CAA as to why it proposes such a different approach. [11]

Risk-Sharing Arrangements

24. We do not understand why the CAA considers that airlines should bear some of the planning risk, should planning consent not be achieved.[12] Under the CAA's proposals, airlines' involvement in planning applications is entirely at the discretion of airport operators and so GAL/HAL are the only parties in any kind of position to bear the planning risk; indeed, the CAA tacitly acknowledges this fact by specifically proposing to reward them accordingly.[13]

25. Airlines do not require to bear what would, for them, be uncontrollable risk – and for which airport operators (but not airlines) are rewarded, in order for airlines to have an incentive to be part of the process - or indeed, to ensure costs are efficient.[14] The CAA will be well aware that IAG (and presumably other airlines) are keenly focussed on exactly these points – and so the CAA's proposal is ***not*** in the interests of users!

26. We are surprised that the CAA suggests that it would be airport operators which would suffer financially, were planning permission not be achieved.[15] Under the CAA's proposals, airlines will bear more than 85% of any financial suffering, in the event that

[10] "Even if the Government approved expansion at Heathrow, other parties, besides HAL, could be chosen to own or operate the new runway or terminals…" CAP 1151: Economic regulation at Heathrow from April 2014: Notice granting the licence, page 170, paragraph A24

[11] "In the case where DCO is not granted, we would welcome views on whether category B costs […] should be recovered over 10 years or over a shorter period, say 3 or 4 years for example." "We consider that it is the generally accepted accountancy practice for unregulated businesses to write off such stranded costs quickly." Paragraph 4.16

[12] "… both GAL/HAL and the airlines bear some risk in the event that planning permission is not granted, is rescinded, or is withdrawn." Paragraph 5.1

[13] "… the airport operator should earn a return on any Category B costs that are added to the pRAB [which] should be […] 5.7% for GAL and 5.35% for HAL." Paragraph 4.17

[14] "If stakeholders bear some risk then they will have every incentive to be part of the process, providing ongoing support and help ensure any costs incurred are efficient." Paragraph 5.1

[15] "… [an airport operator] will stand to suffer financially if the DCO is not granted or if Government policy changes due to public opinion." Paragraph 5.2

an airport operator's planning application fails.[16] We would therefore be grateful if the CAA would explain how it came to the view that it is airport operators, rather than airlines, which would suffer financially, if planning permission were not to be granted.

27. In our view, Category B costs should be treated like R&D; that is to say, not attracting a perpetuity return - and charged back to the users in nominal terms, not real terms, over a suitably long period of time. This should be considerably longer than the 10 years suggested by the CAA.[17] Despite IAG's opposition to the scheme currently being advanced by HAL, the CAA fails to acknowledge that airlines may not benefit from the specific plans of an airport operator, or that alternative plans may offer more benefit.[18]

Promoting Efficiency & Transparency

28. In our view, the introduction of an IFS has had a positive impact on airport/airline discussions at LHR, during the Q6 consultations. This could be improved, were an IFS (with an expanded brief, as the CAA proposes) to report directly to airlines or the CAA. This would mean that reports would be available to GAL/HAL, airlines and the CAA ***as soon as they were available*** and, importantly, ***concurrently***.[19]

29. We agree with the CAA that airport operators and airlines should share responsibility for the design of new capacity; however, consider that the CAA's encouragement may be insufficient. In our view, the CAA needs to implement concrete rules, setting out how this must happen.[20]

Impact on Airport Charges

30. The CAA is incorrect to argue that the impact of its proposals on airfares is marginal/immaterial. In order to understand the full impact of its proposals on passengers, the CAA must understand how its proposal to increase airport charges impacts on the costs of those who provide the services to passengers – i.e. airlines, especially in respect of their ability to compete, invest and ultimately deliver passenger choice and value.

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[16] "Our initial proposal is that a 105%/85% risk-sharing mechanism should be put in place for Category B costs (above the automatically recovered £10 million per annum)." Paragraph 5.5

[17] "Our initial proposal is that the costs in the pRAB should be recovered over a 10 year depreciation period…" Paragraph 4.15

[18] "Airlines stand to benefit from runway expansion." Paragraph 5.3

[19] ".. [reports should be made] available to the airline community, the CAA and relevant stakeholders as early as practicable." Paragraph 6.8

[20] "… we are very keen to encourage GAL/HAL and the airlines to engage collaboratively…" Paragraph 6.9