



## Terms of Reference: Assessment of airport-airline engagement on the appropriate scope, design and cost of new runway capacity

### Introduction

In accordance with the Secretary of State's power under section 16(1) of the Civil Aviation Act 1982, the Secretary of State (SoS) and Department for Transport (DfT) require the Civil Aviation Authority (CAA) to provide advice in connection with the duty of the Secretary of State to develop civil aviation. This advice will comprise views from the CAA on how well, in the CAA's opinion, Heathrow Airport Limited (HAL) has engaged with and responded to the airline community on the appropriate scope, design and costing of new runway capacity at Heathrow Airport.

The SoS will take into account this advice, amongst other factors, when deciding whether to recommend that the Government supports the Heathrow North West Runway scheme in Parliament, through designation of a National Policy Statement, towards the end of 2017.

The CAA is requested to produce a written report for the SoS. Completion of this report may require the CAA to procure specialist advice on cost efficiency. This Terms of Reference outlines the outputs required from this arrangement.

### Background

One of the most important objectives of economic regulation is to secure efficient investment by regulated firms. The CAA already has a number of regulatory tools to aid cost efficiency including Constructive Engagement, capex triggers linked to the delivery of projects, separate categories of 'core' and 'development' capex, the option of 'ex ante' and 'ex post' efficiency reviews and the use of an Independent Fund Surveyor to review major projects as they are being implemented.

The CAA is also currently considering new methods and mechanisms, within the existing regulatory framework, for securing cost efficient delivery of new runway capacity, including the potential for ex-ante financial incentives, strengthening ex-post reviews and enhancing governance oversight. An illustration of how it is examining new approaches can be seen in its recent

consultation on planning costs, where it is looking at applying an incentives-based regime to the treatment of costs.<sup>1</sup>

The CAA and the DfT agreed with the conclusion of the Airports Commission that the current regulatory regime is capable of supporting the delivery of new airport capacity. However, the CAA continues to keep this matter under review and to consider whether it might be appropriate to implement more structural changes to licensing and financing aimed at incentivising cost efficiency, such as a “split RAB” approach.

Overarching this objective of cost efficiency is the CAA’s primary duty under the Civil Aviation Act 2012 Act to “*further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services*”.

Following the Government announcement that the Heathrow North West Runway is its preferred scheme, it is envisaged that HAL and the airlines will engage in a detailed process to review the scope, design and cost of the scheme. The purpose of this process will be to ensure that the scheme meets the reasonable needs of airlines and consumers and, in particular, that the design of the scheme is cost efficient. The CAA will be actively involved in the airport-airline engagement process, observing and advising on the format and quality of engagement throughout the process.

The DfT may wish to observe and potentially participate in elements of the engagement process, but will only do so:

- With the CAA’s prior written agreement and within the bounds of any limits/conditions agreed between the CAA and DfT;
- Subject to any relevant propriety or governance arrangements; and
- In a manner which does not impinge upon the CAA’s independence in carrying out its regulatory duties.

## Objectives and Outputs

The SoS’s primary objective for this work is to understand how well HAL has engaged with and responded to the airline community on the appropriate scope, design and costing of new runway capacity.

The CAA work will focus on three phases (i) reviewing the engagement process; (ii) identifying and evaluating the outputs from the engagement process, predominately the changes made to the design of the scheme; and (iii) assessing the effectiveness of the engagement process. The review will focus on airport-airline engagement principally through the lens of the CAA’s primary duty to ensure that decisions are taken in the best interest of users, i.e. passengers and cargo owners. As the work will be carried out under s.16 and not as part of the CAA’s own regulatory duties, the CAA may also take

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<sup>1</sup> <http://publicapps.caa.co.uk/docs/33/CAP%201435%20JUL16.pdf>

into account other considerations relevant to the SoS's functions where appropriate.

### **(i) Review of the engagement process**

The first part of the review should consider the engagement process between HAL and the airlines. The key outputs include the following:

- Summary of the process proposed and undertaken by HAL and the airlines, covering governance arrangements, timetable, key deliverables and outputs;
- Summary of recommendations put forward by the CAA to improve the engagement process and whether or not those recommendations were implemented by HAL;
- Summary of the scope and content of airport-airline engagement, particularly the extent to which discussions were focused on furthering the interests of passengers and cargo owners or only on narrow commercial issues;
- Assessment of the quality, intensity, maturity and meaningfulness of the engagement between the HAL and the airlines;
- Assessment of any gaps or weaknesses in the engagement process, particularly with respect to passenger interests (and cargo owners), and whether any steps were taken to overcome these;
- Identification of any parties to the engagement process who did not engage in the process, particularly those who 'actively' decided not to engage; and
- Feedback on the engagement process from the HAL, airline representative bodies and specific airlines.
- Any opportunities identified by the CAA, HAL or the airlines to involve consumers or consumer representative bodies in the process (directly or indirectly) and how and whether those opportunities have been exploited.

### **ii) Identification and evaluation of the outputs from the engagement process**

The second part of the review involves the CAA critically assessing the extent to which the engagement process has delivered tangible changes to the scope, design and cost of the runway scheme.

This will largely involve documenting and analysing the outputs, i.e. the changes to the scheme design. This should include, but not be limited to, outlining:

- The key changes made to the scheme design as a result of the airport-airline engagement;

- The key changes made to delivery and implementation plans, particularly any changes to the approach to construction or to the phasing of the project or knock-on effects on the passenger;
- How these changes are expected to impact on the service offered to existing and future passengers and cargo owners;
- Areas where there is agreement over scheme design assets, but significant differences of opinion on the costs and efficiency of these elements of the scheme. This should cover the costs, procurement and delivery methods proposed;
- The key issues identified and discussed during the engagement process, noting any issues which were particularly controversial;
- Any implicit or explicit trade-offs between types of passenger interests (business, leisure, existing, future), or types of airlines (low-cost, full-service etc);
- Any explicit trade-offs made by HAL and the airlines;
- Any proposals advocated by HAL or the airlines which were not included in the final design and the rationale for not including them;
- A summary of outstanding concerns of the CAA, promoter or airlines about the revised scope, design and cost of new runway capacity.

In undertaking this task, the CAA will agree with the DfT the starting design to make its assessment against. This is likely to be either the design detailed in the Statement of Principles or the version presented to the airlines immediately after the Government announcement on scheme preference. It may also be necessary to consider the links to or differences as against the design in the National Policy Statement.

As well as gathering the above evidence, the CAA will also make a general assessment of the nature of the arguments put forward by the airport promoter and the airlines on the aspects of the design that they particularly favoured.

This will include whether the proposed changes would, in general, improve cost efficiency and reduce risks and reflect the passengers' and cargo owners' interests rather than promoting the commercial interests of individual airlines only.

### **iii) Assessment of effectiveness of the engagement process**

The CAA will combine the findings from the review of the engagement process, with the identified outputs, to make an assessment of:

- The extent to which the reasonable interests of existing and future passengers and cargo owners were reflected;
- The extent to which any steps taken to involve consumers/consumer representatives in the process aided in identifying, clarifying and implementing those interests;

- The cost efficiency of the scheme design, with reference to cost benchmarks of other airports and comparable infrastructure projects;
- The overall effectiveness of the airport-airline engagement process and any outstanding airline or other stakeholder concerns about the engagement process;
- The extent to which reasonable airline preferences for the scope, design and cost of new runway capacity have been incorporated;
- The acceptability to the airlines, investors and other stakeholders of the revised scheme design (i.e. the level of agreement reached); and
- Any key risks that HAL and its investors, the airlines, the CAA and Government could be exposed to as a result of the engagement process or the revised scheme design.

The CAA will set out its conclusions on how well HAL has engaged with and responded to the airline community on cost efficiency of the scheme scope, design and costing.

The CAA will also set out its conclusions on whether engagement has led to an appropriate scope, design and cost for the scheme, and an implementation approach, that serves to further the interests of current and future passengers, cargo owners, airlines and other relevant stakeholders. Any lessons from the engagement process that could be used to enhance and inform the regulatory process for setting airport charges in Heathrow's upcoming H7 price control period and beyond would also be noted by the CAA.

## Products

Following the Government announcement on 25 October 2016 that the Heathrow North West runway is its preferred scheme, the CAA will provide the SoS with:

- An initial "health check" in February 2017 on whether HAL has made a good start and whether its plans for the remainder of 2017 are appropriate;
- Summary reports on the CAA's interim findings on a quarterly basis; and
- A final report in November 2017, covering the CAA's conclusions and findings. The timing for the draft report will be agreed at the start of the project when the timeline for airport-airline engagement is clearer.

The timescales for delivery of these products will be subject to the Government's schedule for the delivery of the National Policy Statement and HAL's airline engagement plans.

## Specialist Advice

The CAA will be responsible for delivery of the report. It is acknowledged, however, that the CAA may wish to draw upon the skills and expertise of firms with experience in the planning and management of complex major construction projects, as well as undertaking cost benchmarking. The CAA will discuss any such engagements with the DfT prior to commissioning them and will be responsible for ensuring that they deliver value for money. The CAA accepts that the DfT will have to conduct its own process to scrutinise and sign off their budget before work is commissioned.

In addition, the CAA will be able to access DfT officials and advisors at the DfT's discretion where both parties agree that those officials/advisors could add value to the CAA's activities.

## Reporting and Monitoring

As set out above, the CAA will provide the SoS with quarterly updates on the progress of airport-airline engagement, beginning with the initial "health check" in February 2017. Those updates shall be delivered in the first instance to the Commercial Team in the DfT's Airport Capacity Directorate, although the CAA should be prepared to brief other DfT staff and/or governance bodies if requested to do so.

There will be regular monthly project management meetings with the DfT to ensure the work remains on track. This will also allow any findings on airport-airline engagement to be communicated early and the engagement process revised accordingly. As well as reporting on progress to date and against budget, the CAA should be prepared to provide a forward look on upcoming activities and resource requirements at these meetings.

## Budgeting, Invoicing and Payment

It is acknowledged that the CAA has provided the DfT with an indicative budget setting out the CAA's expected resource requirement and therefore costs by month for the period from October 2016 to December 2017. It is expected that this budget will be refined and confirmed once there is greater clarity on HAL's engagement plans. The DfT and CAA may by agreement amend that budget from time to time as appropriate in the circumstances.

In accordance with section 16(4) of the Civil Aviation Act 1982, the CAA will be entitled to recover from the Secretary of State expenses reasonably incurred by the CAA in providing the advice specified in this terms of reference. The CAA should keep a record of the expenses it incurs in the provision of this advice. For CAA staff, expenses will be based on day rates and pro-rated as appropriate; day rates for different bands of CAA staff will be set out in the budget once reviewed and confirmed. For specialist advice, expenses will be those amounts actually and properly paid by the CAA to advisers.

In recovering such expenses, the CAA should provide the DfT with draft invoices on a quarterly basis at a minimum. The CAA should be prepared to

provide any such information as the DfT may reasonably require in order to determine that expenses have been reasonably and efficiently incurred. This information might include, for example, timesheets detailing time spent by CAA staff on the project or, in the case of external specialist advice, invoices detailing expenditure actually incurred by the CAA. Once the DfT has approved the draft invoices, the CAA should submit final invoices to the appropriate Shared Services Centre for processing: the DfT will provide the requisite details in due course.

## Changes to Terms of Reference

The DfT may, in discussion with the CAA, amend and/or change these terms of reference from time to time, as appropriate in order to meet the SoS's requirements. The CAA will provide an update on the impact any such changes may have on time and/or cost of delivery of the advice.

The DfT reserves the right to terminate this commission at any time and will reimburse the CAA for any expenses reasonably incurred in carrying out work prior to termination.