

Chief Executive's Office

John Holland-Kaye

Chief Executive
Heathrow Airport
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Dear John

ECONOMIC REGULATION OF AIRPORT CAPACITY EXPANSION

The Government's announcement today that Heathrow is its preferred location for airport capacity expansion in the South-East of England means the regulatory and planning processes can now begin in earnest. I thought you would find it helpful if I set out our expectations on what we see as some immediate next steps.

The CAA has consistently made the case that more aviation capacity is needed to prevent future consumers from experiencing higher airfares, reduced choice and lower service quality and so we are pleased that the Government has set out a clear way forward with today's announcement.

The importance of you engaging the airlines to help drive value for money and cost efficiency

Heathrow's landing charges are already among the highest in the world for a major airport and ensuring that capacity expansion can be designed and delivered in a cost efficient manner must be a priority for you. Given our primary duty to further the interests of consumers (both present and future), value for money and cost efficiency will be major areas we will focus on in our regulatory process, whilst ensuring that the project can be successfully privately financed.

Experience from other very large complex infrastructure projects demonstrates that a significant percentage of the total cost envelope will be determined during the design stage. Value for money and cost efficiency must therefore be 'designed in'. The airlines have an important role to play in this. To demonstrate your commitment to value for money and cost efficiency we expect you to undertake a thorough and meaningful process of strategic engagement with the airline community over the options for the detailed design of the scheme. Your engagement should cover the scheme's scope, project phasing and its expected impact on future landing charges.

To be clear, our view is that HAL and the airline community have built up a much better relationship in recent years through working together on capital projects. But a new runway project cannot simply be treated as 'business as usual' and it will require airport-airline engagement to be taken to a deeper and much more productive level by both sides.

We intend to monitor your engagement with the airlines on the design of the scheme. Our role will extend beyond our functions in the Civil Aviation Act 2012, which enables us to set limits on your maximum landing charges to airlines. Specifically, using his power under Section 16(1) of the Civil Aviation Act 1982, the Secretary of State for Transport, has asked the CAA to report to him in late 2017 on our view on how effectively HAL has engaged with the airline community on the design of the scheme. We understand that the Government will take into account the CAA's report, amongst other things, when it decides whether to recommend to Parliament its continued support for capacity expansion at Heathrow, with any recommendation expected by the end of 2017. It is likely that the Department will wish to observe and potentially participate in elements of this process.

As a first step we would like you to develop and present to the airlines and the CAA a set of proposals for how you will secure productive engagement over the next year. We expect you to take into account the reasonable needs of airlines with regard to the design and phasing of the project in addition to being clear about your strategic ambition with regard the evolution of airport charges. You will have seen the Government's aspiration that airport charges should remain close to current levels, indeed the Secretary of State was clear on this being a goal in his announcement. You will appreciate that keeping charges flat in real terms is also an outcome that many of the airlines hope to secure in exchange for their support for expansion. We were very encouraged that your Chair, Lord Deighton, made public statements in September indicating that you were developing plans to achieve this ambition and we understand from recent press reports that you too have personally committed to keeping charges flat. This is potentially very helpful: if you committed to this now in a way that made clear what this would mean in practice and how you intend to follow through on the commitment, it would help you build support from the airline community. The degree of such support would be relevant to us as we develop the regulatory framework under and in accordance with the Civil Aviation Act 2012 and reduce the risk of challenges and delay. I also suspect current and potential investors would value reduced risks at this early stage.

For the avoidance of doubt, we appreciate that the quality of the engagement process needs both sides to enter into discussions in good faith; invest sufficient resources in the process at both the strategic and operational levels; maintain adequate pace and momentum; and take into account the broad interests of present and future consumers and not solely their own narrow commercial interests. Accordingly, we will reinforce with the airlines the importance of their commitment to meaningful engagement with you.

The importance of you and the airlines helping the CAA develop our long-term regulatory framework

We understand that current and potential airport investors value certainty about the framework for economic regulation of capacity expansion. Development of this framework is a strategic priority for the CAA, although you will be aware that the pace with which this can be achieved needs to account for the process of proper analysis of legitimate options and thorough consultation with interested parties.

Over the last couple of years we have published a number of documents setting out guiding principles that will shape our approach. More specifically, we recently consulted on our proposals on the regulatory treatment of the costs associated with obtaining planning permission (Category B costs). We expect to publish our final proposals on this subject in November. This will provide you with sufficient certainty about our approach to these costs to enable you to pursue the next phase of the process with vigour and without delay.

Looking beyond the immediate issue of the costs you will incur during the planning process, we are keen to work with you, the airlines and other interested parties on the appropriate framework for the recovery of future construction costs (Category C costs). Our immediate priorities are:

- 1) The development of a clear timetable for the review including major milestones – to be published in the New Year.
- 2) A substantive consultation document outlining some key options for the priority elements of the economic regulation framework – to be published by the end of June 2017.

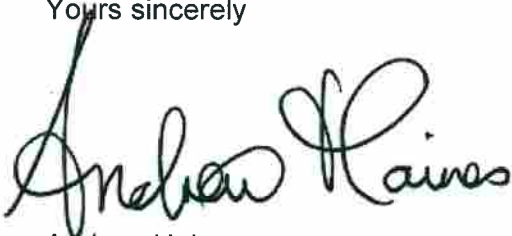
The importance of you engaging with local communities

Alongside the legitimate aspirations of consumers and airlines you will of course be acutely conscious of the importance of engaging with local communities. Alongside both the Airports Commission and the present government we have been clear in our conviction that airport expansion can only be permitted if there is a credible package of measures to deal with the legitimate concerns of local communities. Our understanding is that although the Government is clear about its goals on costs, this must not be at the expense of communities. Some of those concerns will relate to compensation; others will require changes to operating practices and full community participation in the airspace changes that will be required. Combined with our own proposals for significant improvements to the Airspace Change Process, the anticipated revised Government policy will provide a coherent framework within which Heathrow will be expected to develop its proposals.

We look forward to working with you, your team, your airline customers and other key stakeholders to help make sure that new capacity places the interests of consumers at its heart and is designed and delivered in a timely and cost efficient way. We are keen to meet with you, your Board and investors, to explain our approach and priorities.

In addition to the Secretary of State, I am also copying this letter to the CEOs of the five largest airlines currently operating at Heathrow (by passenger numbers at the airport), the Chair of the LACC and MD of the AOC. Given that interest in this subject extends beyond these stakeholders, we will also be publishing this letter and placing a copy on our website.

Yours sincerely



Andrew Haines
CHIEF EXECUTIVE

cc Chris Grayling MP, Secretary of State for Transport
Alex Cruz, BA
Craig Kreeger, Virgin Atlantic
Doug Parker, American Airlines
Stephen Kavanagh, Aer Lingus
Oscar Munoz, United Airlines
Mark Gardiner, LACC
Simon Arthur, AOC