

**Assessment of capital expenditure and consultation at
Heathrow and Gatwick airports during the first two years of
Q5**

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Basis for assessment

1. In its March 2008 price control decision for Heathrow and Gatwick airports for the five year period starting 1 April 2008 to March 2013 (known as the fifth quinquennium or Q5), the CAA set out as part of the Regulatory Policy Statement its intention to conduct an assessment, around the midpoint of Q5, of each airport's performance in relation to capital expenditure and consultation on airport development and investment. In a letter, dated 24 July 2009, the CAA consulted interested parties on the proposed terms of reference and conduct of the assessment.
2. This document sets out a summary of, and CAA's consideration of, the responses to the letter of 24 July. These responses have shaped the final terms of reference and plan for the conduct of the assessment, set out in paragraphs 28-32 and Annex 3.
3. Although, the CAA does not intend this assessment should itself reach regulatory judgements and/or decisions affecting either the price cap regime in Q5 or the Q6 period, it will inform the Q6 review¹, and subject to ongoing requirements for price cap regulation will help to identify issues to be addressed during that review. Furthermore, the assessment should provide a useful independent scrutiny for each airport's management and offer pointers for improvements that could be made during the remainder of Q5.

Heathrow and Gatwick airport's capital investment programmes (CIP)

4. Both of London's principal airports are engaged on major investment programmes during the Q5 period and beyond. Heathrow plans to spend £4.4bn and Gatwick around £900m (both 2008/9 prices, undiscounted) in the five years to 2013. Given the scale of these programmes, it is important that airlines, passenger groups and other stakeholders are consulted properly about the overall plan and individual projects. It is equally important to assess the way capital resources are being deployed by the airports to achieve efficiency of expenditure and management of risk at both a project and portfolio level.
5. Actual capital expenditure in the first year of Q5 (2008/09) is shown for each airport compared to the CAA's March 2008 regulatory settlement.

	Airport Capex (2008/09) ²	
	Actual	CAA settlement
Heathrow ³	739.9	912.2
Gatwick	104.0	200.6

¹ It may also inform any ex post review of capital investment, as might be necessary for the CAA to identify whether (and the extent to which) the level of investment during Q5 has fallen short of that which might reasonably have been expected to have taken place had the airports adopted financial arrangements consistent with those assumed in setting the price control – see Annex E of the CAA's March 2008 decision.

² 2008/9 prices

³ Both actual and CAA settlement exclude PSDH expenditure.

6. Similar information for the second year of the quinquennium (2009/10) will become available around March/April 2010 and will be taken into account for this assessment.

CAA's consultation letter

7. In its consultation letter of 24 July, the CAA consulted interested parties on the scope of this exercise. The CAA stated its objectives were to consult interested parties on the proposed terms of reference and conduct of this assessment.
8. The CAA stated that the intent of the assessment, at approximately the mid point of the price control period was to provide a transparent independent assessment of (i) progress by Heathrow and Gatwick airports in achieving capital expenditure efficiency at each airport, and (ii) each airport's performance to date in its consultation with users on airport development and investment.
9. More particularly, the letter asked respondents to provide comments on:
 - the proposed terms of reference;
 - the proposed scope of the assessment; and,
 - the proposed conduct of the assessment.

Summary of consultation responses

10. Responses were received from Heathrow, Gatwick and nine other organisations and are available on the CAA website. In general terms most respondents thought that the proposed terms of reference and conduct of the assessment were acceptable. A number of airlines and user groups wanted the terms of reference expanded to include capital management and Project for Sustainable Development of Heathrow (PSDH) funding. In particular, the forecast Anticipated Final Cost (AFC) overspend of £600-700m in Q5 at Heathrow was highlighted by several airline respondents as requiring detailed examination.
11. There was similar interest in ensuring that any justification for capex based on operational cost savings was fully supported. Some respondents requested the scope to include operating costs, non-regulated charges, traffic forecasts and service quality. One respondent said the review should not only look at risk allowances but also other provisions such as inflation allowances. Lastly, there was interest in broadening the consultation part of the assessment beyond capital investment plans to all forms of consultation, although one airline respondent did not support widening the scope of consultation and would prefer to see a streamlined consultation structure supported by defined information protocols.
12. The CAA's approach to these matters is discussed in the next two sections of the document. A more detailed analysis of the issues identified in the responses to the letter of 24 July and the CAA's consideration thereof is provided in Annex 1.

Scope of the assessment*Capital Expenditure efficiency*

13. The CAA's consultation letter set out the proposed terms of reference for the capex efficiency assessment as follows:
 - development and application of cost benchmarks to the Q5 capital investment plan, and prospectively, to the initial development of capital plans for Q6 and beyond;
 - application and evolution of risk allowances for projects;
 - progress in management of certain risks at airport investment portfolio, rather than individual project and implications for setting future risk allowances
14. Although a number of respondents asked for the scope of the assessment to be enlarged, the CAA believes that it would be better to focus its resources on capital expenditure efficiency and consultation on capital projects as a much broader scope would be unduly burdensome to the parties, detract from the main purpose and lengthen the already quite extended timetable.
15. After some thought, the CAA has decided to modify the scope and terms of reference to address a number of the issues raised in the consultation. The CAA will examine for example the extent to which anticipated operating cost savings have flowed from selected capital projects. However, the CAA does not intend to widen the review to examine all aspects of capital management. Similarly, it would be impractical to examine all airport-airline consultation as some parties requested, which would not be relevant to this assessment. The CAA recognises though that these matters are likely to form an important part of the next price control review in 2013.
16. The reason for having a tight scope (rather than full scale review) is because the original basis for this mid term assessment, set out in the CAA's March 2008 decision, was a continuing concern among airlines regarding the performance in developing capital plans at Heathrow and Gatwick, and consulting users on the plans. To go significantly beyond these matters would change the regulatory settlement and introduce issues that have not been identified in previous capital expenditure reviews. However, following responses to the recent consultation, the assessment will seek explanation of the AFC budget gap at Heathrow and consider if any part of the gap is relevant to an assessment of capital expenditure efficiency. This analysis will need to be conducted carefully, looking at the different causes of the AFC gap, before reaching any conclusions about the efficiency of capital deployment.
17. The assessment of capex efficiency at each airport will be based on the scope items set out in paragraph E58 of the CAA's March 2008 decision. However, where the original justification for a capital project was significantly to achieve savings in operational expenditure, it will be within the ambit of the assessment to examine whether systems were in place to evaluate whether the anticipated opex efficiencies have been achieved. But as a point of principle, the price control incentive mechanism operates in a way that forecast cost efficiencies

(derived from published benchmarking and other studies) are taken into account when the price control is initially set, and reductions in opex actually realised do not get translated into further reductions in airport charges during the period, but are taken into account as part of an overall efficiency review when the price control is next reset. A complete review of operating costs, as requested by some respondents, would not therefore be appropriate at this point in time.

Consultation on airport development and investment

18. The consultation letter set out the proposed terms of reference in relation to consultation as follows:
 - each airport's consultation performance against its revised agreement on information disclosure and consultation (Annex G to the decision document); and
 - at Heathrow, consultation on, and efficient delivery of, preliminary capital expenditure associated with the expansion of airport capacity via mixed mode operations and/or a third runway.
19. The main response of airlines and users to this part of the assessment was that consultation should be extended to other forms of consultation in addition to capital expenditure and that funds earmarked for PSDH should not be deployed on non-PSDH capital projects. As noted above, to include all forms of consultation would extend the assessment well beyond that envisaged at the time of the March 2008 decision, and there is no material reason to examine operating costs in detail at this stage of the price control.
20. In its Q5 decision, the CAA allowed BAA a return on forecast expenditure of £639 million for future airport development relating to a third runway and sixth terminal. As a protection to airport users, the CAA noted in that decision that it would review PSDH expenditure in the middle of the quinquennium, including whether the expenditure was necessary at the time it was incurred. The CAA will therefore include the efficiency of PSDH expenditures and consultation as part of this assessment, with the tests being no different from those applied to other Q5 capital expenditure. For sake of clarity, in its March 2008 decision, the CAA envisaged that the tests for including PSDH in the regulatory asset base would include an additional test of necessity by reference to the CAA's statutory duties. The CAA has no reason to depart from this position, but the test of necessity will not form part of this mid-term assessment.
21. The draft 2008 CIP was part of the price control settlement for Q5 and the process itself was relevant to the development of Annex G. Therefore the focus of the current performance assessment will be on 2009 and 2010 CIPs. The timing of this work needs to consider when information for 2010 will become available from the airports. The CAA understands that the plans will be finalised in March/April 2010, but will need to adapt to any change of schedule.

22. The CAA is mindful that in March 2009 the Competition Commission⁴ identified that Annex G should be supplemented to include further requirements, such as improved timelines of information provision, transparency of decision making, facilitation of consultation (where needed) and the “equitable treatment” of airlines. Although Heathrow airport and the airlines have been discussing a revised consultation protocol for some months, at this time no agreement has been reached. In any case, for this assessment into the way in which consultation has operated in practice during Q5, it is appropriate to adopt Annex G as the standard, rather than apply a new standard retrospectively.
23. The CAA will be discussing with its appointed consultants the appropriate way to test performance against this standard, but is likely to examine the working of Annex G with reference to:
- timeliness of information disclosure
 - quality and appropriateness (e.g. commercial restrictions) of information disclosure
 - active participation and engagement of the parties
 - ability of users to make proactive proposals and to see how their views have been taken into account
 - has it helped parties to reach agreements, or be clearer on reasons for disagreement?
 - has it helped to identify and determine trade-offs?
 - has it improved outputs and deliverables?
24. Although not strictly part of Annex G, the CAA will consider some wider issues such as:
- would a facilitator improve the consultation process?
 - consultation practices at other major airports
 - what (if any) changes are needed to Annex G (bearing in mind the discussions since the Competition Commission proposals)
25. In summary, at what will be approximately the mid-point in the price control period, it is the CAA’s intention to confine the review to a relatively tight set of issues relating to the efficiency of capital expenditure and the consultation performance during the first two years of the period, rather than a full-scale re-examination of Q5 capital expenditure plans. The assessment of capital efficiency will be conducted by investigating a representative range of projects, including projects identified by the airline community, that collectively form a major part of the overall investment programme at each airport. The assessment will take into account background data including historic studies where relevant. However, it is anticipated that most weight will be placed on evidence and studies pertaining to actual performance in Q5 itself.

⁴ Competition Commission, BAA airports market investigation: A report on the supply of airport services by BAA in the UK, 19 March 2009

Consultancy studies

26. The CAA intends to appoint specialist consultants to assist the examination of capex efficiency and consultation. The skills and experience needed to conduct these two work streams may differ sufficiently to warrant the appointment of separate consultants. Furthermore, as the work will be carried out largely in parallel, separate consultants should help to ensure timely delivery of the different work packages. However, the CAA does not rule out appointing one consultant if it receives a compelling proposal.
27. The CAA intends to tender for consultancy support in December. It is envisaged that capex efficiency consultants will be appointed to begin work in January 2010 and consultants examining consultation performance will be appointed in February 2010. The consultants will report in the summer of 2010 and be asked to make specific recommendations including any changes that might be needed in Annex G.

Terms of reference, timetable and conduct

28. The terms of reference for the assessment of capital expenditure and consultation remain similar to the terms published by the CAA in March 2008, as set out below. Revisions to the earlier terms of reference are highlighted in bold and the final terms of reference set out in Annex 3.

Objective

29. To provide for the first two years of Q5 a transparent independent assessment of (i) progress by Heathrow and Gatwick airports in achieving capital expenditure efficiency at each airport, and (ii) each airport's performance ~~to~~ **date** in its consultation with users on airport development and investment.

Scope

- 30.
- Development and application of cost benchmarks to the Q5 capital investment plan and, prospectively, to the initial development of capital plans for Q6 and beyond;
 - **the impact of selected capex projects on operating costs;**
 - application and evolution of risk allowances for projects;
 - progress in management of certain risks at airport investment portfolio, rather than individual project, level and implications for setting future risk allowances;
 - each airport's consultation performance against its revised agreement on information disclosure and consultation (Annex G to the decision document) and

- at Heathrow, consultation on, and efficient delivery of, **preliminary** capital expenditure associated with the expansion of airport capacity via **mixed mode operations⁵ and/or** a third runway.
31. As set out in Annex 2, the timetable for the assessment has been revised to take into account the comments received and the probable dates when information will become available from the airports. Compared to the timetable in the consultation letter, it is now intended to begin the assessment slightly earlier, in January 2010, starting with a review of 2008/09 capex. Since 2009/10 capex data will not be finalised until about April 2010, the capex efficiency assessment will be staggered to accommodate information availability. This will be followed in February by commencement of the consultation review which will allow the 2010 capital investment plans to be included. Following a period of consultation with interested parties during the summer, when the consultancy studies also will be available, the CAA intends still to publish the final findings of this assessment in November 2010.
32. The conduct of the assessment will ensure that all parties have a reasonable opportunity to attend stakeholder meetings, engage with the CAA's appointed consultants and provide comments throughout the assessment process. Agendas for the stakeholder meetings will be prepared well in advance. It is also intended that the consultancy studies will be published to allow parties a full opportunity to submit comments. All parties are expected to support their views and positions, where possible, with objective evidence.

⁵ Mixed mode operation at Heathrow was rejected by the government earlier this year. Department for Transport, Adding Capacity at Heathrow airport: Decisions following Consultation, January 2009

Annex 1**Responses to CAA Letter of 24 July 2009**

Issues	CAA response
Widen terms of reference to include opex and non regulated charges	The focus will remain the airports' capex efficiency and consultation performance relating to capital investment plans
Assess all consultation, not just that relating to capex	Extending the review to all consultation (opex, non regulated charges, etc) would dilute the focus on capital expenditure which was the basis for the mid term review. In addition to ongoing capex, the assessment will include airport development and capacity expansion at Heathrow.
Examine forecast AFC budget gap at Heathrow	It is not intended to conduct a full scale re-examination of capex plans, but the assessment will look into the reasons for the AFC budget gap and the extent to which capital deployment efficiency may be a contributing factor
Analyse whether trigger projects have been completed on time and calculation of rebates	There is already a well established CAA process for evaluating the delivery of trigger projects
Include trigger projects in the assessment	A number of trigger projects will be included
Examine capex justification base on opex savings	This aspect will be considered for selected projects as part of capital efficiency scrutiny, but the CAA will not undertake a review of opex efficiency at the mid term.
Provide opportunity to comment on consultants' studies	The studies will be published and comments invited
Consult Passenger Advisory Group and Gatwick Airport Consultative Committee	Passenger groups will be included in the consultation
Use of PSDH funding	It is not part of this assessment to consider PSDH funding <i>per se</i> but consultation and capital efficiency regarding airport development and capacity expansion at Heathrow will be included
How will conclusions of assessment be shared	The consultants' reports will be published. The final findings will be published
Hold additional meetings or workshops to allow widest possible attendance	The CAA will hold additional meetings if required but it is hoped that by giving good advance notice of meetings that this may not be needed
What is the precise purpose of stakeholder workshops	The workshops are intended to provide a forum for discussion and ensure all key issues are addressed. There will also be an opportunity for parties to meet the consultants and discuss their findings
Consider evidence produced by Obermeyer Panen+Beraten and WSP	All relevant background data and evidence will be taken into account subject to the comment below
Do not place undue reliance on historical data or studies	The assessment will be informed by all relevant data but most weight will be placed on evidence and studies relating to what has actually taken place in the Q5 period

Annex 2**Assessment of capital expenditure and consultation - timetable**

Date	Action
July 2009	CAA writes to interested parties to consult on terms of reference
October	End of CAA consultation on terms of reference
December	CAA announces terms of reference and process for assessment
December	CAA tenders for two consultancy studies on capital expenditure efficiency and customer consultation
January 2010	CAA appoints capex efficiency consultants Consultants download data from airports for 1 st year of Q5
February	CAA appoints consultation performance consultants
March	Airport 2010 CIPs available CAA holds first stakeholder workshop
April	Capital expenditure efficiency: consultants download data from airports for 2 nd year of Q5
May	Further evidence gathering through interviews and documentary analysis
June	CAA publishes the two consultancy reports for comment
July	CAA holds second stakeholder workshop – presentation of emerging findings for consultation over summer
August	Any further data gathering and analysis over summer
September	Consultation closes
October	Final CAA assessment
November	CAA publishes results of assessment

Annex 3

Terms of Reference

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Scope

- development and application of cost benchmarks to the Q5 capital investment plan and, prospectively, to the initial development of capital plans for Q6 and beyond;
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