Advice to the Secretary of State for Transport

CAA assessment of HAL-airline engagement on capacity expansion during May-September 2018

This paper sets out our assessment of HAL-airline engagement during May 2018 to September 2018 under the Enhanced Engagement Terms of Reference.[1]

Summary of developments during May – September 2018

1. Since issuing our April 2018 Section 16 report, there have been a number of developments in the wider expansion process. Most notably, on 26 June 2018 the Airports National Policy Statement (NPS) was designated by the Secretary of State for Transport. The main focus of HAL-airline engagement during this time has been on further analysis and initial evaluation of components and revised assembly masterplan options via the M3b[2] programme gateway, which revealed further options for HAL to assess. The Independent Fund Surveyor (IFS) has undertaken further capital cost benchmarking (40-50% of updated cost estimates), updated its analysis of key component costs for the M3a[3] and M3b[4] programme gateways and commented on Category B[5] costs, procurement, risk contingency appraisal and programme schedule and phasing.

2. The existing multi-lateral engagement fora[6] have continued with additional deep dive sessions established for night flights and additional air transport movements embedded into the Airline Working Group. HAL has also been engaging with the airline community and cargo carriers on a bilateral basis, including with non-incumbent airlines. In early September, HAL and the airline community finalised a new governance protocol, with input from the IFS, under a process facilitated by Arcadis (the CAA's technical advisers) and the CAA. HAL has also made steady progress on implementing its consumer research and engagement strategy and received positive feedback from the Consumer Challenge Board (CCB) about the progress it has made over the last few months.

3. HAL has progressed its Innovation Partners[7] process. On wider issues relating to alternative delivery possibilities, the Arora Group provided a response to our April 2018 consultation on the regulatory framework[8] and also wrote separately to the CAA regarding the possibility of alternative means of delivering new capacity (or elements of it). The CAA responded with a Technical Information Note[9] which set our further views on licensing and other issues raised by the Arora Group. In addition, we have supported the aspirations of the airline community to start to test the credibility and feasibility of Arora's proposals through an initial study by Arcadis. While this work has been slow to get going, progress is now being made and we will provide further updates to DfT as the study gathers momentum.

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[1] See Terms of Reference.
[2] Assessment of revised assembly options post NPS designation and HAL's public consultation on expansion earlier this year.
[3] Assessment of initial assembly options.
[4] Assessment of revised assembly options post NPS designation and HAL's public consultation on expansion earlier this year.
[5] See link for definition.
[6] These include the Airline Working Group, Options Approval Group, the Costs and Benefits Working Group and the Joint Expansion Board.
[7] HAL introduced the Innovation Partners process to invite businesses/potential partners to enter an expression of interest to develop alternative design, engineering or construction proposals to deliver Heathrow expansion.
[8] See link.
[9] See link.

4. HAL has also been undertaking a full review of its delivery schedule. At the time of drafting this update, we understand some information on the schedule and M3c[10] and M4[11] gateways have been shared with the airline community.

Progress on the CAA's April 2018 recommendations

5. Our April 2018 Section 16 report[12] made recommendations in four areas for HAL and the airline community to progress as part of the Enhanced Engagement process. Our assessment of progress in these areas is set out below.

A. Cost information

April 2018 recommendation

6. Following repeated requests in earlier Section 16 reports, we asked HAL to provide comprehensive information on programme costs and cost efficiency as a matter of urgency. We noted that this should include rising to the challenge of the requests of the airline community on the masterplan process as set out in Appendix 1 of the April 2018 Section 16 report and be responsive to the recommendations set out in the reports by the IFS (Gardiner & Theobald), Arcadis and CEPA[13] on cost estimates and capital governance processes.

HAL feedback

7. HAL notes that it has taken on board comments from the April 2018 Section 16 report and refined the cost development process since May 2018. HAL has also told us that:

    ▪ the estimating strategy and capital cost development process for the masterplan stages has been developed and shared;
    ▪ a detailed review of capital benchmarks has been undertaken by the IFS (Gardiner & Theobald) following recommendations made by the IFS and Arcadis;
    ▪ further information regarding the Westerly Option dashboard and phasing has been produced and shared with airlines, the IFS and CAA;
    ▪ an improved assurance process has been developed and adopted to improve the robustness of capital cost estimates;
    ▪ revised cost estimates have been developed and shared to support the M3a[14] and M3b[15] programme gateways and IFS reviews completed on a detailed fully 'open book' basis;
    ▪ significant information has been provided to the Independent Planning Cost Reviewer (IPCR) to support the review of Category B expenditure;
    ▪ IFS Category B reviews for the first and second quarters in 2018 spend have taken place supported by deep dives into HAL's design team and ground investigation activity, as well as programme reporting and controls.

8. At the same time, HAL has said that it acknowledges the concerns raised by the CAA and the airline community about the lack of progress on cost information and says it has made considerable effort to disclose all available information on costs, consistent with the existing scheme maturity. HAL has stated that it intends to build airline confidence on affordability once the potential preferred scheme has been defined post the M3c[16] programme gateway and will be able to provide a full capital forecast for the preferred scheme and information relating to other assumptions in advance of the M4[17] programme gateway.

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[10] To set the strategic direction to form a preferred masterplan based on the findings from the evaluation process.
[11] To approve the preferred masterplan.
[12] See link.
[13] CEPA was appointed by the CAA to assess whether the new capital expenditure governance regime put in place for the latest control period (Q6).
[14] Initial assembly options.
[15] Revised assembly options post NPS and HAL's public consultation on expansion earlier this year.
[16] To set the strategic direction to form a preferred masterplan based on the findings from the evaluation. process.
[17] To approve the preferred masterplan.

9. The airline community has raised significant concerns regarding the lack of high quality information on costs, efficiency and affordability, echoing similar concerns raised previously and reported by us in earlier Section 16 reports. They consider progress has been limited with the information provided to date being insufficient to either fully assess (or at least understand and be comfortable with) the broad direction of travel in relation to the overall affordability, scope and benefits of the scheme. They have said that the lack of progress in addressing these concerns indicates that the cost assessment process is not working properly. The key concerns that the airline community has reported to us include:

- **Only circa 50% of revised component costs has been provided and assessed by the IFS -** With the M3c programme gateway[18] now set for 25th October both the level of detail and timeliness of information to make informed decisions remains a concern. The recent review of the key components showed some opportunities for efficiencies against the Westerly Option, but it has also uncovered clear and significant cost pressures. The IFS has also challenged HAL for its timetable for the provision of details for the remaining cost components.
- **Category B costs -** The airline community has expressed significant concern regarding inadequate and opaque engagement in this area over an extended period of time. They have noted this remains a retrospective quarterly look back with no clear forward view or engagement on the approach to incurring such costs. They also cite that in the January 2018 Joint Expansion Board (JEB) there was meant be a step change, but they believe they are still facing the same issues and still awaiting validation of second quarter 2018 expenditure. They note that HAL has repeatedly ignored IFS recommendations in relation to these matters.
- **Provision for Cost Risk -** There remains a fundamental difference of opinion between HAL and the IFS on the treatment and amount of risk within the capital plan. The airline community strongly support the IFS' recommendations on these matters and suggests HAL should prioritise addressing these issues.
- **Cost and benefit working group -** The airline community says this key governance group looking at costs and affordability has not been working effectively for some time, with cost information being provided just before the meeting and with key data redacted. They consider further effort needs to be undertaken to ensure the right level of focus and engagement.
- **Uncertainty over surface access costs and earthworks -** Significant uncertainties and risk still exist over the funding for surface access arrangements and cost pressures have become evident in relation to earthworks.
- **Late information and cost information -** The airline community has raised concerns around HAL taking excessive time to release and distribute IFS reports, which has led to a significant lag in information flow.

10. Looking forwards, the airline community has said it is critical that a demonstrable direction of travel with regards to affordability is validated and quantified within the coming weeks. Similarly, where any issues or challenges occur these must be highlighted promptly to ensure appropriate engagement.

CAA assessment and next steps

11. We note that during May-September 2018, additional work was generated for HAL in evaluating masterplan assembly options in response to the designation of the Airports NPS, and in the light of feedback to HAL's public consultation on expansion earlier this year.

12. HAL has struggled throughout the process of capacity expansion to meet stakeholder expectations with respect to information on costs and efficiency. It provided an envelope for overall costs in its Westerly Option dashboard in mid-2017 but has not updated these overall estimates. Nonetheless, it has continued to work towards its preferred masterplan for

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[18] To set the strategic direction to form a preferred masterplan based on the findings from the evaluation process.

capacity expansion – now rescheduled from 2018 to early 2019. While there have been reports from the IFS (Gardiner & Theobald) and Arcadis on aspects of HAL's approach to cost estimates the airline community is also interested in robust estimates of overall costs and remain understandably frustrated at the lack of progress in relation to these matters. Consistent with HAL's position as a credible promoter for the scheme it needs to significantly to improve the flow of information on costs and efficiency – and its M3c[19] and M4[20] programme gateways will be critical tests for the provision of information on costs.

13. We may also consider issuing a formal information request under section 50 Civil Aviation Act 2012 if we judge this would facilitate the disclosure of high quality information by HAL and/or the development of additional licence obligations to require the provision of further detailed information. We recognise such action is unlikely to substitute HAL actively owning and leading on the provision of cost information, but we will consider further regulatory action if HAL fails to deliver appropriate information in support of its M3c and M4 programme gateways.

14. In relation to Category B costs, this is an area in which the airline community has expressed significant concern. HAL has shared cost information with the IPCR, but not on a timely basis and completion of the IPCR report on 2017 costs has consequently been delayed. HAL has recently provided further information and we will publish the IPCR's reports on these costs in due course. HAL has not been able to supply a clear forward plan of deliverables and milestones for each of the Category B workstreams and this is an area of concern which we expect HAL to address.

B. Alternative commercial and delivery arrangements

April 2018 recommendation

15. We expected HAL to prioritise further engagement with interested parties on alternative commercial and delivery arrangements. This included the urgent development of a new workstream focused on key elements of the expansion programme (such as terminal development) by the end of May 2018. We said HAL should develop a clear and inclusive process, timetable and code of practice for engaging with stakeholders (including where appropriate parties other than airlines) on these matters in good faith. We expected the workstream to include arrangements for dealing with commercially in confidence discussions/material and be progressed in a timescale consistent with other programme milestones. We also expected all parties to engage in a professional and constructive manner demonstrating flexibility to find arrangements that benefit consumers.

HAL feedback

16. In response to our recommendation to develop a new workstream, HAL brought forward the Innovation Partners process by inviting businesses/potential partners to enter an expression of interest to develop alternative design, engineering or construction proposals to deliver Heathrow expansion. Approximately 160 proposals were received.

17. HAL has explained the Innovation Partners has so far been a success, noting the widely promoted and inclusive process (including an invitation to participate to the Arora Group). HAL says it has been very encouraged by the number of responses it has received so far and considers that the process offers opportunities to create a more efficient airport that drives further consumer benefits. It has also said it remains ready to support a review by Arcadis of the Arora Group and HAL schemes.

Airline community feedback

18. The airline community welcomed the exploration of alternative delivery arrangements through the Innovation Partners process but noted that this should not exclude other schemes outside the process being considered. They highlight the recently agreed text in the new governance protocol that "*the airline community may also wish HAL to consider other credible schemes that are not submitted through their Innovation Partner process and*

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[19] To set the strategic direction to form a preferred masterplan based on the findings from the evaluation process.
[20] To approve the preferred masterplan.

which may be in the best interests of the consumer." The airline community also expressed the need to ensure realistic timescales to make the process meaningful. We also received some feedback from airlines that the Innovation Partners process appeared rushed and the initial phases over complicated, which may have discouraged participation.

19.   The airline community noted that the proposed evaluation of the Arora scheme by Arcadis has not yet progressed as planned, but they remained committed to understanding the opportunities offered by alternatives to the HAL scheme. We also received airline feedback expressing disappointment about HAL's reluctance to share information with the Arora Group despite this being funded through Category B costs and paid for by the airline community and consumers.

CAA Assessment and next steps

20.   We note the progress made under the Innovation Partners process and await further updates from HAL on its progress. It is for HAL to demonstrate the benefits that this process will deliver for the airline community and consumers.

21.   The Arora Group provided a response to our April 2018 consultation on the regulatory framework[1] and also wrote separately to the CAA regarding the possibility of alternative means of delivering new capacity (or elements of it).[1] The CAA responded with a Technical Information Note which set out further views on our approach to the licensing and other issues raised by the Arora Group.[1] There is also ongoing work with Arcadis to assess the Arora Group's proposals.

C. Consumers

April 2018 recommendation

22.   We expected HAL to deliver fully on its integrated consumer strategy for business as usual activities and capacity expansion. We also expected HAL's approach to consumer engagement to be joined up across the Enhanced Engagement and price control processes. We said that the Consumer Challenge Board (CCB) should play a major role, by helping ensure HAL's masterplan and business plan are based on and fully reflect high quality consumer engagement. We noted that Arcadis would be advising on the steps HAL is taking to ensure consumers' interests have been reflected in its masterplan. We also noted that a key objective of the new Enhanced Engagement process is to assess whether airport-airline engagement and the overall scheme design have appropriately reflected consumers' interests as per the CAA's general duty under the Civil Aviation Act 2012.

HAL feedback

23.   Since the CCB's interim report in March, HAL considers it has made good progress improving its engagement with the CCB and addressing the issues highlighted, noting positive feedback from the CCB Chair. HAL also note that it has made progress against a number of the areas identified for improvement by the CCB and that it has updated its consumer research and engagement strategy to reflect stakeholder feedback. HAL notes the key areas of focus over the coming months include surface access, operational resilience, passengers requiring assistance, future generation of consumers and the arrivals journey. HAL also notes that it has hosted its first series of expansion masterplanning workshops with its online passenger community (Horizon), as part of its approach to co-create the ideal airport journey of the future. HAL is working with the airline community to gather its insights on passenger experience. HAL also said it is in the process of introducing a new internal customer department to bring together all elements of consumers under a single team with a clear mandate and to ensure more joined up approach across all business planning timeframes.

Airline community feedback

24.   The airline community has continued to engage with HAL on its consumer engagement and research strategy, and through the project to collect airline insights. They have said they want HAL to be more joined up with consumer research for business as usual activities and

capacity expansion and to participate and collaborate with HAL in the Horizon passenger community. Regarding the amalgamation of HAL and airline insights research, they note that they want the output to show how each proposal can be traced back to research undertaken and provided by HAL and the airline community. They also welcome the benefit valuation research which is nearing completion (previously referred to as willingness to pay research). The airline community also welcomes the agreement of the Memorandum of Understanding between HAL and the airline community on Consumer Research and Outcome Based Regulation.

CAA assessment and next steps

25.   We welcome the steady progress made by HAL on implementing its consumer research and engagement strategy in response to our previous recommendations. We are also encouraged by HAL's response to challenges from the CAA, the airline community, and the CCB, and that it intends to take further steps to reflect consumer views in its planning process. We also welcome the focus the new governance protocol places on consumer interests.

26.   HAL must continue to work closely and constructively with the airline community and the CCB to ensure that a shared robust understanding of consumer needs is being developed and captured by the engagement and planning processes. We will continue to monitor HAL's progress by engaging with the CCB, the airline community and Arcadis on its progress in reviewing HAL's masterplanning process. Looking forward, we expect HAL to continue to deliver the consumer engagement and research strategy, engage constructively with the airline community, and be responsive to Arcadis' review of the masterplanning process.

D. **New governance protocol**

April 2018 recommendation

27.   Our April 2018 Section 16 report asked HAL and the airline community to work together and agree a new governance protocol by 20 July 2018 with details of how current engagement and governance arrangements would be developed to deliver Enhanced Engagement. We recommended that the parties undertake an holistic review to develop a new protocol that underpins a forward looking and integrated engagement framework. We considered the protocol should be a key document supporting the delivery of Enhanced Engagement through the period at least until HAL submits its DCO application.

HAL feedback

28.   HAL says the new governance protocol provides the platform for successful future engagement and clarifies how projects will be managed and engaged upon as they move between different governance processes and structures. HAL notes that both the original deadline and the extended deadline for finalising the protocol were missed and suggests where joint documents are required in the future all stakeholders agree the timetable in advance. HAL notes that while all parties agree the new document is a success the process for finalising the document was onerous.

29.   HAL has also explained that new infrastructure should be adequately flexible to be used by all airlines, including non-incumbent carriers. It considers that at an appropriate time, new entrant airlines should be invited to attend multi-lateral governance fora and participate in decisions that may impact them.

Airline community feedback

30.   The airline community notes the challenges of engaging with HAL to agree the protocol and that the original versions of the protocol put forward by HAL fell short of their needs. The airline community recognised that the document would need updating over time, but considered it was important to take the time to get the fundamentals correctly structured, including the role of the Joint Expansion Board (JEB) as the key joint governance forum. They also note that they are pleased with the final agreed version of the protocol and that

the involvement of the CAA and Arcadis in the process made a significant difference and was instrumental in achieving completion by the extended deadline.

31. *The airline community welcomes the acknowledgement of their role in the M4 Gateway and the formal addition of the M5a[21] gateway in the governance protocol. Nonetheless, they consider it is critical that there is a jointly articulated, clear engagement plan and process to support these gateways.*

CAA assessment and next steps

32. We are pleased that HAL and the airline community agreed a new governance protocol, but are disappointed that it could not be achieved by the 20 July deadline we had set and took until the 6 September.

33. The document provided on 20 July fell short of our expectations and was not fit for purpose. We outlined our concerns to HAL and the airline community and began engaging with both parties towards end of July to propose a way forward. We suggested Arcadis provide extra resource and support to HAL and the airline community to facilitate a process for parties to revise the document. We granted an extension to 31 August for parties to work together to agree a new document. Despite good progress being made, some outstanding issues took longer to resolve and agree. The agreed version was submitted to the CAA on 6 September.

34. We were disappointed that HAL was slow to undertake an holistic review of the protocol despite several attempts by the CAA to explain the benefits of doing so. We also note the airline community was not as proactive in engaging with HAL to pursue a new document as it could have been. Despite these problems, the CAA recognises the considerable efforts subsequently made by HAL and the airline community to agree the document. We also note that the IFS (Gardiner & Theobald) reviewed and provided comments on the revised draft. We consider the current version is much improved and meets our requirements and also provides a good foundation for parties to build on as a living document.

35. We welcome that HAL's broader engagement strategy encompasses non-incumbent airlines (potential new entrants) and cargo carriers.

Further stakeholder feedback - timetable confidence

36. HAL has recently announced some changes to its overall expansion schedule and now expects to launch its Statutory Consultation in June 2019 rather than the first quarter of 2019. It is our view that HAL must now demonstrate to stakeholders that its new timetable is realistic, achievable and allows sufficient time for high quality engagement whilst ensuring timely delivery. It must clearly articulate the contingency within the timetable and remaining key risks and mitigations.

37. We note that the airline community has been calling for a realistic, fully integrated end-to-end schedule since the early stages of the programme. They consider HAL must work on developing a schedule with the airline community, based on agreed expectations and understanding of what is required in those areas of engagement with the airline community. With delays to some milestones emerging, they say this should not lead to an inappropriate reduction in engagement. The airline community note that the M3c[22] programme gateway has been set for the 25 October 2018 at which point key aspects of the scheme will begin to be set, yet it remains unclear whether their expectations for high quality information on costs will be met by HAL. An immediate priority for HAL is to review and provide assurance to the airline community that the M3c programme gateway is realistic and that it will provide appropriate information on costs and efficiency to allow for proper engagement. At the time of drafting this update, we understand HAL has shared with the airline community some information on the schedule and M3c and M4[23] gateways.

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[21] The M5a gateway allows the airline community to have a formal opportunity to express and properly explain and justify their commercial views on whether sufficient comfort is available on overall scheme affordability.

[22] To set the strategic direction to form a preferred masterplan based on the findings from the evaluation process.

[23] To approve the preferred masterplan.

38. A key objective of the Enhanced Engagement Terms of Reference is to "*deliver high quality engagement with no decline in the current quality and intensity of engagement, building on it where necessary.*"

39. In light of this, we would highlight some positives over this period. We recognise that capacity expansion is an unprecedented and very complex programme and that HAL has been engaging extensively with the airline community on its plans in good faith. We are pleased that HAL and the airline community have agreed the contents of a new protocol to govern the engagement process. HAL has also made steady progress in responding to our previous recommendations aimed at making sure consumers' interests are integral to its expansion and business planning processes.

40. Nonetheless, at this point we are compelled to highlight two important areas where we have concerns that HAL must address decisively and urgently. Our concerns relate to HAL's need to provide high quality information about the costs of the scheme and the need for HAL to provide assurance that its revised timetable is realistic and will credibly ensure timely delivery and genuine engagement with the airline community.

CAA
September 2018