Economic Regulation

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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Civil Aviation Authority
Aviation House
Gatwick Airport South
West Sussex
RH6 0YR

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About this document

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.

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Chapter 1 - Background and Context

Introduction

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)[1] 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,[2] followed by further updates in May 2017,[3] and September 2017.[4]

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")[5] is being published in April 2018 alongside the submission of this final Section 16 report to the SoS. Key objectives of the regulatory framework

[1] Terms of Reference

[2] February initial health check

[3] May report

[4] September report

[5] See Heathrow price control review H7

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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

1.5 In February 2018, we set out our provisional views on the overall effectiveness of airport-airline engagement as required by the ToR.[6] 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

[6] See February 2018 report

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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

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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

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,

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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.[7]

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.[8]

[7] See April 2018 Consultation for more information - Heathrow price control review H7

[8] 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

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