

# Final report on airport-airline engagement on new runway capacity at Heathrow airport and proposals for further engagement and reporting – April 2018

Advice to the Secretary of State for Transport under  
Section 16 of the Civil Aviation Act 1982

**CAP 1656**

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## About this document

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This document is our final report to the Secretary of State for Transport (SoS) on how well Heathrow Airport Limited (HAL) has engaged with, and responded to, the airline community on the appropriate scope, design and costing of the proposed new runway and additional capacity at Heathrow Airport.

The Terms of Reference (ToR) for this work require us to provide reports to the SoS on a regular basis. This report describes the progress that HAL and the airline community has made since we provided our provisional findings in February 2018 and sets out our final views on the engagement that has taken place between December 2016 and April 2018. It also includes our proposals for a process of Enhanced Engagement and reporting, to follow on from our Section 16 reporting, that will support ongoing airport-airline engagement and protect the interests of consumers as HAL works to further develop its plans for capacity expansion.

# Chapter 1 - Background and Context

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## Introduction

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- 1.1 In October 2016, the Government announced that its preferred location for the expansion of airport capacity in the south east of England was the Heathrow north west runway. Shortly afterwards, the SoS requested, under Section 16 of the Civil Aviation Act 1982, that we review and advise him on how well HAL is engaging with, and responding to, the airline community on the appropriate scope, design and costing of the new runway and capacity Heathrow Airport.
- 1.2 The ToR ([see here](#))<sup>1</sup> for this “Section 16” work envisaged that we would report on the following three phases of airport-airline engagement:
- [a review of the engagement process](#), including factors such as the scope and content of the discussions, the quality and maturity of the engagement as well as whether recommendations made by us to improve the process had been implemented;
  - [the identification and evaluation of the outputs from the engagement process](#), by critically assessing the extent to which the engagement process has delivered tangible changes to the scope, design and cost of the scheme; and
  - [an assessment of the overall effectiveness](#) of how well HAL has engaged with, and responded to, the airline community. This covers a number of dimensions including the involvement of consumers, cost efficiency, acceptability and risks.
- 1.3 The engagement process began in earnest in December 2016 and gathered further momentum during 2017. We have been involved throughout the process, observing and reporting on the format and quality of engagement, and making recommendations on how the process could be improved. We provided the SoS with an [‘initial health check’ in February 2017](#),<sup>2</sup> followed by [further updates in May 2017](#),<sup>3</sup> and [September 2017](#).<sup>4</sup>
- 1.4 In parallel, we have been consulting on the core elements of the regulatory framework to support capacity expansion at Heathrow airport. Our latest consultation and update (our “April Consultation”)<sup>5</sup> is being published in April 2018 alongside the submission of this final Section 16 report to the SoS. Key objectives of the regulatory framework

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<sup>1</sup> [Terms of Reference](#)

<sup>2</sup> [February initial health check](#)

<sup>3</sup> [May report](#)

<sup>4</sup> [September report](#)

<sup>5</sup> See [Heathrow price control review H7](#)

include developing arrangements that will incentivise HAL to deliver capacity expansion in a way that is timely, efficient, in the interests of consumers, and is both affordable and financeable. These are also key objectives of the engagement process, with the airline community retaining a particularly sharp focus on affordability. Indeed, a key success factor for the airline community and other stakeholders is the development of an affordable scheme. Therefore, the parallel development of the regulatory framework and the initial work we are undertaking on affordability and financeability, are critical to understanding the success of the engagement process in shaping capacity expansion in a way that is acceptable to stakeholders.

## Provisional assessment

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- 1.5 In February 2018, we set out our provisional views on the overall effectiveness of airport-airline engagement as required by the ToR.<sup>6</sup> That report noted that, due to the evolving programme timetable, including allowing for the Government's consultation on the Airports National Policy Statement (NPS) and HAL's initial public consultation in January 2018, HAL would not produce a preferred masterplan for capacity expansion before the third quarter (Q3) of 2018. We explained that this was important context for our Section 16 reporting, as it would limit our ability to report on the final outputs from the process, and certain aspects of its overall effectiveness, as envisaged in the original ToR.
- 1.6 Nonetheless, we were able to use our "February Report" to set out our provisional views on how well in general terms HAL had engaged with, and responded to the airline community on the appropriate scope, design and costing of capacity expansion at Heathrow airport. The key points are summarised below.

### Stakeholder views

- 1.7 In providing feedback to inform the drafting of our February Report, HAL stressed to us that expanding Heathrow is a unique opportunity to address the airport capacity and connectivity shortage of the United Kingdom, noting that the benefits of expansion should flow both to airport users (i.e. future passengers and cargo owners) and the wider economy. The airline community acknowledged that progress had been made through the engagement process. However, they also said that HAL's proposals, the assessment of affordability, and information on cost efficiency, were all at a relatively immature stage of development.

### Engagement process

- 1.8 We considered that HAL had worked hard to engage in good faith and had responded to many of the requirements and challenges set by the airline community. It had shown flexibility and a willingness to listen, and invested significant resources in its efforts to make the multilateral engagement process effective. However, HAL had made only limited further progress in responding to our earlier recommendations, particularly

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<sup>6</sup> See [February 2018 report](#)

those around providing information on costs and affordability. This had restricted the ability of the airline community to engage across a full range of issues, and meant that consumers' views would need to be better represented in the process in future, particularly as HAL formulates its preferred masterplan.

### **Outputs of engagement**

1.9 Our February Report also noted that HAL's high level cost estimate for its revised expansion option (known as the "Westerly Option") could reduce:

- the overall cost of expansion from its July 2016 revised Airports Commission estimate of £16.5 billion by up to £2.5 billion; and
- the total capital expenditure across the airport (i.e. including business as usual capital expenditure) up to 2035 by over £6 billion.

1.10 The airline community broadly welcomed the emergence of this new option, but continued to have material concerns, particularly around costs and the consequential impact on airport charges.

### **Summary and recommendations**

1.11 Overall, we noted that significant progress had been made on engagement and developing the Westerly Option but recognised much remained to be done both before the Section 16 process would conclude in April 2018, and in the period until HAL formulates its preferred masterplan in Q3 of 2018. We made further recommendations for HAL, including that it should:

- continue engaging with non-incumbent airlines as well as incumbents;
- provide an audit trail (and underlying evidence) showing how it has translated the key outputs from its consumer research and engagement into both its masterplan and price control business plan;
- provide our consultants, Arcadis, with all the assistance it reasonably could to support work on the Westerly Option and to take account of the recommendations being put forward by Arcadis and the Independent Fund Surveyor (IFS) (Gardiner & Theobald) as it develops its preferred masterplan over the coming months;
- clarify its position on the outstanding concerns identified by the airline community;
- work with us and with the airline community to improve the evidence base so that, collectively, we can develop analysis on affordability and financeability; and
- stand by the comments it made in its response to the June 2017 Consultation that it will engage in good faith with airlines and third parties coming forward and wishing to discuss and develop alternative commercial and delivery arrangements.

1.12 We also noted that the Consumer Challenge Board (CCB) should play a major role in scrutinising HAL's audit trail demonstrating how it has translated the key outputs from

its consumer research and engagement into both its masterplan and price control business plan.

- 1.13 We noted that the process of airport and airline engagement at Heathrow has significant advantages for consumers, with the airline community being able to input into the process for overall scheme design, make clear their priorities and share their expertise.
- 1.14 We further observed that both the CAA and DfT wanted to build on the success of the current Section 16 reporting and develop a revised process that would be more flexible and focused to support airport-airline engagement through the next review of HAL's price control and up to when HAL submits its DCO application. We set out some high-level considerations of the factors that could underpin such a process and invited the views of stakeholders.
- 1.15 The February Report also included a joint statement from HAL and the airlines setting out their views on:
- the nine key deliverables specified in Phase (ii) of the Section 16 ToR (i.e. the extent to which the engagement process has developed tangible changes to the scope, design and cost of the runway scheme); and
  - the seven key deliverables in Phase (iii) (i.e. the effectiveness of the engagement process).
- 1.16 We welcomed the progress made by the parties on the joint statement and with engagement more generally, but noted that there remained significant challenges.

## **Developments since February Report**

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- 1.17 Since we issued the February Report, the engagement process has continued and there have been a number of developments in the key areas identified in that report. In this section, we summarise the points that HAL, the airline community and other stakeholders have made in response to the February Report. The next chapter of this report sets out our final observations on how well HAL has engaged with, and responded to, the airline community on the appropriate scope, design and costing of the new runway and capacity at Heathrow Airport in this initial phase of airport-airline engagement. The final chapter then updates our proposals on the process for Enhanced Engagement that should follow on from our Section 16 reporting to support ongoing airport-airline engagement and protect the interests of consumers.

### **HAL's views**

- 1.18 HAL noted that the first quarter of 2018 has seen a marked intensification in its engagement with all stakeholders and that it is continuing to make progress with preliminary masterplan evaluation (which will support final masterplan selection). The first public consultation on both expansion and airspace principles has taken place,

both of which concluded on 28 March 2018. Responses are being considered and fed into the evaluation process ahead of the preferred masterplan selection later in 2018.

- 1.19 Engagement with the airline community continues at both a multilateral and bilateral level, including progress with one non-incumbent carrier whose requirements will be brought into the masterplanning process over the coming months. HAL has welcomed the participation of the airline community in the engagement process, but restated its earlier reservations about some aspects of the approach to engagement taken by certain airlines.

#### Affordability and alternative commercial arrangements

- 1.20 HAL confirmed its commitment to developing expansion plans which meet the ambition expressed by the SoS in October 2016 that it should deliver new capacity at prices close to current levels. HAL has also said that meeting this aspiration must not be “a race to the bottom on costs.” In HAL’s view, any assessment of affordability needs to consider the overall effect of expansion on underlying air fares and air cargo costs, rather than simply being an aspiration for no real increase in airport charges. HAL has provided detailed analysis, including a report from Frontier Economics, in support of these views.<sup>7</sup>

- 1.21 In relation to alternative commercial and delivery arrangements, HAL has restated its previous commitments to engage in good faith with the airline community and third parties on these matters. Nonetheless, it set out its concerns on proposals involving separate terminal operation and/or delivery and said such proposals may not be in the interests of passengers, noting poor passenger experiences at airports in Brussels and New York. It also said that such arrangements could hinder airline competition, delay capacity expansion, lead to inefficiency and higher prices and lead to commercial and operational decisions that could be inconsistent with passengers’ interests. HAL said that alternative commercial arrangements should be consistent with the timely delivery of capacity expansion, enable new airlines to enter and grow as well as promote cost efficiency and service excellence.

#### Licence conditions

- 1.22 HAL said it welcomes new licence conditions that the CAA can demonstrate are targeted, proportionate and appropriately advance the interests of passengers and airport users. It also said that licence conditions requiring it to develop, maintain and operate its assets in an economical and timely manner or setting out the processes and requirements for constructive engagement would not be appropriate.<sup>8</sup>

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<sup>7</sup> See April 2018 Consultation for more information - [Heathrow price control review H7](#)

<sup>8</sup> The CAA’s assessment of these matters is discussed further in the April 2018 consultation on the regulatory framework for HAL. See [Heathrow price control review H7](#)

## Section 16 reporting

1.23 HAL has said that the Section 16 process has proved to be resource intensive and bound by rigid terms of reference, allowing only limited flexibility. In HAL's view, an extension of the process in its current form would not be in the best interests of stakeholders or consumers and it suggested that future engagement should be more flexible and targeted. HAL has developed a set of principles that it considers the new arrangements should be based around. HAL considers the new process should:

- be jointly designed and agreed by HAL and airlines, rather than imposed by the CAA and DfT;
- be transparent and prioritise effective two-way communication to facilitate the correct level of meaningful discussion;
- set out clear objectives for engagement from the outset to provide clear direction without rigid terms of reference;
- ensure the outputs focus on the benefits to the consumer rather than the narrow commercial interests of incumbent airlines;
- enable HAL to take decisions based on a broader airline and passenger perspective;
- ensure airlines have regard to Government policy that expansion is necessary, and, therefore, to work constructively through the engagement process (rather than through media outlets) to deliver expansion in the most efficient manner possible;
- not duplicate any existing governance process or place any reporting requirements on Heathrow;
- not undermine the SoS's statutory role in granting DCO consent;
- be sufficiently flexible in terms of its governance, reporting obligations and role, to be able to adapt to changing circumstances; and
- not undermine the CAA's role as regulator.

1.24 In our February Report, we also asked HAL to clarify the outstanding concerns identified by the airlines as summarised in paragraph 52 of that report. HAL's response is set out in Appendix 2 of this report.

## Airlines' views

1.25 The airline community confirmed that they strongly supported the current Section 16 process and that they had engaged in good faith with HAL. They also strongly supported the continuation of engagement and reporting but acknowledged difficulties with the current arrangements, for example in relation to preparation of the joint statement. The airline community also said that the engagement process should not prioritise speed ahead of allowing sufficient time to properly consider decisions.

1.26 They re-emphasised that they operate in a competitive market and are focused on understanding the needs of their passengers. They suggested that their position should not be characterised as a focus on price to the exclusion of all else, but capacity expansion at Heathrow requires affordable charges for there to be a valid business case for expansion and to deliver benefits for passengers. They challenged some of the points made by HAL in its submission prior to the February Report, including that airlines are narrowly focused on their own commercial interests.

1.27 The airline community also noted that:

- the Cost and Benefits Working Group is not performing well and that the focus on the costs of expansion should not be restricted to the capital costs of capacity expansion, but should also include business as usual capital expenditure, operating costs and commercial revenues;
- they support the further exploration of the Westerly Option, including the implications for the Eastern campus;
- they did not understand our statement from the February Report that airlines must not “obstruct the reasonable interests of new entrants” as they have engaged fully and in good faith; and
- there might be scope to streamline the work of the IFS (Gardiner & Theobald), Independent Planning and Cost Reviewer (IPCR) and Arcadis (our technical consultants) and that the independence of the CCB should be confirmed.

1.28 Suggestions for enhancing the Section 16 arrangements were put forward by IATA, and endorsed by the AOC/LACC, including that the new arrangements should:

- be run in a way similar to the current Section 16 process and continue at least until the submission of HAL’s DCO application;
- incorporate quarterly reporting and should facilitate agreement between HAL and airlines where possible;
- focus on ensuring an affordable, deliverable proposal for the DCO application that meets airlines’ broad requirements, including a design which is fit for purpose;
- be developed around a clear understandable masterplan process with appropriate project gateways, with defined entry and exit criteria, and early construction expenditure to only proceed following a “go” decision at the designated gateway;
- be supported by a robust and clear engagement plan from HAL which is stable and does not keep changing;

- make use of financial and affordability analysis carried out using the CAA's financial model with sufficient information being provided by HAL in a timely, relevant and proportionate manner so that airlines can understand and evaluate masterplan options; and
- be supported by scrutiny by the IFS potentially with the IFS having an enhanced role.

### **Other stakeholders**

1.29 We also received responses to the February Report from Heathrow Southern Rail and Heathrow Hub Ltd/Runway Innovations Ltd. Noting that the issues raised by these responses are much broader than the airport-airline engagement that is the focus of our Section 16 reporting, we will discuss separately with DfT the implications of these responses.

## Chapter 2 - CAA's final views

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### Approach to assessing airport-airline engagement

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- 2.1 Since the Section 16 process began, we have adopted an evidence based approach with a view to producing a balanced assessment of the effectiveness of airport-airline engagement. In monitoring progress and developing our views, we have relied upon information from a number of sources including:
- our own observations of the key meetings and the associated papers and discussions;
  - the joint statement provided by HAL and the airlines for the February Report;
  - other submissions made by the parties;
  - regular bilateral discussions that we have held with both HAL and the airlines;
  - feedback from discussions with DfT officials;
  - reports prepared by the IFS (Gardiner & Theobald); and
  - our own analysis (including financial and affordability modelling, and advice that we have received on cost efficiency from our expert consultants, Arcadis).
- 2.2 Based on this information, we set out below our final views for this phase of engagement (December 2016 – April 2018) on how well HAL has engaged with, and responded to, the airline community on the appropriate scope, design and costing of capacity expansion at Heathrow airport. We focus on areas of key importance to the SoS and to airlines including:
- whether the interests of consumers have been appropriately reflected in scheme design;
  - cost information;
  - affordability;
  - alternative commercial arrangements and delivery mechanisms; and
  - engagement with non-incumbent airlines.

### Consumers

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- 2.3 Under the Civil Aviation Act 2012, our primary duty is to further the interests of consumers. In addition, understanding the extent to which airport-airline engagement has delivered an overall scheme that reflects the reasonable interests of consumers is an important feature of the ToR for our Section 16 reporting.

- 2.4 In our February Report, we noted that HAL had provided us with its high-level timeline for engaging consumers on expansion, through existing and planned research and engagement during 2018. We welcomed the progress HAL had made, and challenged HAL to ensure that it provides an audit trail and the underlying evidence showing how it has translated the key outputs from its consumer research and engagement into its masterplan and price control business plan. This should provide assurance that consumers' priorities and preferences have been reflected in HAL's approach to key areas including resilience, terminal design and surface access. We said that the CCB should also play a major role in scrutinising HAL's consumer research and engagement.
- 2.5 HAL's response to the February Report said that its consumer research and engagement strategy is delivering a step change in the breadth of consumer research and engagement. It will place the consumer voice at the heart of expansion through engagement with both the CCB and with airport users. HAL notes that the CCB has also recently provided an interim report<sup>9</sup> that comments on the overall work programme and specific aspects of the research, most importantly how HAL should interpret the results and reflect these in its business plan.
- 2.6 Looking forward to the next phase of airport-airline engagement, we expect HAL to fully deliver on its integrated consumer strategy including by taking account of our recommendations for its approach while making best use of airlines' existing consumer research. We will be asking the CCB to prepare a report assessing how well HAL has reflected consumers' views and other evidence on consumer preferences in its 2018 preferred masterplan.
- 2.7 This report should include the CCB's recommendations to HAL on the type of evidence that the CCB considers will be required to refine and improve the masterplan. As well as commenting on HAL's masterplan, the CCB will also provide reports to us on how well HAL's initial and final price control business plans have incorporated the views of consumers. We expect HAL's approach to consumer research and engagement to be joined up across the Enhanced Engagement process discussed below and as part of the price control process. The reports that the CCB provides to us will be published on our website.
- 2.8 In addition to these reports from the CCB, we will also be asking Arcadis to advise us on the steps that HAL is taking to ensure consumers' interests have been taken into account in developing its preferred masterplan later in 2018.

## Cost information

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- 2.9 We said in the February Report that HAL had made good progress in optioneering and evaluating components as part of the masterplanning process. In terms of the Westerly Option, we noted that the level of information available was constrained by the timing

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<sup>9</sup> [CCB Report](#)

of HAL's preferred masterplan (due in Q3 2018). Nonetheless, a report from the IFS (Gardiner & Theobald) provided to us in January 2018 had raised a number of concerns including that there should be a more detailed explanation of the scope of amendments envisaged in the Westerly Option and that more information and clarity was required on cost benchmarks and allowances for contingency.

2.10 In light of the IFS report, which made several recommendations on the Westerly Option, we commissioned Arcadis to review the costings of the Westerly Option and its report on these matters will be published shortly. The key points to note are that:

- the cost estimates for the Westerly Option are high level and are supported by only limited documentation. Nonetheless, assessment of this documentation, and further discussions with HAL, have given Arcadis reassurance that the Westerly Option is a credible scenario and that the key components of that option warrant further consideration by HAL as it develops its masterplan;
- the benchmark rates used in deriving the costs for the Westerly Option generally appear reasonable; and
- on the basis of Arcadis' benchmark assessment of other airports, the aspiration for 8,000 square metres of gross internal floor area per million passengers per annum for new terminal facilities could put pressure on passenger service levels and require the re-provision of space elsewhere.

2.11 The Arcadis report includes some more detailed findings and recommendations to HAL such as further developing the cost estimates during the masterplan formation process and getting greater input and buy-in from the airlines. We will expect HAL to take full account of these recommendations as it develops its masterplan over the coming months.

2.12 We also note that over the past six months the IFS (Gardiner & Theobald) has made various recommendations to HAL for improvement to the expansion process. Some of these are similar to observations made by CEPA in a report that we published in April 2017.<sup>10</sup> In response to that report HAL indicated it would progress discussions with the airline community and us throughout late 2017 and early 2018. We understand that discussions have been held at the Q6 IFS working group although we are not aware that substantive progress has been made in implementation. We therefore expect HAL to more positively respond to the CEPA recommendations and to either adopt or provide a reasoned rejection of IFS recommendations in the future. We expect to see clear improvement in these areas and will review progress in our next regulatory update document planned for November 2018.

2.13 In parallel, we will continue to work with the IFS and Arcadis to develop our own cost assessment strategy and we will periodically issue updated assessments at key stages

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<sup>10</sup> Review of Heathrow Airport's Q6 Capex governance framework. See [CEPA report](#)

of the regulatory process. HAL has much additional work to do on providing assurance and evidence that its projections of costs are robust and efficient.

### **Masterplan development process**

2.14 We also noted in the February Report that it would be important for stakeholders to have confidence in the processes and information that HAL provides on cost efficiency. HAL had provided a timetable for the provision of further information and we invited stakeholders' views on this timetable.

2.15 The airline community have subsequently submitted a paper to HAL setting out their requirements for the masterplan gateway process which is attached as Appendix 1 to this document. In summary, the airline community has said that they want:

- a clear and understandable process;
- the scheme requirements and evaluation criteria to be agreed;
- to understand how operating concepts fit in to the process;
- sufficient information to properly evaluate masterplan options; and
- a clear and stable plan that does not keep changing.

2.16 Looking ahead, it is now critical that HAL prioritises these matters over the coming months by working with airlines to agree a process and plan for providing the relevant design, cost and other related information. HAL should also have regard to these matters in developing the new governance protocol with the airlines as discussed below in paragraphs 3.6 to 3.9.

## **Further information on affordability**

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2.17 Throughout the Section 16 process, and in response to our regulatory consultations to date, airlines have retained a particularly sharp focus on the affordability of capacity expansion. The Transport Select Committee also recently commented that it "*would like to see evidence to demonstrate that the Northwest Runway scheme is both affordable and deliverable and that steps are being taken to address the valid concerns we heard in evidence about the high cost of the scheme and the significant risk that costs will rise*".<sup>11</sup>

2.18 In the February Report, we noted that HAL had made limited progress on building upon the affordability information that it had included in its earlier Westerly Option dashboard. We asked HAL to provide further supporting information and evidence on its key assumptions (passenger traffic scenarios, likely ranges for capital expenditure, net non-aero revenues, and regulatory depreciation) and urgently work with us to provide greater assurance on the robustness of these assumptions.

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<sup>11</sup> See Paragraph 54 of [TSC report](#)

- 2.19 To take this forward, we hosted a series of workshops to examine affordability and financeability in greater detail during March 2018. We invited HAL, the airlines and the IFS to attend and take part so that, collectively, we could develop the analysis to help inform this key issue in time for our final report to the SoS. We used these discussions to share more details of our initial assessment, using a financial model and inputs developed following engagement with HAL and airline community representatives. The modelling was primarily based on early and indicative cost and other information on the Westerly Option provided by HAL.
- 2.20 The key point to note from this work is that while the range of plausible outcomes remains wide, our initial assessment suggests that there are credible scenarios in which capacity expansion can be delivered affordably and financeably, with airport charges per passenger remaining close to current levels in real terms and in line with the ambition expressed by the SoS on these matters in 2016.
- 2.21 For instance, our April Consultation illustrates a possible scenario based on HAL's assumptions for the costs of the Westerly Option, combined with a mid-range estimate for the cost of capital based on PwC's early and preliminary work on these matters (which was published alongside our December 2017 consultation) that gives airport charges per passenger that are broadly consistent with 2016 levels in real terms. This is only initial analysis and is subject to further consultation, assessment, development and change.
- 2.22 Of course, this is only one scenario and all stakeholders will need to work constructively together to ensure that capacity expansion is delivered efficiently (and no unnecessary costs are incurred) to support the delivery of affordable levels of airport charges. We will seek to develop and improve this initial assessment as further information on the preferred expansion scheme becomes available during 2018 and 2019. We will continue to model scenarios as the scheme is refined and we obviously cannot rule out the need to address scenarios where airport charges per passenger vary significantly from our initial analysis, not least given the considerable uncertainties that relate to HAL's current cost estimates. The detail of our approach to conducting this initial analysis and a fuller presentation of the result are set out in our April Consultation.

## **Alternative commercial and delivery arrangements**

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- 2.23 Our February Report said that HAL should stand by the comments it made in its response to our June 2017 Consultation that it will engage in good faith with the airline community and third parties coming forward and wishing to discuss and develop such alternative commercial and delivery arrangements.
- 2.24 We have considered the representations we have received from stakeholders on these issues in response to our December 2017 consultation on the regulatory framework and the lack of evidence from HAL that it has actively engaged with stakeholders on these matters.

- 2.25 Shortly before we finalised this report, HAL provided an overview of its proposals for engagement on alternative commercial and delivery arrangements. We welcome the initiative that HAL has shown in respect of these matters and will want to understand its approach in more detail. Nonetheless, our initial view is that it will be important that HAL takes the airline community and other stakeholders along with it in developing these arrangements and that it ensures that the arrangements are sufficiently flexible, to allow for open minded and genuine dialogue. HAL's process should also allow for credible alternative proposals to be modified and evolve so that they can be properly evaluated in terms of integrating with wider plans for capacity expansion and protecting consumers.
- 2.26 In the light of these considerations our April Consultation includes proposals for further engagement between HAL and interested parties on alternative commercial and delivery arrangements. This will include a new workstream focused on alternative commercial and delivery arrangements for elements of the programme (such as new terminal development). 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. This should commence before the end of May 2018 and include the arrangements for providing sufficient information to facilitate the assessment of alternative arrangements. It should also include arrangements for dealing with commercially in confidence discussions/material and also be progressed in a timescale consistent with other programme milestones. Further details are set out in our April Consultation.
- 2.27 This will be an important workstream as part of the Enhanced Engagement and reporting process described in Chapter Three below.

## **Engagement with non-incumbent airlines**

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- 2.28 HAL has told us that its engagement with one non-incumbent carrier has reached further maturity in recent months through regular meetings to discuss different aspects of the scheme with more meetings planned in the coming months. In addition, HAL has made several attempts to engage other major carriers, although these airlines have not yet been in a position to fully engage. HAL has said it will shortly begin the process of engaging with all UK domestic airlines about delivering additional services across the country from an expanded Heathrow. The first stage of this will be through a regional connectivity conference hosted by Heathrow. We welcome this initiative and will expect HAL to continue to pursue engagement with non-incumbent airlines as part of the ongoing Enhanced Engagement and reporting process set out in Chapter Three.

## **Other factors from Section 16 Terms of Reference**

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- 2.29 As we note earlier in this report, HAL has said it cannot assemble the preferred masterplan for capacity expansion before it has assessed the results of its initial public consultation and a decision is taken to designate the NPS so its masterplan will not be ready until Q3 2018. This timetable means that we are not able to address all of the

detailed points set out in phases two and phases three of the ToR (for example, the acceptability to investors and other stakeholders of the final scheme design) for this report. Nonetheless, Chapter Three of his report includes proposals for Enhanced Engagement and reporting that should support consideration of the full range of issues necessary for the development of capacity expansion in a way consistent with the interests of consumers.

## Summary

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- 2.30 Overall, we consider that the process of airport-airline engagement has considerable benefits for consumers. A new set of governance arrangements has evolved through this process which provides a solid foundation for future discussions on the appropriate scope, design and costing of new runway capacity. The engagement process has led to tangible changes in the scheme design including a reduction in costs of some £2.5 billion with the emergence of the Westerly Option. Moreover, early analysis of the cost information provided by HAL suggests that there are credible assumptions that could lead to a path of prices that is broadly consistent with the SoS's ambition of keeping charges close to current levels in real terms.
- 2.31 HAL has engaged meaningfully with the airline community on the scope, design and costing of new runway capacity at Heathrow airport – and this process has delivered tangible improvements to the scheme. The quality, maturity and intensity of the engagement process has improved markedly since the process started in December 2016. The scope of engagement has been extensive, particularly through the Airline Working Groups (AWGs). These have covered a wide range of topics, including capacity and efficiency, land use, runway operations, sustainability, surface access, terminals and satellites, the sub-masterplan assembly process, resilience and airline community requirements.
- 2.32 Nonetheless, there remain important areas which HAL must progress urgently to secure the confidence of stakeholders including:
- ensuring that consumers' interests are reflected in the design;
  - demonstrating that it has properly considered alternative commercial and delivery arrangements;
  - providing comprehensive information on programme costs and cost efficiency as a matter of urgency; and
  - demonstrating the overall affordability and financeability of capacity expansion.
- 2.33 In order to address these points and to promote the delivery of capacity expansion in a timely way that will be in the interests of consumers, we propose an Enhanced Engagement and reporting process to build upon and improve the current Section 16 arrangements. Our proposed approach to Enhanced Engagement is explained in Chapter Three.

## Chapter 3 - Next steps

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- 3.1 All stakeholders have agreed that the process of airport and airline engagement at Heathrow has significant advantages for consumers, with airlines being able to input into the process for overall scheme design while making clear their priorities and sharing their expertise.

### Enhanced Engagement

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- 3.2 We now propose to build on the success of the current Section 16 reporting with an improved Enhanced Engagement process that is sufficiently flexible to support airport-airline engagement through the next review of HAL's price control including the period during which HAL prepares its DCO application. It will also be better integrated with the development of the framework for economic regulation. In May 2018, we will publish a Terms of Reference for Enhanced Engagement and reporting, which has taken account of feedback from stakeholders and has been agreed between us and the DfT.
- 3.3 Taken together this broad approach will allow the CAA to provide its views to DfT on:
- how well HAL has engaged with and responded to the airline community on its plans for capacity expansion at Heathrow airport; and
  - whether this engagement is appropriately reflecting the interests of consumers in line with the CAA's duties under the Civil Aviation Act 2012.
- 3.4 To achieve these aims Enhanced Engagement will need to:
- strive to deliver the SoS's cost ambition which he made in October 2016 to keep airport charges close to current levels in real terms;
  - focus on value for money, including through benchmarking and the use of expert independent advice such as the enhanced role of the Independent Fund Surveyor;
  - be inclusive of all airlines, including both airlines currently operating at Heathrow and potential new entrants, including the provision of accessible and appropriately tailored information;
  - require all parties to be prepared to engage in good faith, including in relation to credible alternative commercial or delivery arrangements;
  - ensure the process is proportionate and sufficiently well resourced, without placing excessive burdens on either airlines or HAL or other stakeholders;
  - deliver high quality engagement with no decline in the current quality and intensity of engagement, building on it where necessary;

- be flexible to reflect changes in the wider capacity expansion programme;
  - include an important workstream relating to alternative commercial arrangements, as discussed in the April 2018 consultation on the regulatory framework for HAL; and
  - ensure that the process includes an appropriate gateway or gateways for airlines to have a formal opportunity to express their commercial views on whether sufficient comfort is available on overall scheme affordability.
- 3.5 We will continue to be actively involved in the engagement process, facilitating discussion and ensuring that the interests of consumers are fully reflected in the plans for capacity expansion. Given the national importance of infrastructure development at Heathrow airport, we will continue to report to the DfT and ensure that the process is sufficiently transparent, including in relation to the tracking of risks and risk mitigation strategies.

## **New governance protocol**

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- 3.6 We now invite HAL and the airline community to build on these principles by working together to develop and agree a new governance protocol by 20 July 2018 with details of how the current engagement arrangements will be developed to deliver Enhanced Engagement. We recommend that the parties undertake a holistic review to develop a new protocol that sets out the governance arrangements, rules of engagement and escalation mechanisms for Q6 governance fora and expansion fora. It should set out how these fora interact as part of an overall integrated engagement framework. We expect the protocol to be a consolidated, well signposted single point of reference for engagement matters.
- 3.7 This protocol is an opportunity to ensure governance is fit for purpose and should be used to underpin the effective delivery of Enhanced Engagement through the period at least until HAL submits its DCO application (when engagement requirements may be reviewed). In the interim period until 20 July 2018, the existing capital governance protocol should continue to apply.
- 3.8 As a minimum, we would expect the new protocol to include:
- a clear statement that the Enhanced Engagement will be focused on establishing and delivering the framework for engagement summarised in paragraphs 3.2 to 3.4 above;
  - details of the arrangements within the expansion process for the airline community to have a formal opportunity to express and properly explain and justify their commercial views, through a process gateway, on whether sufficient comfort is available on overall scheme affordability before HAL incurs significant early construction costs or submits a DCO application;

- a summary of the governance groups used in the process, including their terms of reference, consultation milestones, deadlines, information protocols and other relevant issues that will better enable all sides to plan their resourcing and engagement in the process;
- commitments from the parties as to how they intend to provide the appropriate resources to the engagement process as well as commitments to engage constructively and to respond to reasonable requests for information;
- clearly defined dispute resolution and escalation measures;
- how HAL intends to develop its communications strategy to ensure non-incumbent carriers are able to access appropriately tailored information on expansion; and
- details of the masterplanning and business planning processes with clear references to the key milestones and gateways as well as agreement on the key constituents of the process such as the overall scheme requirements, the business case, evaluation criteria etc having due regard to the airline community requirements identified in Appendix 1.

3.9 We expect this protocol to underpin the effective delivery of Enhanced Engagement through the period until HAL submits its DCO application at which time the broader arrangements can be reviewed. We note that the protocol may be updated from time to time to reflect any developments that arise in the wider expansion process. We will also ask Arcadis to review the protocol and provide advice to us on whether it is fit for purpose and will help protect the interests of consumers.

## Other stakeholders

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3.10 Other stakeholders are also important to the Enhanced Engagement process and should have appropriate roles in it. The IFS should continue to report to HAL and the airline community on capital efficiency, with stakeholders taking steps to ensure that its draft and final reports are circulated to all relevant parties in a timely manner. In addition, the role of the IFS will be enhanced to include more formalised reporting to the CAA.

3.11 The CCB should also have an active role in the process, helping to ensure that HAL's masterplan and subsequent price control business plans are based on, and fully reflect, good quality consumer research and engagement. As noted above, in paragraphs 2.6 and 2.7, we will be asking the CCB to prepare a report assessing how well HAL has reflected consumer views and evidence on consumer preferences and priorities in its preferred masterplan in 2018, and to make recommendations for how HAL should continue to reflect consumer views in refining the masterplan up until it submits its DCO application.

## Summary of next steps/actions

3.12 The box below summarises the next steps/actions we expect HAL and the airline community to progress as part of the new Enhanced Engagement and reporting process. We will review progress in each of these areas and provide an update in our next regulatory update in November 2018.

### Alternative commercial arrangements

- We expect HAL to prioritise further engagement with interested parties on alternative commercial and delivery arrangements. This includes the urgent development of a new workstream focused on elements of the expansion programme (such as new terminal development). 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.
- This should commence before the end of May 2018 and include the arrangements for dealing with commercially in confidence discussions/material and be progressed in a timescale consistent with other programme milestones.
- We expect all participants in these discussions to act in a professional and constructive way, demonstrating the flexibility to find arrangements that will benefit consumers.

### New governance protocol

- HAL and the airlines should work together to agree a new governance protocol by 20 July with details of how the current engagement arrangements will be developed to deliver Enhanced Engagement.
- We expect the protocol to include the matters set out in paragraphs 3.6 to 3.9 above and Appendix 1.

### Consumers

- We expect HAL to fully deliver on its integrated consumer strategy for H7 and expansion, including our recommendations for its approach and also making best use of airlines' existing consumer research. We expect HAL's approach to consumer research and engagement to be joined up across the Enhanced Engagement process discussed in Chapter Three and as part of the price control process.
- We expect the CCB to play a major role in the process, by helping ensure that the masterplan and business plan are based on, and fully reflect good quality consumer research and engagement.

### .Cost information

- We expect HAL to provide comprehensive information on programme costs and cost efficiency as a matter of urgency.
- This should include rising to the challenge of the requests from the airline community for the masterplan process as set out in Appendix 1 and being responsive to the recommendations set out in the reports by the IFS, Arcadis and CEPA on its cost estimates and capital governance processes.

# Appendix 1 – Airline community requirements for masterplan process

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## 1. Process

### **Airlines want a clear and understandable process**

- The M3, M4 gateway process must be clear and understandable
- The relevant constituents of the process must be clearly defined and their role within the process clearly understood. These constituents should be made available to and agreed with the airline community. These constituents include:
  - Overall scheme requirements
  - The business case
  - Masterplans
  - Evaluation criteria
  - Preference keys
  - Operating concepts
- There needs to be clarity on how the business case / modelling work is part of this process
- There needs to be an explanation on how processes not captured within the AWG 15 slides are being incorporated e.g. Capacity Deliverables (as per March OAG), Estimating Process (March JEB), Preference Keys

### **The scheme requirements and evaluation criteria need to be agreed**

- We need to revisit the requirements and agree what they are and what their priority is.
- We want visibility of the evaluation criteria, sub criteria and Preference Keys ahead of milestone 3b and want to be fully consulted on and to agree these

### **We need to understand how Operating Concepts fit into the process**

- How are they constructed?
- How and when we will airlines be involved in agreeing them?
- How do they fit into the process and how will they be used for assessment purposes?

### **We need sufficient information to evaluate Masterplan options**

- For each masterplan we want a clear description of what is included (e.g. TTS etc.), with clarity on: scope; assumptions; cost and indicative phasing.
- For each masterplan option we believe that as a minimum we need the following information to assess the masterplans against the criteria to clear numerical capex costs for the total cost together with a breakdown into major components from milestone 3b. (This should be a key deliverable for 3b and we will be unable to declare 3b reached without this)
- these costs to be tracked along with a confidence level as we move through the milestones
- A high level comparative assessment of Opex and commercial revenue for each masterplan.
- An assessment of operability for each masterplan

- An assessment of airport charges for each masterplan using the CAA evaluation model to test affordability including 2R Masterplan and BAU costs.

## 2. Plan

### Airlines want a clear, stable plan that does not keep changing

- The plan for M3, M4 process must be clear and understandable
- Milestones in the plan should have clear dates and clear deliverables. These dates should be strictly adhered to. Any more detailed schedules should also have clear dates.
- There must be adequate reading and preparation time built into the process and agreed up front by the airline community.
- There must be clear engagement processes and forums, so we can plan resource accordingly
- There is a need to clearly distinguish between gateways and milestones; there should be clear deliverables for each milestone and clear criteria for each gateway. (Our view of the criteria for M4 is shown below)
- If dates are not met the process should be delayed until they are met
- There should be a consolidated assumptions log / tracker
- M4 is a crucial period for the engagement process and will test the governance of the project.

## 3. M4 Gateway – our view on key criteria

- Entry Gateway for M4 (Conclusion of the current stage)
- Brief – Masterplan level requirements for (e.g. Pier Service against which the Masterplan will be assessed.)
- Business Case – Full proposition modelled for viability (affordability).
- Design Deliverables – Report presenting the response to the Brief and clarifying the scope.
- Design Report for Costing – To contain area schedules related to facilities and high level quantification of the scope.
- Delivery Strategy – Comparative at M3 and optimised at M4 to provide outline phasing for delivery of scope (supporting the assumed timeframes in the model)
- Programme Level Timeplan
- Cost Estimate – Comparative at M3 and final at M4. To be accompanied by a full basis of estimate document.
- Risk Report – Providing a clear understanding of the risks, opportunities, assumptions and exclusions built into the programme assessment.
- Reconciliation of Category B Spend to M4.
- At least a month with documentation to allow full IFS review.

### Exit Gate (Readiness for Next Stage)

- Governance & Management plan – critically identifying the next gateway and the principal activities to achieve.
- Detailed Activity Plan – co-ordinated plan to achieve the next stage, resourced to demonstrate planned efficiency and identifying key risks associated.
- Processes & Procedures captured in a stage execution plan – to include management of design delivery, change (project and stage), risk, stakeholder communications, planning and political etc.

- Organisation Chart for next stage.
- Stage Deliverables Schedule.

## Appendix 2 – HAL clarification of its position on issues raised by airlines

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In our February report, we asked HAL to clarify the outstanding concerns identified by the airlines as summarised in paragraph 52 of the report. HAL has provided the following response.

### ***“The costs and risks of alterations to the M25 and bridging the new runway over the motorway”***

Heathrow is developing the masterplan in a systematic process, following best practise that incorporates inputs from public consultation as required for DCO application. The M25 is a component of that masterplan and we are working with Highways England to develop the scope, and once we have completed Consultation 1 we will incorporate Highways England and the public’s feedback into that scope development. The costs of M25 will be developed in line with the design process, and commensurate to the stage of the programme. The next step in systematic masterplan process is to evaluate “assembly options” which will include revised costings and associated risk for the M25. We are also working with Highways England to develop “cost principles” to give clarity as to what Heathrow will pay for associate to alterations to the strategic road network including the M25.

### ***“The treatment of planning and early compensation and construction costs”***

The CAA has defined its policy regarding the treatment, reporting and remuneration of planning costs (category B costs) including the required Licence modification. Heathrow understands it and it is following it. We are following the prescribed steps to enabling the airlines and the Independent Planning and Cost Reviewer (IPCR) to play the role assigned to them by the CAA.

Regarding early compensation and pre-consent construction costs (early category C costs), Heathrow has consistently requested for policy certainty at the earliest opportunity. It is instrumental for a timely, efficient and fair delivery of Expansion that this policy is place in 2018, ahead of the significant investment that Heathrow will have to carry out in 2018 and onwards. Heathrow is also engaging with the CAA and the airline community to support the delivery of this policy. We are committed to continue working with the CAA and the airlines to comply with the policy once it is final.

### ***“Facilitating third party development at Heathrow to introduce competition to HAL”***

As part of our ongoing work with the airlines, we are going to set up a sub group of the Joint Expansion Board which will develop the Expansion Procurement Strategy in a broad and open manner. We will look for ideas for alternative forms of procurement from the Airlines as well as Heathrow

### ***“The treatment of risk and contingency”***

Heathrow run regular Risk Working Groups to manage the allowances made within the estimates for contingency. Within the risk working group a strategy to manage risk and contingency has been developed that enables the relationship between masterplan development and risk allowances to be proactively managed. The affordability envelope sets a maximum Capex profile that is to be worked within. The base scope within the masterplan has been developed and the key components benchmarked and assured by the Independent Fund Surveyors (IFS). In addition to this the project on-costs (Project Specifics, Preliminaries, Overheads and Profit, Design and Leadership and Logistics) have also been reviewed by the IFS.

The base costs and the associated on-costs contained within the masterplan are known as the “cost stack”. The difference between the cost stack and the affordability envelope is the contingency / risk allowance. As masterplan assemblies develop the cost stacks will flex (upwards or downwards) according to the scope contained within the assembly. The associated risks for the key components will be identified and assessed. The affordability envelope will remain and scope will accordingly reduce or increase in the cost stacks to gain the optimum balance between risk allowances and developing the strongest, most affordable masterplan assemblies.

### ***“The operation of terminals and airfield and how this drives demand, particularly with regard to automation”***

Since the beginning of 2018, Heathrow has been assembling component options and integrating them to create masterplan assemblies. A shortlist of assemblies has now been agreed upon and will be evaluated against a broad range of criteria (e.g. airfield performance, landside and airside connectivity). This evaluation work will produce operational performance data for each of the options which will help to contribute to an informed discussion on the advantages and disadvantages of different operating procedures. The early modelling data to inform such evaluations has already been shared with the airline community during February and March 2018 with further data expected to be available from between April and June 2018.

### ***“The objective to improve resilience compared to today”***

Heathrow has recently begun discussions with the airline community and the CAA on the subject of resilience. This has allowed us to jointly understand what is meant by resilience and begin capturing requirements to build into the Masterplanning process. Significant future work, with input from airport users is required to identify the strategic choices to be made on how an expanded Heathrow will incorporate appropriate levels of resilience.

Heathrow also plans to progress the question of resilience through consumer led engagement to identify the appropriate trade-offs from an airport user perspective.

### ***“Issues around surface access, including passenger and colleague modal shift and congestion charging (and the impact of these measures on passengers and passenger traffic scenarios)”***

Heathrow has been focussing on completing interim surface access modelling over recent months. The team has now begun to use these models to understand the performance of

difference surface access scenarios such as the impact on public transport mode share and colleague car trip reduction. Once this work has been validated Heathrow will be able to share its outputs with the airline community and seek feedback.

During the course of 2018, the surface access strategy will continue to be developed and its commercial impact will be shared with the airlines. Once the analysis is completed it will help us and the airlines to understand the range of options available within the emerging strategy

***“Night flights and respite options including the concern that Heathrow does not appear to have considered airlines’ proposals for increased respite for local communities”***

5.6.14. At Airline Working Group 15 Heathrow proposed to set up a night flights working group to create a forum for Heathrow and the airline community to share and examine options, evaluation criteria and implementation options for the introduction of a night flight ban. Terms of reference for the working group have been agreed with the airlines. The working group will meet bi-weekly commencing in April. The initial objective will be to share common understanding of Heathrow’s base assumptions and for the airlines’ to share detail about their proposed concept.