

Heathrow response to CAA's Draft Guidance on capital expenditure governance (CAP2524G)

CAA-H7-806

Date: 28 April 2023

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Status: Non-Confidential

Executive Summary

1. This document sets out our response to the Civil Aviation Authority (CAA) consultation on capital expenditure governance (CAP2524G) (the **Draft Guidance**).
2. On 8 March 2023, the CAA released its final decision regarding the economic regulation of Heathrow for the H7 period (**Final Decision**). The Final Decision outlines a new framework for capital incentives including the requirement to agree detailed Delivery Obligations (**DOs**) for all capex projects passing through Gateway 3 (**G3**). Alongside its Final Decision, the CAA published the Draft Guidance which requests input on certain questions in relation to the implementation of this new framework.
3. We have repeatedly maintained that the Q6 capex arrangements have been successful and worked in the interest of consumers by enabling the delivery of key infrastructure projects helping Heathrow to become a more resilient, efficient and safe airport for our passengers, airlines and other stakeholders.
4. We have carefully reviewed all the work leading up to and including the CAA's Final Decision on the H7 capex arrangements and have concluded that these arrangements are *inter alia* not workable, proportionate, or targeted. Therefore, on 17 April 2023, Heathrow applied to the Competition and Markets Authority (**CMA**) for permission to appeal the CAA's capex incentives regime for the H7 period as outlined in the Final Decision and associated licence modifications. Heathrow's position is that the new capital incentives framework as set out in the Final Decision should not be adopted. The CAA's consultation, which is based on the assumption that the new arrangements will be implemented is accordingly premature, pending the determination of the CMA.
5. The CAA's Draft Guidance consultation explores certain topics of implementation which are also applicable to the Q6 arrangements, such as agreeing standards of information provision, the role of the IFS and the escalation process to the CAA. Heathrow's response on these issues builds on discussions that we have been having with airlines in relation to arrangements under Q6. However, to the extent any question in the Draft Guidance is premised on the assumption that the CAA's new capex framework is brought into force, any engagement with or commentary on such elements of the new regime should not be considered acceptance of them and nothing in this response document should be understood to reflect or amount to a change in Heathrow's position before the CMA.
6. Subject to the comments above, Heathrow's position on the different elements of the consultation can be summarised as follows:
 - a. Standard information provision: we agree with the CAA's principle to establish a common standard of information required across the appropriate Gateway stages but note there continues to be lack of clarity from the CAA on when a question has been sufficiently answered – see questions 1 and 2.
 - b. Independent review of Heathrow's standards and processes: we are always open to improving our standards and processes and we already review these as part of our continuous improvement. However, we do not agree that, in its current form, the CAA's proposal to introduce a further review of Heathrow's standards and process brings additional assurance when compared with Heathrow's self-assurance and the periodic external reviews that already take place. We therefore question the need for this additional assurance – see question 3.

- c. In-depth technical scrutiny on projects: we agree that projects should have a level of appropriate scrutiny, but this must be carried out in a targeted manner on the areas that have the most importance. Heathrow is already working with the airline community to explore the appointment of third-party independent experts to assist with in-depth scrutiny on certain higher value and more complex projects, and are examining the possibility of expanding the IFS's role to accommodate this need – see questions 4, 5, 6 and 7.
 - d. Delivery Obligations: Heathrow maintains its opposition to the CAA's Final Decision in respect of DOs, for the reasons set out in its notice of appeal to the CMA – see question 8.
 - e. Accessible information on projects and performance: making appropriate project information accessible is important to all stakeholders and we set out further below how we will build on our current arrangements to ensure that information on projects and performance is accessible – see question 9.
 - f. Role of the CAA and next steps: the CAA has a key role in making decisions on projects where Heathrow and airlines cannot reach agreement. We outline why it is not possible to reach a new agreed escalation process at this time but request that the CAA make available its dispute resolution process to better enable timely decisions – see question 10.
7. The remainder of this document responds to the CAA's consultation questions.

Q1. Do you have any comments on the proposed set of standard questions we have set out in the Appendix?

Heathrow response:

The CAA's proposed set of standard questions

8. Heathrow agrees that there should be a pre-agreed set of questions that outline the information provision standard to be met. This will facilitate the timely and efficient execution of capital investment in the best interest of consumers.
9. The list of standard questions proposed by the CAA provides a useful reference point in the discussions between Heathrow and the airline community.
10. However, ongoing collaboration between Heathrow and the airline community is focused on developing a more targeted set of standard questions, along with the gateway at which each question should be answered and indicative answer templates.
11. The current plan, agreed with the airline community at the Programme Airline Working Group on 14th April 2023, is to integrate certain requests made by airlines that develop the standard set of questions into the existing standard Gateway slide template, and revise the supporting guidance accordingly.
12. Due to the ongoing nature of the discussion with the airline community, the list of standard questions will not be finalised by the time this current consultation closes. For this reason, in our consultation response we are not sharing an alternative list of questions.
13. At the point when Heathrow and the airline community reach agreement on a list of standard questions through an approval at the Capital Portfolio Board (CPB), it is intended that this list will be added as an appendix to the Enhanced Engagement & Governance Protocol Addendum (and should supersede any list of standard questions previously proposed by the CAA).

The point at which a question has been sufficiently answered

14. The CAA's proposal to have a standardised list of questions is a step in the right direction, but by itself, this list does not address one of the main points of contention between Heathrow and the airline community: the point at which a question has been answered sufficiently.
15. The difference in view on whether a question has been answered sufficiently has increased in recent years, leading to an ever more burdensome decision-making process and adding cost and delays to the detriment of both passengers and airlines.
16. The effective veto rights that airlines have on each project can force Heathrow to prolong the governance far beyond the point at which we believe a question has been sufficiently answered. The follow-up related questions focus on specific and narrow details that have little bearing on the project – this creates project delays and increases cost.
17. We recognise that that there may be situations in which we need to address information requests falling outside the pre-agreed set of questions. These situations must represent exceptions to the rule, rather than apply to each investment decision – otherwise, the value of agreeing a standard set of questions will be eliminated.

In such cases, we propose to accommodate all reasonable requests for information, but must have the right to decline questions deemed neither targeted nor proportionate.

18. If airlines still consider Heathrow should respond to their requests, we propose that the appropriate step to resolve this would be for the airlines to use the escalation process in place, as set out in the Enhanced Engagement & Governance Protocol, before the issue is brought to the CAA. As part of any escalation process, the airlines should clearly outline why the information already shared does not enable them to make an informed decision and how their additional request is targeted, reasonable and better enables them to make an informed decision.

Q2. By which gateway in the project process should the response to each standard question be provided by Heathrow?

Heathrow response:

19. As per our answer to Question 1, Heathrow and the airline community are developing a list of standard questions. Our aim is to include the relevant gateway at which a question should be answered as part of the standard list.

Q3. Do you have any comments on our proposal to require an independent assessment of the standards and processes that Heathrow commonly applies to capex projects?

Heathrow response:

20. Establishing standards and processes is common practice in delivering capital investments according to industry best practices. Heathrow follows a well-established set of standards and processes that guide the delivery of capital investments.
21. Our standards and processes are regularly reviewed to ensure they remain current and consistently reflect industry best practices. Q6 reviews conducted by Arcadis (commissioned by the CAA) have reviewed some of the most challenging capex projects and have found that Heathrow was generally efficient. Furthermore, throughout Q6, the IFS regularly reviewed our processes and concluded that Heathrow had a high level of efficiency over the Q6 period. Indeed, the IFS has delivered real time regular reporting on key projects over the Q6 period and produced over 650 reports in total, covering 44% of the portfolio by value.
22. With this in mind, we consider the review proposed by the CAA will have limited if any added benefit on the assurance on standards and processes already conducted by Heathrow and external reviewers.

Q4. What are your views on whether the IFS should support a more detailed review and/or whether a different approach to supporting these assessments should be developed?

Heathrow response:

23. The CAA's Draft Guidance considers whether an independent reviewer – namely the IFS – should be introduced for more in-depth scrutiny of costly/complex/impactful projects.
24. The CAA rightly provides clarification that the independent reviewer's role is not to co-design projects, and that Heathrow is the responsible and accountable party for capex solutions.
25. In response to airline requests we are currently working with the airline community to explore the appointment of third-party independent experts or organisations to assist with project development, reporting to both Heathrow and the airlines. We are examining the possibility of expanding the IFS's role to accommodate this need. The first area being trialled is on T2 Baggage tranche 5, consisting of a new baggage system.
26. However, it is crucial that any independent reviews on our project proposals are targeted and add value. To this purpose, we support the use of a £25m (2022p) cost threshold to determine project eligibility for additional reviews, consistent with our responses to the CAA's previous capex engagement. The cost threshold is similar to the current definition of Key Projects, which at the beginning of Q6 set a project cost of £20m as one of the characteristics.
27. For projects below the threshold, we believe sufficient assurance on the project proposals will be offered through the standard information provision and the existing assurances on our standards and processes.
28. Above the threshold, this proposal provides predictability over which upcoming projects require additional scrutiny, allowing all parties to plan resources for in-depth reviews accordingly. We also propose that any independent review of Heathrow's capital projects must focus on providing assurance on specific technical capabilities which the airlines do not have, and on which the airline community would find it difficult to make an informed decision. The in-depth reviews must not be catch-all generic deep-dives and must not duplicate the review proposed by the CAA in Question 3 of this consultation.
29. While Heathrow and airlines are best placed to define the review scope for individual projects, in cases where agreement is not reached, the CAA should have a role in intervening to prevent gridlock, including specific timelines by which to make a decision.

Q5. Do you have any comments on our proposal to require Heathrow to publish a list of projects due to proceed through G3, at least 6 months in advance of the start of each year?

Heathrow response:

30. The CAA's proposals present challenges due to the dynamic nature of the capital portfolio. Having to identify the exact projects requiring additional scrutiny up to 18 months in advance would not give Heathrow sufficient flexibility to respond to portfolio changes. In its current form, the CAA's proposal does not address scenarios where a project reaches G3 earlier than scheduled and is not part of the agreed list, or a project is delayed and does not reach G3 during the intended year.
31. Heathrow currently publishes a monthly list of upcoming capital projects which cover the planned G2 and G3 gateways until the end of calendar year 2023. This is issued to the CPB and Future Portfolio Group, two forums attended by the airline community. This will evolve as the capital programme matures, and it will likely develop into a rolling 12-month view.
32. We propose to select projects for in-depth scrutiny as part of the programmatic approach adopted by Heathrow and the airline community. The selection of projects requiring additional reviews should occur within the P2 Tranche gateway, which provides approval of the overall Programme requirement and delivery approach.
33. By adopting this approach, Heathrow and the airline community can more effectively respond to the dynamic nature of capital projects and focus on the most critical aspects for review. This method will facilitate a more targeted and streamlined process, and will also allow specific items to be discussed at an early development stage. For some more complex projects, it may well take more than twelve months to proceed from G2 to G3 and at times there may be a requirement for additional engagement prior to the G2.

Q6. Which projects that are due to proceed through G3 in the next 12 months would be suitable for a more detailed review?

Heathrow response:

34. The CAA proposes to use the next 12 months' project schedule to assess the level of resources required for the in-depth technical scrutiny.
35. We note that the H7 Final Decision was only published on the 8th March 2023 and the capital expenditure envelope has only just been set. In addition to this, for some programmes (such as Commercial and Efficient Airport), which were not fully included in the Final Proposals, there is not an agreed portfolio allocation with the airline community, or Programme composition. Therefore, we do not believe the capital portfolio for the next 12 months is sufficiently matured to make this assessment comprehensive.
36. For the above reasons, we believe the assessment of resources required for in-depth review would be more relevant if it were based on the current list of projects to be reviewed by the third party expert.

37. Question 7 lists the initial projects and programmes for the third party expert which was proposed by the airline community on 23rd February 2023.
38. As the list is likely to evolve over time, we ask the CAA to permit Heathrow and the airline community to agree the exact project list.

Q7. For each project you think should be subject to a more detailed review, please specify:

Why you think this project is suitable?

Between which gateways should this assessment take place?

What percentage of the estimated overall cost of the project, should be allocated for this assessment?

Heathrow response:

Criteria for in-depth scrutiny

39. We propose that projects considered for in-depth scrutiny should have a few common characteristics:

- **Capital Value higher than £25m:** Additional technical scrutiny prevents stakeholder time and money from being allocated elsewhere. Targeting projects with high costs ensures that these resources are allocated strategically and effectively, maximizing the potential benefits of the additional scrutiny.
- **Complexity:** High-complexity projects with bespoke delivery inherently carry greater risks, as they often involve larger financial commitments, people, process and technology changes, as well as more complex execution plans. By focusing the in-depth scrutiny on these projects, we can ensure the airlines' technical understanding is supported, identifying potential misalignments between the us and the airline community, which would result in improved project outcomes.
- **Operational Impact:** Projects with significant operational impact can affect the airport ecosystem, its day-to-day activities and its long-term objectives. Therefore, it is crucial to ensure that these projects are thoroughly reviewed and analysed to minimise disruptions, reduce inefficiencies, and optimise outcomes.

40. This approach ensures that the benefits of additional scrutiny are maximised, while avoiding unnecessary expenditure on projects with lower risks and complexity.

Potential list of projects

41. The table below shows the list of projects currently proposed by the airlines for the in-depth third party technical reviews. This list was discussed at a high level with the airline community during a bilateral meeting about the third party expert proposal held on 23rd February. The list is likely to evolve over time and we consider that it should be up to Heathrow and the airline community to agree the exact project list which is yet to be finalised.

- T2 Baggage
- T4 Car park (MSCP4)
- Security Programme (Terminal 3 and Campus projects)
- Electric Vehicle charging
- Pre-conditioned Air
- Asset Management and Compliance programme

42. In relation to the final part of Question 7, we consider that assigning a fixed percentage of a project's cost for in-depth technical scrutiny is not an optimal approach. Such a percentage would be arbitrary and may not adequately address the unique requirements of each project review. Instead, we propose that the total cost associated with conducting the in-depth scrutiny reviews should not cost more than the current IFS reviews. This approach ensures that resources for technical scrutiny are allocated based on project-specific needs, rather than an arbitrary percentage.

Q8. Is there any further guidance that the CAA can reasonably provide at this time that would be helpful in setting DOs?

Heathrow response:

43. The CAA’s decision to introduce DOs as a feature of the CAA’s new H7 capex incentives framework is now the subject of Heathrow’s application for permission to appeal the Final Decision. Heathrow’s position remains that requiring Heathrow to secure agreement with airlines on detailed DOs for all projects reaching G3 will make the capex incentives regime overly complex, disproportionate and inefficient, resulting in higher costs and significant delays. The Notice of Appeal also highlighted the lack of clarity in terms of how any reconciliation process for DOs would work in practice with only a limited example provided at H7 Final Proposals stage with which Heathrow had various concerns.
44. Therefore, by way of relief in its CMA Appeal, Heathrow has requested that the CMA quash the decision to introduce the new H7 capital incentives regime requiring agreement with airlines on DOs for all projects – and proposed that the existing Q6 regime remains in place.

Q9. Do you have any views on our proposed requirements for Heathrow to provide accessible information on projects and performance?

In responding to this consultation, we invite Heathrow to outline the format and location through which it will make this information available.

Heathrow response:

45. We take our cost transparency seriously and based on the current information that we provide we are confident that we go beyond the intended requirements.
46. In the table below, we outline how we plan to make the information available:

Documentation topic	How we will make the information available
How we will make the capital efficiency handbook available to stakeholders (CAA consultation, Paragraph 1.5)	Once the decision from the CAA on its guidance is published, and when the Capital protocol has been consulted on and agreed with the airline community, we will update the relevant documents and make the documents available to the relevant stakeholders through a SharePoint site.
Standards and practices put in place for Capex activities (CAA consultation, Paragraph 3.19)	Heathrow has a comprehensive reference document listing all the standards and processes which apply to capital projects. We can make this document available to the relevant stakeholders through a SharePoint site.
The annual list of projects subject to in-depth scrutiny (CAA consultation, Paragraph 3.33)	The current list of Key Projects subject to IFS review is managed by the IFS Co-ordinators and stored on a common SharePoint site. We propose a similar process should apply to the projects under additional scrutiny.
Project-level information about DOs (CAA consultation, Paragraph 3.55-3.56)	We do not agree on the need for DOs – please see our Notice of Appeal.

Q10. Is there any further guidance that stakeholders think would be helpful in relation to the ongoing role of the CAA in this process?
In responding to this consultation, we invite Heathrow to outline the process it has agreed with airlines for escalating disputes.

Heathrow response:

47. Notwithstanding the publication of the H7 Final Decision there are still several steps that need to be completed over the course of 2023, such as:

- The CAA's final decision on its guidance (having considered these responses) will be published sometime during the Summer of 2023.
- Heathrow and the airline community will need to agree the H7 capital protocol by the end 2023.
- The CMA determination on Heathrow's appeal will be issued by 22 August 2023 (or, at latest, by 17 October 2023 if the appeal deadline is extended).

48. Therefore, given the several outstanding areas, it is premature to agree an escalation process with the airline community and we propose that this is instead agreed as part of the capital protocol to be agreed with airlines. We will also need to develop an escalation process that is common across the relevant areas that Heathrow consults on (i.e. Other Regulated Charges) and we cannot create a capex escalation process in isolation.

49. In developing an escalation process, we will draw on learnings from Q6. We will ensure an escalation process is fit for purpose and enables timely escalations to the CAA. Ultimately any disagreement should be escalated to the JSB, as this is the most senior governance forum, before being submitted to the CAA. We will agree this with the airline community as part of the protocol work.

50. Alongside developing the escalation process, we request that the CAA hold itself accountable to resolve issues, including publishing its own process on how it will resolve disputes and the timetable it will follow.

51. We do not agree with the CAA characterising its approach to dispute resolution to be on a case-by-case basis, as set out in paragraph 4.6 of the Draft Guidance. It is critical that the CAA follows a clear, well-defined and predictable process which quickly and responsively considers the issues at hand and ensures it makes timely decisions to avoid the risk of unnecessary delay in the interests of consumers.