Civil Aviation Authority

Caroline Low
Director, Airport Capacity Directorate
Department for Transport
1/27 Great Minster House
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11 July 2019

Dear Caroline

Your letter of 23 January 2019 requested that we update the Department for Transport on the following:

(i) our views on how HAL's proposed timetable reflects the best interests of consumers (e.g. in relation to the phasing of its proposals);

(ii) our views on 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

(iii) 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.

In the light of the recent publication of HAL's statutory consultation on capacity expansion, we set out below our update on these matters.

This builds on the work we have been doing in our:

- Section 16 reporting on Enhanced Engagement between HAL and airlines on capacity expansion;[1] and
- work to develop the regulatory framework (including our March 2019 Consultation[2] and June 2019 working paper on Affordability and Financeability[3]).

The Department should note that our views on these matters are likely to evolve in response to feedback on our consultations, further stakeholder engagement and as HAL's plans for capacity expansion mature.

(i) our views on how HAL's proposed timetable reflects the best interests of consumers (e.g. in relation to the phasing of its proposals)

We have consistently supported the timely delivery of capacity expansion to further the interests of consumers. However, we have also made it clear that timely delivery is not the only objective of capacity expansion and that HAL must:

- examine a full range of plausible options for capacity expansion;
- provide stakeholders with high quality information on these options;

[1] See link.
[2] See CAP 1782.
[3] See CAP1812.

- engage in a meaningful way with stakeholders on key programme decisions; and
- deliver efficiently.

Achieving all of this clearly represents a very significant challenge, but a balanced approach to achieving these objectives should have direct benefits to consumers and is essential if the capacity expansion programme is to retain wider support from stakeholders.

While HAL's current target date for the opening of the new runway is the end of 2026, it has informed us that, to retain this target date, it needs to increase significantly the level of its pre-DCO expenditure[4] to more than £3 billion. This represents a sharp escalation from HAL's earlier estimates. The IFS has also identified other risks that might crystallise and lead to further delays of 12-24 months to the date for runway opening (including in relation to the planning process, enabling works and earthworks).

Given that a relatively large proportion of these costs could become sunk and provide consumers with no benefit if HAL were not to obtain a DCO, these recent developments have raised important questions over:

- whether there is a compelling case for such large amounts of pre-DCO expenditure; and
- whether HAL's current target date for runway opening continues to be appropriate and whether there might be further delays to the timetable.

To support discussion with stakeholders on these matters, we have asked HAL to look at a range of options for early Category C spending and report on the likely impact on costs, the wider programme timetable and the likely impact on consumers of each option. HAL has indicated its intention to provide an assessment of different options by the end of July 2019. We consider it will be particularly important that HAL takes a leading role in engaging with the airlines on these matters and actively seeks agreement on an option that both HAL and the airlines can support and is also in the best interests of consumers.

This approach is consistent with our May 2019 report on Enhanced Engagement[5] that recommended more work is needed by HAL to demonstrate to the airline community that its timetable is realistic, achievable and allows sufficient time for high quality engagement while ensuring timely delivery. We stressed that HAL must work this through with the airline community (which has expressed significant concerns on the current timetable and HAL's proposal for early expenditure) as an immediate priority. In particular, it should take full account of the pressures identified by the IFS on the timetable and set out for discussion an appropriate range of options including in relation to the level of pre-DCO spending.

We also consider issues around costs and the timetable in our July 2019 consultation[6] (CAP 1819) and will consider the responses we receive to this consultation, the further information to be provided by HAL on options and the results of further engagement with stakeholders on reaching our decisions on these matters. It will be important to take these decisions in a timely way as HAL's current plans envisage substantial spending on early Category C costs in early 2020. In doing so, we will act in a way which is consistent with our CAA12 statutory duties, including our primary duty to further the interests of consumers. HAL's work on options will also take into account the findings of the IFS noted above and so involves certain scenarios with the date for runway opening delayed until 2029 or 2030, with other scenarios focusing on earlier dates for runway opening from 2026 to 2028. It should be noted that these scenarios

[4] This includes expenditure that HAL is expected to incur before it obtains a DCO (including Category B and early Category C costs). See CAP1819 for more information.

[5] See link.

[6] Consultation on early costs and the regulatory timetable. See link.

involve dates for runway opening by 2030, the year in which the Airports National Policy Statement sets out the need for an additional runway at Heathrow airport.

In addition to these broad issues, we are aware that HAL's preferred masterplan identified earlier this year included changes to the phasing and scope of capital expenditure in the period to 2026 compared to some of the earlier options it had discussed with stakeholders. We understand that these changes have been driven by HAL's focus on retaining a budget for capital expenditure of approximately £14 billion (in 2014 prices) to 2026, broadly consistent with the estimate used as part of its Westerly Option Dashboard Case developed in 2017.[7] Such an approach should support capacity expansion being delivered in a way that is both affordable and financeable. At the same time, HAL is continuing to engage on its masterplan and so stakeholders will have the opportunity to make representations on the phasing or scope of capital expenditure if they have concerns. Our technical consultants (Arcadis) are also undertaking a review of HAL's masterplan which is expected to conclude in October 2019.

(ii) our views on 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)

As we have explained in the section above, there is important further work to undertake to understand whether HAL's target date of 2026 for runway opening remains appropriate. Decisions on these matters will be needed in 2019 as HAL's present plans involve significant levels of spending in 2020. If new or modified licence conditions are required to help deal with these matters these are likely to take time to implement and this may limit our flexibility in responding to these developments. These matters are discussed further in our July 2019 consultation on early costs and the regulatory timetable.

If it becomes clear that 2026 is no longer an appropriate target date for the opening of the new runway, then we will need to consider whether the timetable for developing HAL's next main price control remains appropriate. There are advantages in avoiding a further transitional period and we may be to retain an approach of setting the next main price control from the start of 2022 and deal with any uncertainty arising from delays to the wider capacity expansion programme through adjustment mechanisms in the price control. We will make decisions on these matters after HAL provides more information on the options for the timetable and following further discussions with stakeholders. In doing so we will be mindful of the advantages of retaining sufficient time for airport/airline engagement on HAL's plans for capacity expansion.

At present the main pressure on airport/airline engagement on the wider scheme appears to be HAL's target date for submission of its DCO application in summer 2020, rather than the interfaces between HAL's plans and the regulatory timetable.

Our May 2019 report on Enhanced Engagement stressed the importance of HAL working with the airlines in the build up to the M5a programme gateway. This will give airlines an opportunity to provide HAL with their commercial views on the overall appropriateness and affordability of its plans in the first quarter of 2020, ahead of HAL submitting its DCO application.[8] We said that:

- engagement must be more efficient, targeted and focused around the airlines' requirements and priorities on affordability, operability and deliverability as set out in Appendix 3 to the report;

[7] We also note that the overall capital expenditure estimate for the creation of a 122.5mppa capacity scheme has increased. Please see May 2019 Enhanced Engagement report for further information.

[8] See Enhanced Engagement Terms of Reference.

- the effectiveness of the M5a gateway process will be significantly enhanced if HAL and the airlines jointly develop a clear plan for the information that HAL should provide, both before and during the M5a process, with clear and agreed arrangements for the oversight of the provision of this information (both in relation to timeliness and quality of the information); and
- we noted that work on this has already started on these and that engagement should also be joined up across the M5a and regulatory (price control business plan) processes.

We note the importance that the airlines place on the M5a gateway and its significance in terms of retaining airline support for the capacity expansion programme. Bearing this in mind, HAL should take steps to ensure that airlines receive high quality and timely information to support this gateway. HAL should also retain a focus on developing its masterplan in a way that meets reasonable expectations with respect to operability and deliverability, as well as an overall programme that is both affordable and financeable. To support the timely preparation for the M5a gateway, we are meeting trilaterally with HAL and the airlines at a senior level at regular intervals to monitor progress with preparing for this important programme gateway.

Our July 2019 consultation[9] on early costs and the regulatory timetable provides further guidance on airport and airline engagement on HAL's price control business plans (the Constructive Engagement process).

Finally, we have also written to DfT to update our April 2018 assurance letter[10] regarding our broader approach to managing possible risks relevant to our economic regulation of capacity expansion at Heathrow airport. This updates on the wider risks associated with the development of a regulatory framework for capacity expansion.

(iii) Views on 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

Our views on this matter are set out in our published June 2019 working paper[11] that summarises our updated affordability and financeability assessment.

The analysis in the working paper is high level and illustrative and is intended to update stakeholders in the light of the latest available information on capacity expansion at Heathrow airport. While the base case is informed by information from HAL's masterplan, the scenarios are illustrative rather than detailed "bottom up" or engineering led options. The analysis indicates that there are a range of credible scenarios that are both affordable and financeable. There are also scenarios where affordability and financeability would be more difficult and unsurprisingly lower costs and a lower cost of capital lead to greater affordability, but a lower cost of capital can also put pressure on financeability. These broad findings are consistent with the results of the assessment in our April 2018 Consultation of these matters.

We have continued to assume that affordability can reasonably be judged in terms of airport charges per passenger that are broadly consistent with 2016 levels in real terms. It was in 2016 when the Secretary of State indicated his preference for capacity expansion at Heathrow and stated that "the aim should be to deliver a plan for expansion that keeps landing charges close to current levels".[12] In assessing affordability, and considering our approach to these matters in the future, we will continue to be guided by our overall focus on the interests of

[9] See link.
[10] See link.
[11] See CAP 1812.
[12] See link.

consumers[13], informed by the views of airlines, and retaining their support for capacity expansion at Heathrow airport.

Given our analysis is at a relatively early stage, it also has significant limitations:

- while the base data on capital expenditure comes from HAL's masterplanning process and has been subject to a degree of detail assessment, (a) HAL is continuing to consult on and develop its masterplan and (b) other key aspects of the base input data (including on operating expenditure, non-aero revenues and passenger traffic) have been derived from relatively high level and stylized analysis;

- the scenarios are intended to be plausible assessments of possible upsides and downsides, but are not based on detailed engineering assessments and do not reflect the full range of possible outcomes for the capacity expansion programme and affordability and financeability; and

- the regulatory framework and price control arrangements have yet to be finalised, so there are a number of important aspects to be further developed, including the cost of capital, incentive framework, and the treatment of early costs (together with the possible implications of this for the wider programme timetable). Our work on financeability is at an early stage and the analysis assumes a notional financial structure similar to the arrangements used to set the existing Q6 price control. We will consider further whether this approach remains appropriate for our work on capacity expansion. All these factors could have a significant influence on both affordability and financeability.

I hope that you find the commentary set out in this letter helpful. I should be happy to discuss further if that would be helpful. We will place a copy of this letter on our website when we publish our July 2019 consultation on early costs and the regulatory timetable.

Yours sincerely

A Walker

Andrew Walker
Chief Economist

[13] Which we view through the lens of our general duty to consumers under the Civil Aviation Act 2012.