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Department for Transport
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14 May 2019

Dear Caroline

ASSESSMENT OF HEATHROW AIRPORT LIMITED (HAL) / AIRLINE ENGAGEMENT ON CAPACITY EXPANSION AT HEATHROW AIRPORT (OCTOBER 2018 – APRIL 2019)

We wrote to you in September 2018 setting out our assessment of HAL/airline engagement on capacity expansion at Heathrow airport between May and September 2018 under the “Enhanced Engagement” process. We noted progress in several areas including updating the governance protocol and HAL’s approach to reflecting the interests of consumers in its masterplanning process. Nonetheless, we also highlighted two important areas of ongoing concern that HAL should urgently address:

- the provision of high quality information on costs and efficiency; and
- securing airline confidence in a realistic timetable that would allow sufficient time for high quality engagement while ensuring timely delivery of capacity expansion.

In the update on HAL/airline engagement for the period October 2018 to April 2019 attached to this letter, we explain and welcome the progress made by HAL in reaching a draft preferred masterplan (which will allow HAL to proceed with preparation of the statutory consultation necessary to support its DCO planning application) and recent progress with the provision of information on costs. By contrast, we note that the position on securing airline confidence in the overall timetable remains very difficult.

Since HAL revealed increases in its estimates of programme costs in the second half of 2018, we observe that its management team has adopted a greater focus on cost control and brought its estimates of capital costs up to the date of runway opening (currently targeted for the end of 2026) back to be broadly consistent with the £14 billion (in 2014 prices) estimate used as part of its Westerly Option Dashboard Case developed in 2017, although there are some differences in the scope represented by this capital cost estimate.¹ We strongly welcome this renewed focus on cost control and the greater reassurance on costs and risk estimates

¹ We also note that the overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased from £21.9 billion to £22.9 billion. It should be noted the £22.9 billion includes an increase in contingency allowance of circa £1.5 billion compared to the Westerly Option Dashboard Case.

provided by the work of the Independent Fund Surveyor (IFS) on HAL's masterplan estimates. It is very important that this renewed focus is maintained in future stages of the programme.

The difficulty and complexity of the overall capacity expansion programme has put intense pressure on HAL and the airline community, and both the delivery of several programme milestones and the provision of information to support these milestones have slipped. Although HAL was able to provide its draft preferred masterplan at the end of March, the compression of the timetable has had an impact on the overall quality and effectiveness of the engagement process. In particular, the airline community consider further work is needed on operational performance, capital expenditure phasing and affordability regarding HAL's draft preferred masterplan.

HAL has also recently suggested that, to maintain a target date for the opening of the new runway by the end of 2026, the level of its early spending (i.e. before it has received a DCO) will need to increase to more than £3 billion² although these still fall within HAL's overall budget of £14 billion (in 2014 prices) to runway opening. We will address the implications and potential treatment of this in a further regulatory consultation, which we intend to publish in June 2019. So far, we have seen limited evidence of effective engagement by HAL with the airline community about the options, risks and possible risk mitigations for this expenditure.

The remainder of this year will be critical both for the overall programme and HAL will need to support a number of important programme milestones and objectives, including:

- provide additional information on the options for early spending and the overall programme timetable;
- publish the statutory planning consultation based on its draft preferred masterplan in June 2019;
- provide an initial price control business plan to the airline community, the CAA and other stakeholders in December 2019; and
- work toward the M5a gateway (which will be an opportunity for airlines to provide their commercial views on the overall appropriateness and affordability of HAL's plans) in the first quarter of 2020.

To support these important milestones and objectives we make the following recommendations in section 4 of the attached update on Enhanced Engagement:

1. HAL and the airline community should continue to engage both in the run up to, and during, HAL's public consultation on capacity expansion in June 2019.
2. Engagement must be more efficient, targeted and focused around the airline community's requirements and priorities on affordability, operability and deliverability as set out in Appendix 3. The effectiveness of the M5a gateway process will be significantly enhanced if HAL and the airline community jointly develop a clear plan for the information required from HAL before and during the M5a process, with clear and agreed arrangements for the oversight of the provision of information by HAL (both in relation to

² This represents an increase from previous estimates. Category B costs have increased from £265 million (2014 prices, January 2017 estimate) to £530 million (nominal prices, October 2018 estimate). Early Category C costs have increased from £1,595 million (nominal prices, October 2018 estimate) to £2.8 billion (nominal prices, March 2019 estimate).

timeliness and quality of the information)³. We note that work on this has already started and HAL must respond positively to the airline community's requirements and priorities for M5a.

3. Engagement should be joined up across the M5a and regulatory (business plan) processes. The broad alignment of these two processes represents an opportunity for HAL to develop high quality, detailed and consistent information. Recognising the importance of the information provided at this time, the CAA may consider making more use of its powers under Section 50 Civil Aviation Act 2012 to request information formally consistent with our approach for the Market Power Assessments⁴ and common regulatory practice, and also require appropriate internal and external assurance of the information that is provided.
4. HAL should demonstrate to stakeholders that its timetable is realistic, achievable and allows sufficient time for high quality engagement while ensuring timely delivery. HAL must work this through with the airline community as an immediate priority, taking full account of the pressures identified by the IFS on the timetable⁵, and considering a range of options, including in relation to the level of pre-DCO spending. This is crucial given the scale of pre-DCO spending that HAL is seeking to incur.

Although the airline community may find some of the issues that we are dealing with, such as the proposals to significantly increase pre-DCO spending, extremely difficult, we strongly encourage all stakeholders to remain committed to the engagement process given the importance of capacity expansion at Heathrow airport to consumers.

We will continue to monitor the engagement process carefully and report to the Secretary of State on these matters. As part of our next report, we will respond to the requests made in your 23 January letter that we provide an update ahead of HAL's statutory consultation in June 2019 on:

- how HAL's proposed timetable reflects the best interests of consumers (e.g. in relation to the phasing of its proposals);
- any risks around the interface between HAL's plans to deliver an operational runway by the end of 2026 and the regulatory timetable (e.g. whether there is sufficient time for airline scrutiny of proposals); and
- whether there are credible scenarios in which HAL can deliver its proposed Masterplan in line with the Secretary of State's ambition on the affordability of airport charges.

We continue to strongly support capacity expansion as being in the interests of consumers and consider that the Secretary of State's challenge to HAL in October 2016 to deliver expansion at close to current airport charges is an important aspect of an affordable expansion programme. We also recognise that capacity expansion at Heathrow is a very challenging programme, because of its size and complexity (which will require extensive land purchases, residential and business compensation, earthworks and the construction of a wide range of infrastructure), and the need to privately finance very significant amounts of capital expenditure. As this year progresses we continue our work to further develop the regulatory

³ Appendix 3 of the attached document includes some initial thoughts from the airline community on a series of tests they propose to help ascertain whether the scheme is supportable or not from an airline community perspective by the M5 gateway.

⁴ See [link](#).

⁵ The IFS's masterplan report identified that there is very little provision for delay in HAL's timetable. Given the challenges associated with a programme as difficult and complex as capacity expansion, a delay of 12 to 24 months could easily emerge, with the planning process, enabling works and earthworks creating particular risks.

framework for capacity expansion, leading up to the submission of HAL's initial price control business plan in December 2019.

Although not directly related to capacity expansion, it is also important to recognise the commercial agreement struck between the major airlines at Heathrow airport and HAL to cover airport charges for the period 2020 and 2021. We have indicated that we are 'minded to' support the agreement as being in the interests of consumers, subject to considering responses to our February 2019 consultation. It is encouraging that HAL and the airlines have been able to work together to reach this agreement.

More generally, we also consider it is important that HAL reviews the published lessons learnt from the Crossrail project and assure itself and stakeholders that it has confidence in its processes to avoid a similar scenario arising.

Finally, I would like to place on record my thanks to your team for their continued support.

Yours sincerely,

A handwritten signature in black ink that reads "Paul Smith". The signature is written in a cursive, slightly informal style.

Paul Smith

Director, Consumers and Markets Group

Advice to the Secretary of State for Transport

CAA assessment of HAL/airline engagement on capacity expansion

from October 2018 to April 2019

This paper sets out our assessment of HAL/airline engagement between October 2018 and April 2019 under the Enhanced Engagement Terms of Reference⁶ (ToR).

In reaching this assessment, we have adopted an evidence-based approach that relies on information from a number of sources including:

- the views of HAL and the airline community on this stage of the Enhanced Engagement process (as summarised in Appendix 1);
- our observation of key meetings and monitoring of associated papers and discussions;
- regular bilateral discussions with HAL and the airline community; and
- reports prepared by the IFS (Gardiner & Theobald) and our technical consultants (Arcadis).

This assessment has the following structure:

1. overall assessment of Enhanced Engagement between October 2018 and April 2019;
2. assessment of progress on the provision of quality information on costs and efficiency;
3. assessment of progress on providing stakeholder confidence in HAL's timetable; and
4. recommendations and next steps.

We also attach the following supporting materials:

- Appendix 1 - summary of stakeholder views;
- Appendix 2 - airline community requests for the CAA; and
- Appendix 3 - airline community M5a requirements.

1. Overall assessment of Enhanced Engagement between October 2018 and April 2019

Since issuing our September 2018 interim update, there have been significant developments in the engagement and masterplan development process. Overall, this has been a particularly intense period in which HAL's expansion scheme has transformed from a range of "assembly options" to a draft costed preferred masterplan with indicative phasing⁷ up to 2050, that will form the basis of HAL's statutory consultation for the planning process in June 2019.

Over the last six months, HAL and the airline community have invested considerable resources and engaged in good faith on the critical M3c and M4 programme gateways. The scope of engagement has been extensive, covering a wide range of complex issues. HAL has made significant efforts to develop its masterplan to reflect both wide-ranging stakeholder

⁶ See [link](#).

⁷ 2026, 2033 and 2050 phasing time slices – setting out the sequencing of when assets will be built and capacity released.

feedback and the requirements of the Airports' National Policy Statement (ANPS). The various multi-lateral HAL/airline engagement fora have continued (albeit with difficulties in certain key working groups) and some new working groups have recently been introduced.⁸ HAL has also been engaging with the airline community and cargo carriers on a bilateral basis, including with non-incumbent airlines.

In late 2018, HAL revealed that its capital cost estimates for expansion had increased significantly, reflecting a range of challenges including greater difficulties with the earthworks necessary for the construction of the new runway and revised estimates of its planning costs. The IFS also raised concerns as to whether HAL had made sufficient allowances for risks in its estimates of costs.

Subsequently, HAL has focused on addressing the pressure on overall affordability created by these increases in costs. It has looked again at its approach to dealing with existing landfill sites and reconsidered phasing and other aspects of its investment programme to find savings. In the light of recent changes to its plans, HAL's draft preferred masterplan and budget estimates are now broadly back in line with its 2017 Westerly Option Dashboard Case estimated cost of approximately £14 billion (in 2014 prices) for capital expenditure to the target date for runway opening of 2026, although there are some differences in the scope represented by this capital cost estimate.⁹ These estimates now also include revised risk allowances consistent with the recommendations of the IFS. The IFS has reviewed the overall programme costs of an "end state" preferred masterplan to 2050 and is in the process of reviewing HAL's phased expenditure to both the 2026 and 2033 phasing milestones.¹⁰ The work completed by the IFS to date suggests that HAL's estimates appropriately reflect the scope of the scheme and its budget is realistic. We welcome the focus of HAL's management of bringing the cost estimates back under control. It will be important that this focus remains in subsequent stages of the programme.

HAL's focus has been on keeping overall cost estimates in line with its earlier budgets and the greater phasing of the expenditure required further optioneering and re-evaluation of its masterplan. The airline community considers this should have triggered a delay or joint review ahead of the M4 gateway to allow sufficient time for appropriate engagement. Nonetheless, HAL continued at pace, which compressed the timetable and led to significant frustrations on the provision of quality and timely information and difficulties with engagement in key fora (especially the Costs and Benefits Working Group). The airline community¹¹ wrote to us in December 2018 expressing concerns about the engagement process and there was further correspondence from the airline community on these matters in early 2019.¹²

There have been extended hiatuses in each of the Costs and Benefits Working Group ("CBWG"), and the additional ATMs and night flights working groups. The airline community has also highlighted concerns around the late provision of information ahead of key governance groups, that HAL is rushing the governance process and seems to see governance as a 'tick box' exercise driven by its timetable. The airline community has also noted that the Airline Working Group and other fora are not true 'working groups': many still

⁸ Including airfield resilience, risk and early ATM growth and a working group to discuss the M5 process.

⁹ We also note that the overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased from £21.9 billion to £22.9 billion. It should be noted the £22.9 billion includes an increase in contingency allowance of circa £1.5 billion compared to the Westerly Option Dashboard Case.

¹⁰ The IFS has recently issued an addendum to its M4 Programme Estimate Review Report entitled Programme Schedule and Phasing Review.

¹¹ This was a community letter from IATA, the LACC / AOC and BARUK.

¹² This correspondence can be found on our website under "Airport-airline engagement on capacity expansion – s16" on the following page: <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Heathrow-price-control-review-H7/>.

tend to include a one-way flow of information, at times involving repeated or unnecessary information.

The airline community has also cited frustrations with the process leading to M4 entry (delayed from mid-January to mid-February 2019) including the lack of clear definitions, criteria or proper specification of information that would be available. Although HAL did provide its draft preferred masterplan at the delayed M4 entry, not all the associated information and assurance was available at this time. This meant that important information remained outstanding at M4 entry which gave the airline community insufficient time to assess and assure themselves on costs and operability ahead of M4 exit on 28 March. The airline community considers M4 became a point in time rather than the criteria-based gateway that they had reasonably expected.

The airline community was particularly frustrated with the late provision of a detailed cost schedule by HAL, giving the IFS and airline community inadequate time to assess and assure costs. As a result of the late provision of information, the IFS is continuing to work on its assurance report of HAL's masterplan costs for the 2026 and 2033 phasing milestones despite HAL having formally passed the close of the M4 gateway on the 28 March. Overall, the airline community considers that M4 exit was roughly where they expected to be at M4 entry. Nonetheless, the airline community agreed to allow HAL's favoured proposal to proceed beyond the M4 exit gateway subject to certain conditions on the need for further work on operational performance, capital expenditure phasing and affordability.

Overall, the airline community has acknowledged and welcomed HAL's focus on keeping its forecasts of capital expenditure to 2026 in line with the £14 billion estimate (in 2014 prices) for its Westerly Option Dashboard Case in 2017 but remain concerned with the provision of high quality information in a timely manner, compression of the timetable, pace of engagement and continued poor consultation. The airline community has also noted that the overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased.¹³ While they consider affordability to be the key issue, they are also clear that the design must be operable and fit for purpose and stress the need for better information on the operability and deliverability of HAL's plans and the trade-offs between affordability and scope. They have made clear that the M5a¹⁴ gateway cannot be a repeat of the M4 process and that they will require high quality and timely information on affordability, operability and deliverability from HAL so they can properly assess HAL's plans and decide whether they will continue to support the capacity expansion programme.

HAL has recently suggested that to retain a target date for the opening of the new runway in 2026, the level of its early spending (i.e. before it has received a DCO) will need to increase¹⁵ to around £3 billion. While this is allowed for in HAL's estimates of £14 billion in its costs in the period to 2026, the airline community has said that consumers should not bear the risks of HAL not being granted planning consent and have called for a full review of the overall timetable. They have also noted the IFS' view that delays of 12 to 24 months, linked to the planning stage, enabling works and earthworks, could easily occur.

¹³ The overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased from £21.9 billion to £22.9 billion. It should be noted the £22.9 billion includes an increase in contingency allowance of circa £1.5 billion compared to the Westerly Option Dashboard Case.

¹⁴ This will be an opportunity for airlines to provide their commercial views on the overall appropriateness and affordability of HAL's plans.

¹⁵ This represents an increase from previous estimates. Category B costs have increased from £265 million (2014 prices, January 2017 estimate) to £530 million (nominal prices, October 2018 estimate). Early Category C costs have increased from £1,595 million (nominal prices, October 2018 estimate) to £2.8 billion (nominal prices, March 2019 estimate).

Our overall assessment

We strongly welcome HAL's renewed focus on affordability and welcome its plans to deliver the new runway consistent with its 2017 Westerly Option of £14 billion (in 2014 prices) of capital expenditure.¹⁶ We also welcome the assurance provided by the IFS on cost estimates but note that this work is not yet complete. We recognise the considerable efforts and resources invested by HAL and the airline community to engage during this period. In addition, we welcome the proactive and collaborative approach taken by HAL and the airline community to start engaging early on the M5 and M5a gateway processes.

Nonetheless, the difficulty and complexity of the overall capacity expansion programme has put intense pressure on HAL, the airline community and the engagement process, and the late provision by HAL of information on costs has had an impact on the airline community's ability to engage meaningfully and on their confidence in the engagement process. HAL has not always been able to engage effectively with the airline community on how aspects of the new infrastructure will operate. For instance, the airline community was disappointed with the engagement on the night flights ban, early air traffic movements, resilience and operability between late 2018 and early 2019. While HAL has said there is scope for further engagement on these matters, the airline community were understandably concerned that they were being asked to agree a masterplan without proper understanding of whether it would deliver value for money or good consumer outcomes.

The pressure on the timetable remains a critical issue:

- in the short term, the slippage of project milestones creates pressure on the engagement process and HAL needs to do all it can to manage and improve the flow of information to the airline community (in accordance with the information sharing provisions in the Enhanced Engagement governance protocol) to help mitigate these difficulties;
- in particular, HAL should respond positively to the airline community's aspirations of further timely, robust and detailed information on affordability, operability and deliverability to inform the M5 and M5a programme gateways, and engagement fora/groups should be more focused around these three criteria; and
- all stakeholders should recognise that engagement needs to provide information that is appropriate given the level of scheme maturity. Requests for more detailed information should be properly justified and HAL should be allowed the appropriate time to respond against clearly identified review and response periods. At the same time, where requests are justified HAL should respond to requests in a timely and effective manner.

In its recent report on masterplan costs, the IFS highlighted pressure on the overall timetable and the risks of delays of one to two years. This, coupled with HAL's increased estimate for its pre-DCO spending and a target date for opening the new runway of 2026, raises important issues associated with possible stranded costs if HAL were not to be successful in obtaining planning consent. At the same time, capacity expansion is important to consumers as they would experience the costs associated with constraints on airport capacity in the southeast of England for longer if capacity expansion at Heathrow were to be delayed. So far, we have seen limited evidence of effective engagement by HAL with airline community about the options, risks and possible risk mitigations for this expenditure.

¹⁶ We also note that the overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased from £21.9 billion to £22.9 billion. It should be noted the £22.9 billion includes an increase in contingency allowance of circa £1.5 billion compared to the Westerly Option Dashboard Case.

The provision of quality information on costs and efficiency is discussed further in section 2. Matters relating to the timetable are discussed further in section 3.

2. Assessment of progress on the provision of quality information on costs and efficiency

September 2018 report

In our September report, we said that HAL should urgently rise to our challenge of improving the flow of high quality information if it is to secure the airline community's confidence in its ability to deliver an affordable scheme and to support our work on the affordability of airport charges. We noted that HAL's M3c and M4 programme gateways would provide critical tests of HAL's credibility in providing high quality information on costs and efficiency. We also said that unless there is a significant improvement in this area we would consider whether there are further steps we should take to support the proper discharge of our statutory duties including the option of issuing a formal information request to HAL under Section 50 of the Civil Aviation Act 2012.

Progress

In response to our challenge to improve the flow of quality information on costs and efficiency and to address the airline community's significant concerns in this area, in September 2018 HAL issued an Information Sharing Proposal setting out when it intended to provide information on capital expenditure and the other main drivers of affordability (e.g. forecasts of passenger traffic, net non-aero revenue, etc.) to the airline community and us over 2019. This was subject to various iterations and was updated in January 2019.

On 28 February 2019, HAL provided updated information on capital expenditure and some further information on the other main drivers of affordability (some of which was based on its draft preferred masterplan and some based on its earlier 2017 Westerly Option Dashboard case). While we considered this was a helpful start, it was limited in terms of providing up to date information or explaining either the underlying assumptions on which it was based or the inter-relationships between the various drivers of affordability.

We then sent HAL a letter in the form of a draft Section 50 notice to better explain the information that we needed at this stage of the process to support our work on affordability. This also highlighted the importance of HAL providing assurance that it would share with us the best information that it has available on costs and affordability. Our request focused primarily on information related to the non-capital expenditure drivers of airport charges and affordability. This was because the masterplan process and the associated assurance from the IFS (albeit with some delays) was delivering information on capital expenditure. On 29 March 2019, HAL provided us with an assurance letter and technical appendices setting out further information on the other drivers of affordability.

Assessment and next steps

The provision of quality information on costs and efficiency has been a significant concern for both the airline community and us since 2017. The prolonged period of uncertainty and ambiguity on information provision from HAL has meant that we have not been able to provide an update on the affordability of the expansion scheme since our April 2018 assessment, which was based on the 2017 Westerly Option Dashboard case. It has also caused significant frustration and difficulty for airline stakeholders.

Nonetheless, the additional information we received in late March 2019 puts us in a better position to understand HAL's approach to making forecasts and the robustness of the

information that it has provided. It is also helpful that HAL has provided assurance that this is the best information that it has available. Combined with the masterplan information and assurance on capital expenditure, we should be able to update our assessment of affordability taking into account HAL's draft preferred masterplan. We welcome the efforts that HAL has made to provide this information and assurance.

Our next step is to undertake an affordability analysis using the information HAL has provided. We anticipate that we will provide DfT and stakeholders with an update on our affordability assessment in June 2019, consistent with the request from the DfT for an update on these matters ahead of HAL's statutory consultation on its draft preferred masterplan.

We consider that the provision of robust information on costs and affordability is an essential element of maintaining stakeholder confidence in the capacity expansion programme. In this context, as and when it is appropriate and once more developed information becomes available, HAL should proactively share this with the airline community and us in advance of relevant programme gateways. For instance, to support key programme gateways or to respond to any significant changes in the timetable for capacity expansion, it may be necessary for HAL to provide updated information on costs and affordability.

HAL should also provide, and regularly update in the light of discussions with the airline community, a clear roadmap showing the specific information that will be provided to them to support the orderly review of the scheme in the light of HAL's initial price control business plan due in late 2019 and the M5a programme gateway due in early 2020. We will also consider whether we should make greater use of our Section 50 Civil Aviation Act 2012 information gathering powers and/or provide further guidance to HAL on the provision of information and assurance to support these important price control and programme gateways.

3. Assessment of progress on providing stakeholder confidence in HAL's timetable

Context

As we explained in section 1, there are a number of important issues relating to the timetable for capacity expansion. We have already discussed the adverse impact on the engagement process arising from delays to programme milestones and changes to the masterplan created by HAL's renewed focus on the overall budget and affordability. We return to these issues in section 4, making recommendations for strengthening the engagement processes over the remainder of this year and in early 2020.

We have also highlighted the recent increases in HAL's estimates of pre-DCO costs, although these still fall within HAL's overall budget of £14 billion (in 2014 prices) to runway opening. We will address these issues further in a regulatory consultation that we intend to issue in June 2019.

The airline community has also expressed concerns over the robustness of the overall timetable, calling for HAL to review it and, if necessary, set out a revised timetable that is both robust and realistic and which allows sufficient time for careful engagement with stakeholders. These matters are discussed further below.

September 2018 report

In our September 2018 report, we noted that the airline community had been calling for a realistic, fully integrated end-to-end schedule since the early stages of the expansion programme, and that the pace of the programme must not reduce the time needed for meaningful engagement. We said that HAL must demonstrate to stakeholders that its new timetable is realistic, achievable and allows sufficient time for high quality engagement while

ensuring timely delivery. We also said HAL must clearly articulate the contingency provision within the timetable and the remaining key risks and mitigations.

Progress

Over the last six months, HAL kept up the pace of its work on the masterplanning process to reach a draft preferred masterplan at M4 exit on 28 March 2019. This will form the basis for its public planning consultation in June 2019. Although important programme milestones have slipped, it has kept to the target date for runway opening at 2026. While there are advantages for consumers in the timely delivery of capacity expansion, there are, at the same time, significant consequences arising from the pressure on the overall timetable. These include pressure on the engagement process and HAL's estimates of pre-DCO costs as discussed above.

We also note that the IFS' masterplan report has identified that there is very little provision for delay in HAL's timetable. Given the challenges associated with a programme as difficult and complex as capacity expansion, a delay of 12 to 24 months could easily emerge, with the planning process, enabling works and earthworks creating particular risks.

Assessment and next steps

We recognise the importance of driving the delivery of major infrastructure projects and we have consistently supported the timely delivery of capacity expansion at Heathrow airport throughout our regulatory consultations. Nonetheless, we have also made clear that timely delivery is not the only objective of capacity expansion and that it is essential that HAL examines a full range of plausible options for capacity expansion, provides stakeholders with high quality information on these options, engages in a meaningful way with stakeholders on key programme decisions and then delivers efficiently. Achieving all of this clearly represents a very significant challenge, but such a balanced approach should have direct benefits to consumers and is essential if the capacity expansion programme is to retain wider support from stakeholders.

We consider more work is needed by HAL to demonstrate to stakeholders that its timetable is realistic, achievable and allows sufficient time for high quality engagement while ensuring timely delivery. HAL must work this through with the airline community as an immediate priority, taking full account of the pressures identified by the IFS on the timetable, and setting out for discussion with the airline community an appropriate range of options. As part of this process HAL should provide a clear and persuasive description of a range of plausible options with respect to pre-DCO spending, including options where the majority of this spending is delayed until after the grant of a DCO. While such options do not necessarily reflect HAL's preferred approach, this information and discussion would greatly assist decision making on the timetable and the appropriate levels of early spending that should be funded from airport charges. It should also support our work in considering the most appropriate regulatory treatment for this spending and our consultation on these matters, planned for June 2019.

We will also consider HAL's timetable as part of DfT's request for an Enhanced Engagement update ahead of HAL's statutory consultation in June 2019 on:

- how HAL's proposed timetable reflects the best interests of consumers (e.g. with regard to phasing proposals); and
- any risks around the interface between HAL's plans to deliver an operational runway by 2026 and the regulatory timetable (e.g. whether there is sufficient time for airline scrutiny of proposals).

We have also commissioned our technical advisors (Arcadis) to look at these issues as part of a wider masterplan review.

4. Recommendations and next steps

The next period of Enhanced Engagement will be critical for capacity expansion. HAL's draft preferred masterplan will continue to mature and become more refined in response to stakeholder feedback and public consultation. HAL will need to work towards both its initial price control business plan at the end of 2019 and its M5a programme gateway in early 2020.

In order to rise to the challenges in the next period of engagement, HAL and the airline community will need to remain focused on the longer-term consumer prize that will be realised from timely, affordable delivery of expansion. Over the coming months, we strongly encourage all stakeholders to continue to engage in good faith to achieve steady progress and momentum towards an expansion scheme that reflects the best interests of consumers. The engagement process will need to be more agile, efficient and targeted around the airline community's requirements on affordability, deliverability and operability as set out in Appendix 3. Engagement should also become more joined up across the regulatory and masterplanning processes as HAL progresses towards its initial price control business plan in December 2019.

HAL will also need to work with the airline community as an immediate priority on its overall timetable, to ensure that there is adequate time for engagement and that there is a shared view of a realistic timetable for delivery, bearing in mind the advantages of ensuring costs are incurred efficiently and that consumers will benefit significantly from capacity expansion.

It will also be necessary for HAL to build on the good progress made in the M5 workshops to plan for the M5 and M5a gateways. The airline community have stressed the need for a more orderly, planned, well defined process in the run up to M5, particularly around M5a which is critical for the airline community.¹⁷ We agree with the airline community's view that the M5 process cannot be a repeat of the approach we have seen at M3c and M4: the airline community will require high quality and timely information on affordability, operability and deliverability from HAL in order to assess HAL's plans properly and decide whether they will continue to support the capacity expansion programme. We expect HAL to learn the lessons of the M3c and M4 gateway process so that it can better achieve the airline community's requirements for the M5a gateway.

Key recommendations

- 1. HAL and the airline community should continue to engage both in the run up to, and during, HAL's public consultation on capacity expansion in June 2019.**
- 2. Engagement must be more efficient, targeted and focused around the airline community's requirements and priorities on affordability, operability and deliverability as set out in Appendix 3. The effectiveness of the M5a gateway process will be significantly enhanced if HAL and the airline community jointly develop a clear plan for the information required from HAL before and during the M5a process, with clear and agreed arrangements for the oversight of the provision of information by HAL (both in relation to timeliness and quality of the information).¹⁸ We note that**

¹⁷ This will be an opportunity for the airline community to provide their commercial views on the overall appropriateness and affordability of HAL's plans.

¹⁸ Appendix 3 of the attached document includes some initial thoughts from the airline community on a series of tests they propose to help ascertain whether the scheme is supportable or not from an airline community perspective by the M5 gateway.

work on this has already started and HAL must respond positively to the airline community's requirements and priorities for M5a.

3. Engagement should be joined up across the M5a and regulatory (business plan) processes. The broad alignment of these two processes represents an opportunity for HAL to develop high quality, detailed and consistent information. Recognising the importance of the information provided at this time, the CAA may consider making more use of its powers under Section 50 Civil Aviation Act 2012 to request information formally consistent with our approach for the Market Power Assessments¹⁹ and common regulatory practice, and also require appropriate internal and external assurance of the information that is provided.
4. HAL should demonstrate to stakeholders that its timetable is realistic, achievable and allows sufficient time for high quality engagement while ensuring timely delivery. HAL must work this through with the airline community as an immediate priority, taking full account of the pressures identified by the IFS on the timetable, and considering a range of options, including in relation to the level of pre-DCO spending. This is crucial given the scale of pre-DCO spending that HAL is seeking to incur.

Next steps

We intend to issue a consultation on the regulatory treatment of pre-DCO spending and will also report again on Enhanced Engagement (including updating our views on affordability and the timetable as per DfT's request) in June 2019.

¹⁹ See [link](#).

Appendix 1 – Summary of stakeholder views

HAL views

As well as noting the wider context for expansion in terms of the consumer benefits and the affordability challenge, HAL also observed that:

- it has made significant progress since our September 2018 update on developing the masterplan and the associated capital expenditure forecasts, noting that these had been reviewed by the IFS;
- it is developing a holistic approach to pre-DCO Category C investment now that it has reached a preferred draft masterplan and will engage with the airline community to embed this into agreed governance;
- it considers it has met the requirements of our Category B policy including by providing an indicative budget and supporting information. The IFS has also scrutinised this information and HAL has commissioned an independent piece of work to assess its Category B cost projections;
- it has tried to ensure that there is sufficient scope within the timetable to allow for genuine airline engagement;
- it has made considerable effort to disclose information consistent with the maturity of the programme and has invested significant resources in the evaluation process and engagement from M3c to M4 entry;
- an agreement has been reached with the airlines on the iH7 period. HAL considers this to be a step change in the way commercial arrangements are agreed with the airline community at Heathrow airport; and
- it has continued to engage with the CCB, airlines and consumers directly to ensure that the expansion plans reflect consumer requirements.

HAL also expressed some concerns noting that it is important to strike the right balance in the level of detail to be shared with stakeholders particularly as some of the information requests received are not well targeted and often include more detail than is necessary for a planning application.

HAL has reflected on lessons learned since our September 2018 report, observing the importance of structured engagement and the need to focus on strategic themes to help lower the burden on all sides.

Looking forward, HAL identified the priorities for the next stage of engagement including the upcoming statutory consultation in June 2019, early Category C costs, the Initial Business Plan in December 2019 and M5 in early 2020. HAL noted that its overall aim is to meet the requirements of the Enhanced Engagement Protocol and the CAA's Business Planning Guidance. HAL remains confident that it will be able to meet the DCO submission date of June 2020, unless significant changes are required following consultation or other external factors dictate otherwise.

Airline community views

While the airline community recognise HAL has made improvements in some key areas, it considers that HAL still needs to address a large range of issues that work against its engagement being effective, including:

- serious concerns over HAL's cost controls: citing earthworks, Category B and early Category C costs as examples. It also considers there should be more focus on costs and the information required to understand the trade-offs between affordability and scope;
- a lack of detail on the sub-assembly masterplan options and last-minute provision of a detailed cost schedule, giving the IFS and airlines inadequate time to assess and assure the costs as well as inconsistent definitions making comparisons between plans difficult or impossible;
- concerns with the price base with all costs currently expressed in 2014 prices which airlines consider should be updated as soon as possible;
- lack of information on the non-capex building blocks which are currently based on the 2017 Westerly Option Dashboard;
- ongoing concerns around HAL's approach to timescales including a view that HAL did not consult meaningfully with airlines when it attempted to revise the masterplan, leaving inadequate time work through iterations of the plan jointly with airlines and effectively devaluing the masterplan gateways;
- the M3c and M4 gateways not working well, emphasising the importance of HAL clearly setting out and agreeing the information, the criteria for its decisions and timings for gateways;
- engagement feeling like a "tick box" exercise with CBWG²⁰ and AWG²¹ highlighted as not true working groups with a tendency for a one-way flow of information, and at times involving repeated or unnecessary information. Further information was often provided late against the agreed information protocol and ToR; and
- disappointment that the airline request for observer status on HAL's Horizon Community have, so far, been refused by HAL.

Looking forward, the airline community expressed a number of priorities and practical steps that could be taken to improve the process including:

- agreeing a clear definition of M5a with an engagement plan that supports this;
- the IFS being given enough time to complete the assurance of the cost plan to include both the end state and important intermediate stages;
- HAL to provide more detail and background, in advance of the IBP, to support the data in the passenger charge 'building block' model;
- HAL to engage actively with airline concerns over its surface access strategy;
- HAL to maintain its recent more detailed engagement on noise measures and night flights;

²⁰ The Costs and Benefits Working Group.

²¹ The Airline Working Group.

- HAL to evaluate its total business case, including the resilience and day-to-day operational performance impacts of early ATM growth and modify plans in consultation with airlines; and
- HAL to provide airlines with observer status to the HAL Horizon Community which airlines consider essential so all parties can understand the context and the detail of the research (both raw and analysed).

The airline community also used the response to set out some specific requirements for the CAA, as discussed in Appendix 2.

Appendix 2 – Airline community requests for the CAA

In their Section 16 submission, the airline community set out a number of practical steps that they consider the CAA should progress ahead of HAL's statutory consultation and M5. Our current views on these issues are set out below.

Airline issue	CAA comment
CAA senior management for expansion lead attendance at the key forums for governance and development of expansion.	We are currently reviewing our attendance at the expansion fora with a view to ensuring that our representation is appropriate for the subject matter of each meeting.
The need for a CAA financial model to allow the affordability of the expansion masterplan to be properly assessed	We are working to develop an improved version of our financial model and expect this work to be completed in Autumn 2019. We are hosting workshops with stakeholders to explain our proposed approach and to seek views on model development.
An indicative weighted average cost of capital (WACC) range for expansion that can be modelled against by end of Q3 2019, to allow it to be used by HAL in initial business plan (IBP).	In February 2019, we published an update on the WACC for the RP3 review, and a paper that set out the read-across to H7 for the market-wide parameters and a work programme to develop our view on the overall H7 WACC including the impact of capacity expansion. Nonetheless, it is important that HAL owns its IBP and so it will need to set out its view of the WACC that will make capacity expansion efficient, affordable and financeable.
A regulatory decision on pre-DCO costs, including a revised treatment of planning costs reducing the bonuses available to HAL for a successful planning application and allocating more risks to HAL if its DCO application were to fail.	We intend to consult further on these matters in June 2019.

Appendix 3 – Airline community M5a requirements

The Airline Community is devising a series of tests for Heathrow's proposed Masterplan in order to ascertain whether the scheme is supportable or not from an airline community perspective by the M5 gateway. These will form the basis of a "Go/No-go" decision from the airline perspective. The tests are under three key headings:

- **Affordability** – that the scheme is affordable for consumers (defined as charges less than or equal to today's charge in real terms for each and every year during the expansion programme), and that affordability is sustained during the programme.
- **Operability** – that the airport operates at levels at least as good as today during expansion and meets key airline consumer criteria.
- **Deliverability** – that the scheme does not disrupt passengers during the construction phases and the expansion timescales and phasing are robust and able to deliver in a variety of circumstances.

The airline community have agreed an initial set of topics under each heading as described below – the next step is for HAL to confirm detailed plans to address each of these topics and then to deliver to those plans. The intention is for all the information to be available to the airlines by September 30th at the latest. This then allows for iterations to the scheme based on any feedback from airlines/Heathrow's consultation between October and December and planned M5 entry. It is also critical that sufficient time is given between the publication of HAL's Initial Business Plan (IBP) and the "Go / No-go" decision point.

For the avoidance of doubt, the timely provision of the agreed information and timetable will be critical. Any delays will need to ensure engagement is protected.

The airline community expects the CAA's new simpler Price Control Model to be available to support the affordability assessment but will also maintain its own regulatory model as a backup.

Affordability

1. Unit charges flat or better (in real terms) during every year of expansion
 - A stable, fully costed detailed masterplan with phasing to end of DCO timeframe
2. An agreed passenger and cargo forecast with ranges to support 1 above
 - Consistent with the HAL's Initial Business Plan (IBP) submission
3. A phased construction plan with clear links between phases that enables later phases to be speeded up/slowed down depending on passenger growth experienced in earlier stages
4. Scenario evaluations that model the impact of lower growth and the phasing plan on airline charges
5. All significant costs need to have been assured by the IFS at M5a
6. All risk allowances agreed with the IFS at M5a

7. An agreed regulatory model that shows the airport charge with assumptions on WACC and other inputs
8. An opex plan for the whole DCO period. For H7/8/9 part of IBP
9. A commercial revenue plan for the whole DCO period. For H7/8/9 part of IBP
10. No hidden/backdoor costs (e.g. surface access mustn't increase costs to customers)
11. A plan for early Category C (pre-DCO costs) that does not expose the consumer/airlines to unacceptable affordability risks

Operability

1. Airfield Performance
 - Taxi times, congestion, modelled delays, number of tows etc at key points
 - Airfield operation - Allocation rules (Terminal v Compass), alternation, runway modes to be used etc.
2. Airspace
 - Flight angles
 - Independent Parallel Approach
3. Pier Service
 - On-pier estimated performance by year compared to today (should be at least as good)
 - Link to occupancy/schedule
4. Connectivity
 - Minimum Connect Times (Passenger and baggage)
5. Baggage
 - Greater clarity on baggage assumptions
6. Passenger Journey (e2e)
 - From First to last impressions
 - Times/distances/modes
7. Airfield Support facilities (ancillaries)
 - Assumptions on construction/space available for Engineering/Cargo/De-icing facilities etc.
8. Surface Access
 - Western Rail link – confirmation of assumed plan and charging mechanism
 - Parking strategy – agreed strategy on parking including consideration of more off-site (away from airport) parking
 - Colleague travel – acceptable plan on colleague parking that does not undermine operability

- No more vehicles – acceptable plan for airlines that does not impact on airport attractiveness for passengers or an acceptable colleague parking plan.
- Access charge – acceptable proposal on any vehicle charging that does not impact on airport attractiveness for consumers

9. Runway Operations (Night noise etc)

- Proposed Night Flight regime for expansion that is acceptable for consumers
- Noise envelopes
- NIS (insulation schemes)
- Interaction with airspace change

10. Early ATMs

- Business case – clear evidence that there is a positive business case for airlines/consumers for early ATMs
- Clear acceptable plan on how to use additional slots – balance between additional capacity and resilience
- Estimated resilience impact
- Understanding of the link to affordability/ charge
- Understanding of key Trade-offs

Broadly it is expected that HAL's plan to address these topics will cover assumptions, metrics/targets, requirements and assessed performance/evaluation open to independent scrutiny

Deliverability

1. Transition plan during construction

- What will be the impact of construction (at all steps) from the point of view of airline operation and passenger experience and is this acceptable?

2. Masterplan robustness

- Independent assessment/assurance on the robustness of HAL's plans from a cost/timescale perspective, compared to construction norms.
- An acceptable plan from the airline perspective on runway and initial terminal opening that contains adequate contingency and has significant independent confidence that it is achievable.