

Caroline Low
Director, Airport Capacity Directorate
Department for Transport
1/27 Great Minster House
33 Horseferry Road
London SW10 4DR

28 February 2017

Dear Caroline

AIRPORT CAPACITY EXPANSION: REVIEW OF ENGAGEMENT TO DATE

The Secretary of State has requested, under section 16(1) of the Civil Aviation Act 1982, that we review and advise him on how well 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.

This letter sets out our initial views on the process so far and fulfils the requirement in the Terms of Reference (ToR) that we provide an initial health check in February 2017 on whether HAL has made a good start and whether its plans for the remainder of the year are appropriate. Annex 1 provides some further information on the detail points raised in the ToR.

We have observed the initial immersion sessions that took place between HAL and airlines in December 2016 and January 2017. We have also had a programme of focused bilateral discussions with HAL and airlines to consider their views on the process to date.

Summary of our findings

Overall, in the relatively short period of time since detailed discussions began in December 2016, there has been extensive dialogue between HAL and airlines across a broad range of topics. Although the process is at a relatively early stage HAL and the airline community have both shown a real willingness to engage with each other in good faith and make progress. Both also accept that effective engagement is critical if capacity expansion is to proceed in a timely way on the basis of a scheme design that is affordable, financeable and ultimately in the best interests of passengers.

Notwithstanding HAL's efforts and willingness to engage with the airlines, all of the airlines that we have spoken to identified challenges and difficulties with the way the process has started. This is not necessarily surprising given the timescales for and complexity of the capacity expansion programme.

In developing proposals for resolving these challenges and difficulties we expect HAL to take fully into account the inevitable asymmetries between the parties. There are more than 80 separate airlines operating at Heathrow, with diverse interests and resources. Some will want deep bilateral engagement and some will prefer to use the multi-lateral channels. There are also potential new entrants who want to have a voice. HAL has very significant advantages over the airlines in terms of information, dedicated resource and expertise relevant to capacity expansion.

Given this context we are strongly of the view that this places a special responsibility on HAL to take the initiative to bring forward relevant information in the most helpful way

practicable to the airlines, to take the lead on developing a range of creative options to help solve problems that emerge, and engage in ways that airlines find helpful. It is not enough for HAL to simply inform airlines and/or share information; it has responsibilities to ensure that information has been properly understood. It also has responsibilities to ensure it listens and takes into account feedback (and where it is proposing not to change in response to suggestions or feedback it should explain and demonstrate why its proposed course of action remains appropriate).

Airlines also have an important role to play in moving the process forward and we expect airlines to be clear with HAL how they wish to engage and make sure they invest sufficient resources in engagement to be able to make timely progress. In particular, it is important that airlines take reasonable steps over the coming months to support HAL in refining options such that it can start to identify a plausible range of scenarios for its overall scheme design. This is an important window of opportunity for airlines to influence the scheme design and shape the overall cost envelope, which will have a significant impact on HAL's future charges to airlines.

In monitoring progress ahead of our next quarterly report (planned for May 2017) we will continue our dialogue with HAL and airlines. We expect to HAL to be able to demonstrate clearly that it is contributing more to problem solving, and showing more focus and urgency in ensuring that issues are tackled effectively and resolved in a timely and appropriate way.

Turning to three specific key issues we have identified from the process to date, we look to HAL to lead on and urgently address:

- i. clarifying the governance processes;
- ii. responding to the airlines' view that the affordability of future charges should be prioritised; and
- iii. dealing with airlines' concerns relating to the proposed timetable.

(i) Clarifying the governance processes

Airlines have said they want to engage with HAL in a constructive, collaborative way as an equal partner in the programme by building on the present governance structures, which they consider to work well. Airlines are particularly keen to ensure a governance structure and a planned process for engagement which will enable them to have sufficient time to develop their views and to make informed decisions. There is an urgent need for HAL to ensure the governance and engagement processes deliver for airlines. This issue has been discussed between HAL and airlines on a number of occasions including at both sets of immersion sessions and in subsequent dialogue.

HAL acknowledges that working with the airlines is fundamental to realising the passenger benefits that flow from capacity expansion. HAL has suggested that where meaningful engagement has been difficult this can sometimes be explained by the airlines not yet committing sufficient resources and it has made certain recommendations on how progress might be made. In bringing forward suggestions for problem solving it needs to pursue options in parallel and consider a full range of possible solutions. For instance, HAL helpfully suggested it would fund 3 full-time airline representatives to assist with engagement. But when airlines expressed some reservations about this approach it appears that HAL has waited for airlines to suggest a way forward, rather than proactively suggesting other options and ways forward.

We note that discussions on this subject were ongoing at the time of drafting this update including the establishment of a Governance Working Group and the publication of a 2017 work plan by HAL. Nonetheless, further progress is essential.

Recommendation 1: we expect both HAL and the airlines to prioritise governance, planning and resourcing and to agree a Governance Protocol by 1 April 2017. This should include a roadmap for how the engagement process will develop between now and November 2017 with details of meeting dates, terms of reference for the various groups, consultation milestones, deadlines, information protocols and other relevant issues that will better enable all sides to plan their resourcing and engagement in the process. We also expect

HAL to urgently clarify with airlines how the airline engagement processes link with its proposed DCO consultations, including explaining the requirements for the first consultation due in the summer of 2017 how airlines can raise new issues after this point and still influence the final scheme design. HAL should reflect any well supported proposals or options from airlines in its first DCO consultation or to provide carefully justified feedback to airlines on why various options are not being taken forward.

(ii) Prioritising affordability

Airlines have stressed that HAL's airport charges are currently the highest in the world and have suggested that their support for capacity expansion is conditional on the agreement of an affordable plan. It has been suggested that airport charges should remain flat in real terms from the level they are at today and that this should be an overriding principle for all engagement and design scenarios. In addition airlines have highlighted that more information is required for them to better understand how different design options and scenarios will influence affordability.

HAL has acknowledged the importance of affordability and has said that it wants to work with airlines with the aim of developing an affordable plan that keeps charges as close to current levels as practicable. It has also committed as an early priority to work with airlines to explore whether it is possible to develop a scheme design that would ensure future charges do not rise by more than inflation in any year. It is important that HAL urgently pursues this work.

HAL must help this process by making available to airlines its cost and price path modelling and sufficient supporting information so effective discussions can take place. HAL has said that it is starting to share this information with those airlines that have signed non-disclosure agreements (NDAs).

Recommendation 2: we support HAL's commitment to share its cost and price path modelling and related information with those airlines that have signed an appropriate NDA. This should involve responding to questions and suggestions from airlines, embedding knowledge, and defining the key milestones for further model and scenario/sensitivity development by 1 April 2017. We recognise that the present base case may need to be qualified and caveated, but HAL should provide a sufficient level of detail for stakeholders to understand the key assumptions and building blocks. HAL should also develop a process with the airlines that facilitates the effective exploration of options, scenarios and sensitivities. Airlines are keen to see the impact on charges in the round so it is important that the information set includes data relevant to both the capacity expansion programme and HAL's existing business.

Dealing with airline concerns relating to HAL's timetable

A number of airlines have expressed concerns that HAL's timetable is too tight and this means that there is a risk that the wrong decisions will be made on scheme design. They feel they are being asked to respond to unrealistic timelines and that they need to have sufficient time to ensure they have appropriate expertise available to participate in meaningful discussions.

HAL says it understands some of these concerns, but extending the timetable would delay the significant benefits associated with capacity expansion. It has said the existing timetable is feasible if stakeholders work together to overcome the barriers to meaningful engagement that exist, including around resourcing and information sharing.

Recommendation 3: we expect HAL to develop, justify and keep under review, a clear plan and timetable so airlines can fully understand what is required of them by when. In developing this plan and timetable HAL must consult with and take into account the reasonable concerns of airlines. HAL will need to justify the sequencing information provision, decision making milestones and other key aspects of the timetable and ensure that airlines fully understand the timetable. It must be careful to not unduly constrain airlines ability to influence the scheme by its DCO consultation in summer 2017 and make clear how airlines can continue to influence scheme design during and after this

consultation. HAL must also be clear about the priorities, key risks and those issues that are on the critical path for timely delivery.

Next Steps

As well as the immediate issues discussed above it will be important that HAL acts in a way consistent with its special position in the process on a broader basis and actively looks to solve other problems as and when they arise.

We have also identified a number of other areas which will need additional focus by HAL and the airlines over the coming months that we will report on in future quarterly reports.

- a. emerging evidence on cost efficiency, including benchmarking and HAL's likely procurement strategy;
- b. emerging evidence on affordability;
- c. any explicit or implicit trade-offs that may be associated with affordability objectives and the implications of these for future passengers and cargo owners;
- d. the extent to which engagement discussions have taken into account the views of (i) passengers and (ii) cargo owners; and
- e. the extent to which HAL have provided engagement opportunities for airlines not currently operating at the airport.

In relation to (d) we expect the parties to consider how best to involve the Heathrow Consumer Challenge Board, which is currently in the process of being constituted.

We hope you find this initial health check on the process is helpful. We are happy to discuss it with you and your team in greater detail. We will share it with HAL and the airlines and place a copy of this letter on our website given the potential interest in these issues by a broader range of stakeholders.

Yours sincerely



Andrew Walker
Head of Markets and Performance

Annex 1

CAA advice on the initial phase of airport-airline engagement

This Annex forms part of our initial health check to the DfT on how well 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 engagement process will run until November 2017.

We have observed the initial immersion sessions which took place in December 2016 and January 2017 and we then held a number of focused bilateral discussions with airlines and their representative bodies to consider their views on the process to date. In particular we spoke to the International Air Transport Association (IATA), the Heathrow Airline Operators Committee (AOC), London Airline Consultative Committee (LACC), BA/IAG, American Airlines, easyJet, Air Canada, South African Airlines, Star Alliance, Virgin Atlantic, Oneworld and Lufthansa.

We have also discussed the emerging issues with HAL and we have obtained the views of the Independent Fund Surveyor who has been observing some of the engagement process.

Assessment against the Main Elements identified in the ToR

In compiling this initial health check, we have assessed the engagement process against the eight headings identified in part 1 of the ToR document. We will consider the remaining parts of the ToR in future reports. The sections below summarise our initial evaluation with respect to each element of part 1.

1. The process proposed and undertaken by HAL and the airlines, covering governance arrangements, timetable, key deliverables and outputs

With respect to the process and governance arrangements, HAL's proposed approach was discussed at the airport-airline Joint Steering Board (JSB) and subsequently at the December immersion sessions. HAL's proposal was based upon agreeing joint decisions by June 2017 by (i) **sharing** information through a common access database (ii) **informing** through the immersion sessions to accelerate understanding and gather feedback (iii) **embedding** three airline colleagues in to the expansion team and (iv) **governing** by including an airline voice in programme decision making.

HAL's model included a programme delivery board that reports to Heathrow's Board/Exco, informed by engagement with stakeholder board(s) and supported by a series of workstreams on issues such as business case, people, consents and delivery. HAL envisaged that these workstreams would be informed by stakeholder working groups. HAL proposed that these new arrangements would sit alongside the existing governance model (for business as usual spending) including the JSB and the capital governance board.

Airlines tabled an alternative governance model at the second set of immersion sessions. This included an airline co-ordination group supported by subject matter experts as required on specific topics such as operating costs, capital efficiency and

service quality. This group, termed the Airline Community Coordination Group would be a subset of the LACC, was presented as coordinating activity across airlines and to be the central interface to govern joint decision making with HAL. Airlines envisaged that these governance arrangements would build on the existing governance structures that are in place, on the basis that these work well, and do not necessarily require significant change. Airlines do not expect to embed staff in the expansion team in the way envisaged by HAL as they want to be able to deploy subject matter experts across the expansion programme as needed.

We note that discussions on these matters were ongoing at the time of drafting this update, with a Governance Working Group and the publication of a 2017 work plan by HAL, with the objective of producing an agreed Governance Protocol.

We have also made recommendations as set out in the main letter and below that HAL and the airlines urgently take steps to prioritise governance, planning and resourcing and with the objective of agreeing a Governance Protocol by 1 April 2017.

2. Recommendations put forward by the CAA to improve the engagement process and whether or not those recommendations were implemented by HAL

The CAA's initial set of recommendations made as part of this health check are explained in the main letter and are summarised below.

Recommendation 1: we expect both HAL and the airlines to prioritise governance, planning and resourcing and to agree a Governance Protocol by 1 April 2017. This should include a roadmap for how the engagement process will develop between now and November 2017 with details of meeting dates, terms of reference for the various groups, consultation milestones, deadlines, information protocols and other relevant issues that will better enable all sides to plan their resourcing and engagement in the process. We expect HAL to urgently clarify with airlines how their airline engagement processes link with its proposed DCO consultations, including explaining the requirements for the first consultation due in the summer of 2017 how airlines can raise new issues after this point and still influence the final scheme design. We also expect HAL to reflect any well supported proposals or options from airlines in its first DCO consultation or to provide carefully justified feedback to airlines on why various options are not being taken forward.

Recommendation 2: we support HAL's commitment to share its cost and price path modelling and related information with those airlines that have signed an appropriate NDA. This should involve responding to questions and suggestions from airlines, embedding knowledge, and defining the key milestones for further model and scenario/sensitivity development by 1 April 2017. We recognise that the present base case may need to be qualified and caveated, but HAL should provide a sufficient level of detail for stakeholders to understand the key assumptions and building blocks. HAL should also develop a process with the airlines that facilitates the effective exploration of options, scenarios and sensitivities. Airlines are keen to see the impact on charges in the round so it is important that the information set includes data relevant to both the capacity expansion programme and HAL's existing business.

Recommendation 3: we expect HAL to develop, justify and keep under review, a clear plan and timetable so airlines can fully understand what is required of them by when. In developing this plan and timetable HAL must consult with and take into account the reasonable concerns of airlines. HAL will need to justify the sequencing information provision, decision making milestones and other key aspects of the

timetable and ensure that airlines fully understand the timetable. It must be careful to not unduly constrain airlines ability to influence the scheme by its DCO consultation in summer 2017 and make clear how airlines can continue to influence scheme design during and after this consultation. HAL must also be clear about the priorities, key risks and those issues that are on the critical path for timely delivery. We will report on progress against these recommendations in our future updates that are part of the section 16 process.

3. 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

The immersion days organised by HAL during December and January form the largest part of the engagement efforts to date.

The three-day immersion sessions on 13-15 December were largely about HAL providing base line information to airlines, setting out the key areas of work, HAL's latest thinking on design, the planning process, environmental and community commitments and cost. The basis for these discussions included the "quicker and cheaper" option developed by HAL in September 2016. In summary, the key topics covered included:

- the importance of collaborative working: setting out where key joint decisions would be needed and how HAL intended to engage with airlines, including proposed governance arrangements;
- environmental commitments: outlining how the runway must be built sustainably, mitigating impacts on ecology, air quality, water, social issues, health, noise and carbon and climate (such as traffic, energy consumption and materials used) ;
- the planning process: the requirements and timescales for the NPS and DCO process, with more information on HAL's engagement strategy with the wider community;
- details of HAL's master plan and how the proposed design had developed and changed over time;
- HAL's cost plan: setting out high level cost estimates for different aspects of the design, planning and construction phases;
- benchmarking: explaining the benchmarks HAL will use to help ensure the various parts of the programme are built efficiently;
- HAL's proposed strategy for the airport design and passenger experience;
- how it would present the options and choices on fundamental aspects of the design such as runway length and locations, taxiways, terminals, surface access, airspace and capacity;
- HAL's proposals for airport charges and affordability, looking at how expansion sits within a 30 year investment time span for ongoing asset improvement; and
- the forward programme including how HAL would organise its programme team and governance arrangements and how it intended to develop, consult on and evaluate the strategy and options.

The second, two-day immersion sessions on 17-18 January 2017 provided an opportunity for the airlines to feedback their response and to discuss key issues raised in the first session. Topics included:

- airline feedback on the messages from the December immersion sessions: covering airline views on affordability and how it should be defined, the status

of Heathrow's vision with thoughts on how this could be developed including supporting objectives, views on the Strategic Brief, governance and working together as well as outstanding questions.

- an overview of the government processes by the DfT: this covered the overall timetable; priorities for the next 12 months, airspace modernisation, the importance of affordability as well as the DfT's approach to governance and programme coordination.
- HAL's affordability guidelines and principles: noting the balance to be struck between affordability and financeability; identifying the 6 levers HAL considers can be used to handle affordability (operating costs, allowed return, RAB rules, commercial revenues, aeronautical revenues, passenger forecasts), summary of overall scheme costs, the long-term planning horizon to 2048, further detail on the quicker and cheaper option and HAL's proposed affordability guidelines to be used as an input to optioneering.
- HAL's overview of the decision making process through the DCO: including a summary of the DCO approach, its requirements and the powers that can be granted pursuant to this process, a summary of HAL's approach to wider consultation and interfaces with its master planning processes.
- HAL's timelines and decision making processes: how the plans have evolved, the gateway process, and how to build on existing governance structures.
- HAL's forward programme; overview of master plan workstreams, initial response to airline questions and overview of next steps.

These immersion sessions, and later bilateral sessions have largely been focussed on the overall parameters of the new capacity programme and the expected impact on airport charges for airlines. Based on our meetings with both HAL and airlines, there is general agreement among stakeholders that the direct interests of passenger and cargo owners will need more prominence in the engagement process going forward. In this regard, we expect the parties to consider how best to involve the Heathrow Consumer Challenge Board (CCB) in future discussions.

4. The quality, intensity, maturity and meaningfulness of the engagement between the HAL and the airlines

As we have set out in the main letter in the relatively short period of time since detailed discussions began in December 2016, there has been extensive dialogue between HAL and airlines across a broad range of topics. Although the process is at a relatively early stage HAL and the airline community have both shown a real willingness to engage with each other in good faith and make progress. Both also accept that effective engagement is critical if capacity expansion is to proceed in a timely way on the basis of a scheme design that is affordable, financeable and ultimately in the best interests of passengers.

Two particular issues raised by airlines related to (i) the timely provision of information and (ii) concerns that some aspect of expansion have already been settled by HAL and closed down without full engagement.

On the first of these, availability of the cost and price path model was an example of this with airlines suggesting that it would be made available to them at the time of the immersion sessions and they were frustrated this had not happened. We understand that HAL has now shared information with those airlines that have signed non-disclosure agreements.

On the second issue, there were concerns expressed by a number of airlines that some important issues appear to have already been locked down (e.g. compensation costs) without discussion with airlines on whether the proposals is appropriate and reasonable. A number of airlines also raised concerns around planning costs (category B) noting that HAL was forecasting to spend around £100 million in 2017 and while a deep dive to consider these costs had taken place, they felt that more information was required in this area. On 27 February 2017 we published a decision document on planning costs including, requirements on HAL in relation to the transparency of these costs and setting out incentive arrangements to encourage efficiency.

HAL identified what it considered to be obstacles to more meaningful engagement. Examples of this included airlines initially declining the invitation to attend the Options Steering Group (we understand that more progress has now been made in this area). HAL also noted the delay from the airlines in identifying resources to the working group dedicated to providing feedback on the Strategic Brief and the delays from airlines failing to sign NDAs.

In monitoring progress ahead of our next quarterly report (planned for May 2017) we will continue our dialogue with HAL and airlines. As noted in the main letter we expect to HAL to be able to demonstrate clearly that it is contributing more to problem solving, and showing more focus and urgency in ensuring that issues are tackled effectively and resolved in a timely and appropriate way.

5. 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

As well as the immediate issues discussed above (including under section 3 above in relation to understanding the views of consumers and in section 4 above in relation to the provision of information and governance) we have also identified a number of other areas which will need additional focus by HAL and the airlines over the coming months, that we will report on in future quarterly reports:

- emerging evidence on cost efficiency, including benchmarking and HAL's likely procurement strategy;
- emerging evidence on affordability;
- any explicit or implicit trade-offs that may be associated with affordability objectives and the implications of these for future passengers and cargo owners;
- the extent to which engagement discussions have taken into account the views of (i) passengers and (ii) cargo owners; and
- the extent to which HAL has provided engagement opportunities for airlines not currently operating at the airport.

6. Identification of any parties to the engagement process who did not engage in the process, particularly those who 'actively' decided not to engage

Engagement so far has been wide and extensive and, in the main part, those who would be expected to engage in the process have been willing and able to do so. In particular, the airlines with the largest presence and alliances have all been well

represented. Smaller global airlines are much less engaged in the process although a number of representative groups consider airline interests in the round including LACC, AOC and IATA.

A key issue to note is around the involvement of airlines that are not currently operating at Heathrow. HAL told us that [~~easyJet~~] had specifically declined the offer to engage. easyJet attended some of the immersion sessions but as they are not part of the existing airline governance arrangements were not able to take part in the Heathrow airline only sessions and were asked not to attend (by the LACC airlines) the airline feedback session to HAL.

HAL noted that this approach raised a number of concerns and that this had implications for future engagement. HAL intends to hold bilateral discussions to deal with this issue although it notes the additional time and resources that this will require.

We suggest that both HAL and the LACC should consider further how to provide engagement opportunities for airlines not currently operating at the airport. If necessary HAL should establish a dedicated engagement structure for those airlines that are potential new entrants (including easyJet).

7. Feedback on the engagement process from the HAL, airline representative bodies and specific airlines

As noted in the main letter, we consider that three consistent themes are emerging (i) the importance of affordability; (ii) the need for clarity on governance and planning; and (iii) concerns with the timetable including a risk that insufficient time has been built into the early stages.

As we set out in section 1 above, HAL and the airlines began the process with different views on how best to make progress on governance and the associated arrangements. The CAA's recommendations are that both sides urgently take steps to prioritise governance, planning and resourcing and to agree a Governance Protocol by 1 April 2017.

Section 4 includes a summary of issues that have been raised in relation to the quality of the engagement so far. Airlines have concerns about the timely provision of information and their ability to influence some of the costs such as those that relate to compensation. HAL set out what it considered to be obstacles to more meaningful engagement particularly in relation to airline resourcing of the engagement process.

Section 5 summarises a number of areas where the feedback from HAL and the airlines suggests the need for additional focus from the stakeholders over the coming months. This includes cost efficiency, evidence on affordability, trade-offs, views of passengers and cargo owners and airlines not currently operating at Heathrow.

8. 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

There was general agreement that the process had not yet been able to get sufficient direct input from consumers (i.e. passengers and cargo owners, or their representative bodies).

Airlines suggested that in general they were best placed to represent the views of the passenger and that a focus on affordability is consistent with the preferences of passengers. Nonetheless, they also acknowledge there should be further work to take explicitly account of the other interests of passenger and cargo owners. The CAA is in the process of constituting the Heathrow CCB as an independent expert panel that will help ensure that the H7 price control review is driven by a robust understanding of what consumers' value. The CCB is being established by the CAA in partnership with HAL and the Heathrow Airline Community under terms of reference which were finalised in September 2016. The role of the CCB is to provide independent scrutiny and challenge to HAL on behalf of consumers, on how HAL takes account of and reflects the interests of consumers in its business strategy and operations. As noted in the main letter, we expect the parties to consider how best to involve the CCB in the future discussions on capacity expansion.