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5 October 2012

Dear Emma and Mark,

### **Heathrow Airport Mid Constructive Engagement (CE) Review**

Thank you for your letter of 28<sup>th</sup> September 2012 which provides an update on the progress of CE at Heathrow.

In April 2012, the CAA published a Mandate for Constructive Engagement<sup>1</sup> that had been agreed with Heathrow Airport Limited (HAL) and the LACC at Heathrow in order to start the formal CE process. In the CE Mandate the CAA announced that to enable it to take a fully informed view of the progress of and prospects for Constructive Engagement it would conduct one 'mid-term' review in September 2012.

On 20<sup>th</sup> July 2012 the CAA wrote to the co-chairs of CEWG to explain how it proposed to conduct the mid-term review. It stated that important aspects of this would be:

- a progress report requested from the two co-chairs by 15 September 2012 on the progress made within CEWG and the prospects for a successful outcome; and
- a meeting between the CAA and the co-chairs in late September.

### **Summary of CE to date**

Based on your letter and the follow up meeting between HAL, the LACC, the independent facilitator Hugh Westaway and the CAA, the CAA understands the progress of CE to be as follows:

The LACC and HAL have agreed a comprehensive consultation framework, with regular meetings of six constructive engagement groups covering the key regulatory building blocks feeding into the monthly JST. JST is the only decision making forum and is joint chaired by

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<sup>1</sup> <http://www.caa.co.uk/docs/5/HeathrowCEMandate.pdf>

the LACC and HAL. There has also been agreement on the appointment of an independent facilitator. Meetings have been well managed and business like although CE has been a challenging process for all parties.

There is broad agreement on the traffic forecasting methodology and the main issue to be resolved is how demand shocks are taken into account. There is agreement that the service quality regime should build on the existing regime with the majority of elements and the system of rebates retained. The LACC and HAL are hopeful that agreement can be reached on these two elements.

There is general agreement that airport development should focus first on the Eastern campus. The LACC and HAL are hopeful that agreement can be reached on the prioritisation of capex although agreement on the size of the plan is unlikely. There is also agreement around the commercial revenue forecasting methodology and that commercial projects which are 5-year till positive should generally be included in forward capex proposals. There is also some agreement on improvements to capital efficiency incentives and on key elements of a core and development capex programme although further work will be required to refine this. Discussions on operating expenditure have been challenging and are now focused on areas of potential opportunity.

The main area of disagreement between airlines and the airport is the affordability of future airport charges to airlines: the airline community view is that price rises in excess of RPI are unaffordable while the airport considers that this is unrealistic, in particular given the shortfall in Q5 traffic. Only one of the initially envisaged three iterations of the top-down overall costs/affordability has been completed and it may not be possible to complete another by the end of CE. The CAA considers that further iterations of the top-down assessment might have been helpful in making progress on the affordability issue.

### **CAA expectations for remainder of CE**

The CAA appreciates the work undertaken by the airport and airlines as part of CE and the progress that has been made.

The CAA accepts your proposal to submit the final CE report in December 2012 instead of November 2012 as set out in the mandate. This report should record all points and disagreement in relation to each element of the price control. The CAA envisages that the report will include the supporting context, reasons and evidence for each of the inputs to the CAA's setting of the price control for Q6 and provide full visibility of the range of views. In addition to the regulatory building blocks, other issues including the extension of the price control beyond Q6, and the indicative price paths for subsequent quinquennium should be included in the final CE report.

## CAA consultancy work

The CAA will publish its initial proposals for the regulation of Heathrow in April 2013. These proposals will set out any proposed price cap and associated service quality and incentive regimes.

In parallel to CE the CAA is undertaking its own work to inform its initial proposals. The CAA has commissioned or is in the process of commissioning the following consultancy studies which cover Heathrow Airport.

<b>Title</b>	<b>Consultants</b>	<b>Expected completion date</b>
Comparing and capping airport charges at regulated airports <sup>2</sup>	Leigh Fisher	October 2012
Heathrow, Gatwick and Stansted employment cost study <sup>3</sup>	IDS	October 2012
Heathrow Q5 capex review	Alan Stratford and Associates	January 2013
Passenger satisfaction of arriving, departing and connecting passengers	Being undertaken by CAA's own survey team	January 2013

Based on the progress identified in the mid CE review the CAA intends to commission consultancy in the following areas over the remainder of 2012. The CAA would expect to update its consultancy work following the publication of the Airport Business Plan in January 2013 and undertake further consultancy work as required as part of the Q6 review. Where possible and appropriate the CAA expects to consult on the draft terms of reference of consultancy with relevant stakeholders.

<b>Title</b>
Benchmarking of airport central costs
Maintenance and renewal costs
Other operating expenditure
Top down operating expenditure benchmarking
Commercial revenues
Enhancement expenditure

<sup>2</sup> The terms of reference for this study is at: [http://www.caa.co.uk/docs/78/1387SO25Spec%20\(2\).pdf](http://www.caa.co.uk/docs/78/1387SO25Spec%20(2).pdf)

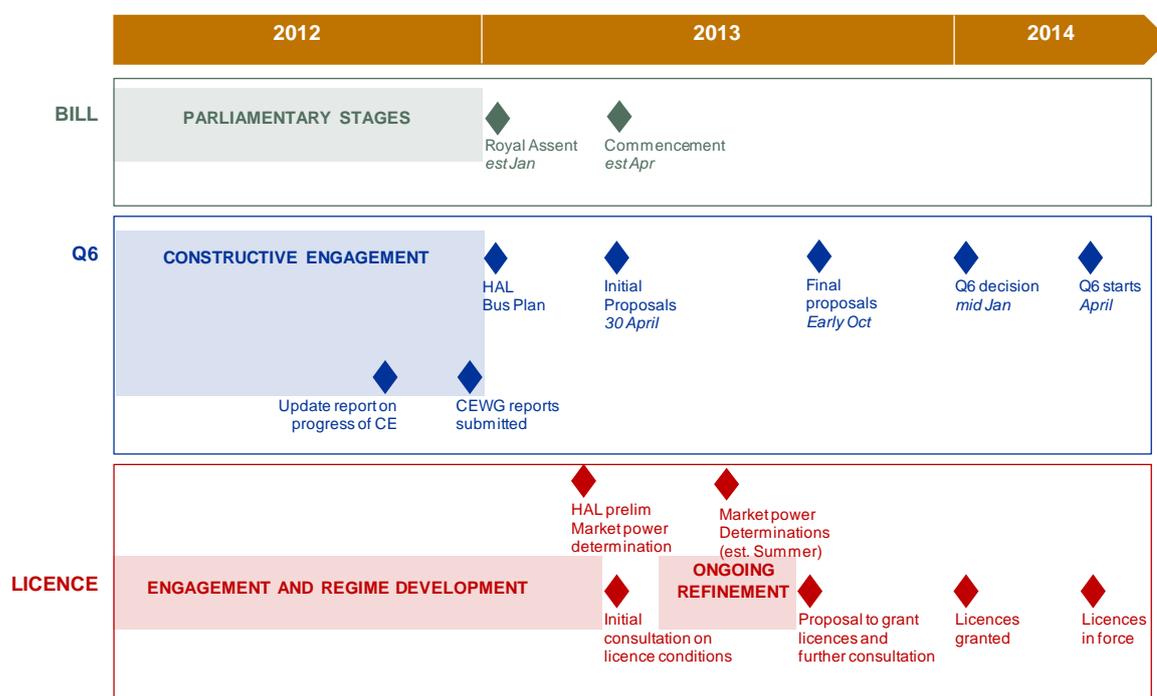
<sup>3</sup> The terms of reference of this study is at: <http://www.caa.co.uk/docs/78/1387SO26Spec.pdf>

<b>Title</b>
Cost of capital review
Long run incremental costs (focused on Gatwick and Stansted)

### Timetable for Q6 review

Based on the progress of the New Civil Aviation Bill and work so far on the Q6 review the CAA envisages the following updated timetable for the remainder of the review. In October 2012, the CAA expects to write to each of the airports to set out its requirements for the January Q6 business plan and the process for submitting updated information during the Q6 review.

The CAA intends to adopt the timetable set out in the diagram.



Apart from the consultancy studies mentioned above and the market power assessment, the CAA has no current intention to publish material ahead of its initial proposals in April 2013. The CAA will, however, keep this under review and will consider publishing further information or analysis if to do so would inform or assist the CE process.

On the timing of consultations during 2013, the CAA would publish its initial price control proposals for consultation at the end of April 2013, followed by stakeholder meetings with the CAA Board in July.

The CAA will then prepare its final proposals for publication in October 2013. The CAA requires any information that is likely to have significant implications for the price control

such as changes in traffic or capital or operating expenditure forecasts to be provided by 20 July 2013 so that it can be taken into account in the final proposals. All parties should assume that any substantive new information provided after this date, will not generally be taken into account, especially if could have been generated earlier and other parties have not had the opportunity to comment.

Yours sincerely,

A handwritten signature in black ink that reads "K Cheong". The signature is written in a cursive, slightly slanted style.

**Ken Cheong**  
**Head of Price Control Regulation**