Economic Regulation of Heathrow Airport Limited: working paper on the efficiency of HAL's capital expenditure during Q6

Response from Richmond Heathrow Campaign
17 November 2020

INTRODUCTION

1. This is a written response of the Richmond Heathrow Campaign (RHC) to the CAA's consultation titled '*working paper on the efficiency of HAL's capital expenditure during Q6, CAP 1964, September 2020.*

2. This working paper examines the approach to establishing inefficiencies in HAL's capital expenditure projects during Q6 (2014-2018) that may lead to disqualification of expenditure additions to HAL's Regulated Asset Base (RAB) and in turn disqualification from HAL earning a return through its charges to the airlines.

3. RHC represents three amenity groups in the London Borough of Richmond upon Thames: The Richmond Society, The Friends of Richmond Green, and the Kew Society, which together have over 2000 members. The members of our amenity groups are adversely affected by noise from Heathrow Airport's flight paths, poor air quality and road and rail congestion in west London. We acknowledge Heathrow's contribution to the UK economy and seek constructive engagement in pursuit of a better Heathrow. We are an active participant in the Heathrow Community Noise Forum.

4. Our premise is that it would be preferable to aim for a better Heathrow rather than bigger Heathrow and to capitalise on the world beating advantage of London's five airports, in particular by improving surface accessibility to all five airports, which would be a major benefit to users. Our approach is to continue supporting the case for no new runways in the UK and sharing growth across the UK; we believe this is well supported by the evidence produced by the Airports Commission and the DfT in relation to the Airports National Policy Statement.

5. Over recent years we have undertaken extensive research on Heathrow and submitted a large number of papers to the Airports Commission, the DfT, CAA and others - all of which can be found at www.richmondheathrowcampaign.org

6. RHC has responded to14 CAA consultations on economic regulation - CAPs 1510, 1541 in 2017, CAPs 1610 and 1658 in 2018 and CAPs 1722, 1769, 1782, 1812 and 1832, in 2019 and CAPs 1871, 1876, 1914, 1940 and 1951 in 2020. The responses and other material are on the RHC website.

7. RHC continues to seek a successful 2-runway Heathrow with improved access and reduced environmental impact and we continue to be interested in economic regulation of the airport and capital expenditure efficiency. Our responses on efficiency are limited because we are not privy to Heathrow's procurement and accounting processes and governance. However, we take this opportunity to add to our previous responses on capex efficiciency.

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RICHMOND HEATHROW CAMPAIGN RESPONSE TO CAP 1964

Introduction and Chapter 1 - Assessing the sample projects for inefficiency

8. Broadly we support the CAA's approach outlined in CAP 1964 to capex inefficiencies. But we do have some caveats as follows.

9. We note that HAL has experienced some substantial cost over-runs in Q6 price control period as summarised in the following table extracted from the Arcadis Report *"Heathrow Q6 Capex Efficiency Review September 2020"*. Ten projects were examined covering the period April 2014 to December 2018.

Project *Forecast	Last Approved Budget £m	Final cost £m	Variance £m
B051: T3 Integrated Baggage	92.2	136.1	43.9
B238: T5 Western Baggage Upgrade	20.7	25.9	5.2
B131: Main Tunnel Refurbishment	86.0	146.3*	60.3
B131: Cargo Tunnel Refurbishment	44.9	197.0*	152.1
B066: Energy & Utilities Management	51.3	48.2	3.1
B101: T3 Pier 7 Roof Works	29.9	29.78	0.2
B101: T4 Rooflight Replacement	13.1	11.3	-1.8
B101: T4 Toilets & Finishes	14.5	15.2	0.7
B316: T3 IDL Refurbishment & Enhancement	18.6	18.5	-0.1
B009: T5 Northern Perimeter Parking	3.1	4.9	1.8

10. We also note that HAL experienced substantial cost over-runs in regard Heathrow expansion - category B and early category C costs, as discussed in previous RHC responses to the CAA. Although we understand these costs are not the subject of CAP 1964 but of separate discussion.

11. By our calculations, HAL accumulated substantial excess profits in Q6, at least prior to the CV19 pandemic and this is also evidenced recently by the CAA in CAPs 1966 and 1966a.

12. In the light of this evidence we encourage the CAA to root out robustly capex inefficiencies.

13. CAP 1964 discusses the appropriateness of using a sample of 10 projects and we understand the CAA's conclusion is that the sample size and choice of project is probably adequate to identify systemic inefficiencies in project management and in quantifying the inefficiency deductions from RAB additions during Q6. But the aggregate budgeted expenditure of the ten projects is £374 million and when compared to the total capex of £3.2bn (2019 money) across 220 projects, the sample is relatively small.

14. We understand the remaining "internal audit" steps will involve determining for the ten projects the final outturn costs and final assessments as to the quantum of expenditure *ex post* that is deemed inefficient. We realise the CAA and IFS are closely involved in monitoring performance but we do question whether there might be material aggregate inefficiencies in the

remaining near £2.8bn of capex and, in fairness to HAL, over-performance that might be offset against the inefficiencies.

15. Broadly, we support the approach adopted by the CAA in assessing the inefficiencies of each of the ten projects in CAP 1964 but we have some questions as follows.

16. We note the importance given by the CAA in getting the initial steps such as scope in any project right at the start. We also, note that the end-value is one of the efficiency criteria. We would place greater emphasis on end-value than we detect in the CAA's approach. In other words, the decision as to whether a project should go ahead presumably compares the value against cost and applies HAL's hurdle cost of capital with risk taken into account. We query whether the benefit and cost are tested on completion of each project, allowing for any change in scope. It would seem that any capex on projects where the rate of return exceeds the cost of capital should be allowed, other things being equal. The excess capex giving rise to a shortfall in return should be disallowed. Seemingly, this is not dealt with by the CAA's approach, at least as outlined in CAP 1964. Cost budgets and time schedules are important but over-reliance on these factors could lead to control of the project inputs being inadequately related to the outputs.

17. We see little reference to risks and contingency cost management in CAP 1964 and suggest the approach should take these important factors explicitly into account.

Chapter 2 - Broader Issues

18. We have included some comments on broader issues above but further comments are as follows:

19. CAP 1964 is not about incentives but we said in our recent response to CAP 1951 on incentives, that we believe the addition of capex to the RAB should be incentive enough, since HAL has a licence to operate on the grounds it can well manage the business; HAL is provided incentive through the regulated weighted average cost of capital. We believe the emphasis should be on penalties for under-performance including capex inefficiencies. We believe therefore that the CAA's approach to capex inefficiencies should robustly root out the inefficiencies and we are not fully convinced that the CAA's approach is sufficiently robust.

20. We are not clear how HAL's overall capex programme is decided, although we presume this is tied in with HAL's Business Plan and regulatory 5-year control period. Perhaps it is outwith the scope of the project efficiency tests dealt with by CAP 1964 but we query the extent the overall capex programme (e.g. choice of project) is optimised in achieving the regulatory goals. Aggregate capex sub-optimal outcomes are a form of inefficiency and it is not clear how this is monitored and remedied. In normal times Heathrow airport is a relatively stable business but the CV-19 pandemic highlights this issue and what optimal capex programme is needed over the next few years. This ties in with the issues raised by HAL's request for financial support discussed in the recent CAP 1966.

21. Overheads are discussed in CAP 1964. We believe it is important HAL's overheads are efficient in themselves and that their apportionment and allocation to capex projects is fully justified. This is especially important in the context of substantial reduction in volume of business resulting from CV-19. Presumably HAL has reduced its variable costs to offset the reduction in income. But by definition fixed costs are not subject to reduction, at least in the short term, thereby resulting in higher overhead charge out rates. There is a question as to the proportion of overheads the consumer should be charged through additions to the RAB or in other words what volume risks should the consumer bear. END