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Re: Response to Economic Regulation of Heathrow – CAP1996 Q6 and Expansion Cost Assessment

Thank you for the opportunity to respond to the CAA's above consultation, updating on the CAA's latest development with regards to the Q6 capital efficiency assessment and the assessment of costs associated with Heathrow expansion (the "Consultation").

This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address. Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

1.0 Update on the Q6 Capex Efficiency Review (Chapter 1)

1.1 General Comments

- 1.1.1 The Airline Community continue to express our disappointment and frustration in the outcome of the CAA's findings in the Consultation with regards to the level of capital inefficiency identified - over £200m short from that which the Airline Community had identified in our previous feedback¹ and that our customers will now be expected to bear.
- 1.1.2 Given the low level of confidence the Airline Community has in the current process of evaluating capital inefficiency, and the concerns the CAA have raised with regards to HAL achieving an on time and on budget delivery of complex projects², the Airline Community believes that this further enhances the need for ex-ante capital efficiency arrangements in H7. Only by having the appropriate incentives on HAL can we be sure that appropriately robust upfront planning regarding costs, timing, scope and benefits will be made and that optimal and efficient delivery and implementation will be completed .
- 1.1.3 Whilst we are frustrated this has not resulted in what we continue to think is the only logical outcome (an assessment that inefficient spend reached extraordinary levels of over £200m in Q6) , we do note the CAA recognition of a failure in governance at times, particularly on complex projects, and welcome that this will inform the CAA's views in the future³

¹ "Airline Community feedback to CAA re Arcadis Capital Efficiency Report", dated April 2020 and "Airline Community response to CAA Consultation CAP1964" dated November 2020

² Para 1.47, Consultation document

³ Para 1.26 & 1.27, Consultation document

1.2 Treating the outcome of the Main and Cargo Tunnel review as interim

- 1.2.1 Given the incomplete status of both projects, the Airline Community are supportive of the CAA's proposal to treat these as interim arrangements.
- 1.2.2 However, given the CAA findings so far, we believe that the CAA should be able to undertake a full interim review based on the projected spend of the Tunnel Programme and be able to conclude on this basis. In addition, we believe the CAA should be committing to undertake a review of both projects upon their completion, as opposed to relying on new evidence to be put forward. It should be incumbent upon the CAA to conclude with a final review of each.

1.3 Adjusting to the higher end of Arcadis' assessment on the Cargo Tunnel

- 1.3.1 Notwithstanding the above, whilst we note the CAA have proposed to adjust to the higher end of the Arcadis assessment, the Airline Community's view still remains that all expenditure to date (£40m) remains unjustified.

1.4 Updating the Capital Efficiency Handbook

- 1.4.1 The Airline Community concur that the Capital Efficiency Handbook ("CEH") will be required to be updated, particularly in light of developments that arise for H7.
- 1.4.2 As well as reflecting any structural changes to the capital incentive framework, the Airline Community have provided the CAA with a list of areas for improved capital governance as part of our response to CAA consultation CAP1951 which we will be encouraging to be addressed within H7 and would be reflected within the CEH.
- 1.4.3 There are some key areas that we would either like updating in the CEH or we are calling for them to be newly included. Specifically, these areas are:
 - a. L&L – we would like to change how these are treated within business cases, within the decision-making process, and within the reconciliation of capital spend. We believe these should be evaluated and challenged separately, and budgets need to be fully justified and linked to the planned capital plan in the subsequent year. Much like an ORC, on an efficient, transparent and pass through basis onto the RAB.
 - b. Programme and Portfolio Risk – we would like to explore options on managing risk within both portfolios and programmes. We believe the current process needs to be enhanced regarding transparency and key learnings. We believe that having a central risk allocation and drawdown process will improve certain aspects of managing the capital budget and reduce HAL's exposure in an ex-ante environment. The extra emphasis planning (pre G3) and on scrutiny of spend of risk monies will evolve the current Governance and Control.
 - c. Annual Reconciliation of capital included within the RAB by the CAA.
 - d. Annual reconciliation of capital that earns a return for HAL (i.e. those projects that are both pre and post G3)
 - e. Triggers – an update with regard to how these are treated on projects that span multiple price control periods.

- f. A sign off for all of the above with regard to calculating the following year's annual rate card consultation.

We do believe that we need to conclude discussions on all of the above to inform the H7 licence and we are confident that we can reach agreement with HAL on all the above topics, or be in a position to escalate only those areas of disagreement to the CAA.

3.0 Final Policy for Costs Incurred before March 2020 (Chapter 2) and Policy for Costs Incurred after March 2020 (Chapter 3)

3.1 General Comments

- 3.1.1 Whilst noting the CAA has not sought further feedback on its policy decision set out in Chapter 2 of the Consultation, the Airline Community wishes to note its disappointment with the outcome.
- 3.1.2 The Airline Community note that following the CAA's determination as set out within the Consultation, in the event of the expansion programme being reconvened, future engagement can only be on the basis of the CAA having an established policy on the treatment and governance arrangements that has been subject to prior consultation. The Airline Community engaged in good faith with HAL's programme despite recorded issues with the overall timetable and associated expenditure yet never gave approval for early Category C costs and made it clear to HAL and the CAA that any spend would be made 'at risk'. Clearly, there has been no consequence to HAL of continuing 'at risk' and that consumers will bear the cost of early Category C costs regardless of the fact they were unapproved by the Airline Community.
- 3.1.3 Both in making the decision above and in allowing HAL to recover all of the capital expenditure on certain projects within Q6 despite known failings in governance process⁴ demonstrates that, despite statements otherwise of HAL progressing projects 'at risk' whilst it seeks airline approval, is not the case and creates an unwelcome precedent for future capital projects. This is not a capital governance framework that is acceptable to the Airline Community moving forward and would need to be addressed by the CAA as part of the H7 process.
- 3.1.4 The CAA have highlighted the different stakeholder views with regards to the cost of capital⁵ but we note here our explicit rejection of HAL's proposal to rollover the level from Q6. As per the Airline Community's evidence provided to the CAA as part of our ongoing engagement on the next regulatory price control period (H7), this amount is not reflective of current market conditions and is wholly inappropriate.
- 3.1.5 The Airline Community would also stress a condition of any recommencement of the expansion programme in the future cannot have consumers paying twice for costs or activities already awarded to HAL under this policy. It must be incumbent upon the CAA as part of the 'close out' work of the incurred costs that sufficient detail is captured to ensure

⁴ Please refer to the Airline Community comments regarding T3IB

⁵ Para 2.6 and 2.7 of the Consultation document

such due diligence can be properly undertaken and assurances provided prior to any restart and future costs incurred.

- 3.1.6 The Airline Community agree a full review of the wind down costs must be completed and reiterate our principles set out in 3.1.5 above must apply.
- 3.1.7 Given the exceptional nature of the Interim Property Hardship Scheme (“IPHS”) the Airline Community are agreeable, subject to the satisfactory implementation of the governance arrangements as described in the joint HAL / Airline Community letter⁶ and support the conditions of the CAA’s approval, as set out in 3.20 of the Consultation. The Airline Community do however remain concerned on the ongoing liability the scheme presents, including in relation to IPHS and would welcome further clarity from the CAA on this matter.
- 3.1.8 Furthermore, we would note that since the CAA’s previous consultation the situation has significantly changed whereby the ANPS has been reinstated yet not being progressed by HAL. We welcome clarity from the CAA in how this situation has been considered.

4.0 Assessing the Efficiency of Early Costs (Chapter 4)

4.1 General Comments

- 4.1.1 The Airline Community are broadly agreeable with the direction the CAA have set out within Chapter 4 of the Consultation but shall continue to provide further feedback as this develops further.
- 4.1.2 Given the above, the Airline Community strongly encourage the CAA to ensure such reviews provide opportunities to the Airline Community to review and comment on particular outputs of the CAA’s review work.
- 4.1.3 We strongly encourage the CAA to focus on those areas rated ‘red’ or ‘amber’ in particular, as well as taking a robust approach to the issues identified previously by the IPCR.

5.0 Other Matters: Developments through iH7

5.1 General Comments

- 5.1.1 Notwithstanding any further projects the Airline Community may raise with the CAA, the Airline Community would note the following projects for consideration of a review within iH7:
- (i) Magenta: Given the issues on governance and benefit definition; and
 - (ii) T4 HBS: Given both the definition of the original scope, which has subsequently been jointly amended as no longer required, and the scale of the programme.
- 5.1.2 In addition to the specific capital projects identified above, the Airline Community would highlight to the CAA on the need to review:
- (i) Complete the audit on the Cost of Change programme (as described in CAA Consultation CAP2139);

⁶ Para 3.18 of the Consultation document

- (ii) the implications of HAL's property strategy; and
- (iii) the outcome of the review of HAL's 'Stopped'⁷ projects with consideration for any specific capital treatment issues, if required.

5.1.3 The Airline Community remain available to discuss further the specifics of 5.1.1 and 5.1.2 above.

We thank you for your consideration on the matters raised within this submission. Should you have any questions on any of the points made within please do not hesitate to contact us.

Yours sincerely,



Gavin Molloy
Chair
London (Heathrow) Airline Consultative Committee



Nigel Wicking
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⁷ Those iH7 projects that HAL is seeking to 'impair' following the cessation of the projects