

July 24, 2009

Dear Colleague,

**Assessment of capital expenditure and consultation at Heathrow and Gatwick airports**

1. In its March 2008 price control decision document for Heathrow and Gatwick airports, the CAA set out its intention to conduct an assessment, around the midpoint of the quinquennium, of each airport's performance in relation to capital expenditure and consultation. The purpose of this letter is to consult interested parties on the proposed terms of reference and conduct of this assessment.

*Proposed terms of reference*

2. The proposed outline terms of reference remain as published by the CAA in March 2008<sup>1</sup>, as set out below:

Objective:

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.

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;
- application and evolution of risk allowances for projects;

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<sup>1</sup> Economic regulation of Heathrow and Gatwick airports, 2008-2013, CAA, March 2008, paragraph 8.52. References to BAA have been updated to refer (more neutrally) to each airport and its respective management.

- 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 operations and / or a third runway.
3. The underlying purpose of conducting the proposed assessment next year is to start to build the evidence base for each airport for the Q6 price control review, which is anticipated to start in earnest in 2011 and to conclude in the first quarter of 2013. Notwithstanding that the future legislative framework for economic regulation is currently subject to Government policy review, the CAA considers that the results of the proposed assessment would be relevant and useful to a range of different regulatory approaches for each airport, including the current regulatory asset base price caps. This evidence base will be for the primary use of the CAA (and subsequently the Competition Commission in its consideration of the price control and public interest reference by the CAA). But it should also provide a useful independent scrutiny for each airport's management and to assist it to achieve continuous improvement. The process of the assessment itself and its conclusions should also contribute to the ongoing scrutiny provided by airlines of each airport's investment plans and their delivery, thereby encouraging effective consultation on, and efficient delivery of, projects. Finally, the results will start to set the scene for Q6 price control reviews, and may identify issues to be addressed more fully as part of that review.
4. The CAA does not intend that the assessment should itself reach regulatory judgements and/or decisions affecting either the price cap regime in the Q5 or the Q6 period. Nor should it become a 'dry run' of any broader issues which might be considered by the Q6 price control review: Under the legal framework for airport regulation, the CAA's regulation of designated airports is likely to be most effective in meeting users' needs over time when it sets clear economic incentives within which each airport must operate for the five years of each quinquennium, rather than intervening within each quinquennium with *ad hoc* regulatory decisions. It also considers that judgement about each airport's overall performance during Q5 in consulting effectively with users and delivering capital investment efficiently is best reached in the round in the context of the overall judgements made as part of the Q6 price control review. The assessment will inform that subsequent regulatory judgement but will not itself draw conclusions, for example, on whether capital expenditure to date should be allowed into the regulatory asset base.
5. The CAA will aim to focus its resources on the task in hand in the capital expenditure and consultation assessment, so as to avoid its scope becoming unduly enlarged and burdensome to interested parties, and will encourage interested parties similarly to focus on the issues within the scope of the assessment.

6. It is quite possible – indeed likely – that during the course of the assessment the ownership of Gatwick airport will change. This does not affect the need for the assessment, nor does the CAA expect it to affect the way the assessment will be conducted. This is because the CAA's approach to airport regulation is generally determined by the risk of abuse of market power as opposed to the identity of the airport owner.

*Proposed scope of the assessment*

7. It is proposed that the assessment will cover aspects of capital expenditure efficiency and consultation on airport development, as set out above. It will assess the performance of Heathrow and Gatwick separately, regardless of the ownership of the airports. (Stansted airport, subject to a five year price control starting one year later than that of Heathrow and Gatwick, is outside the scope of this assessment, and an in-depth capital expenditure assessment is not envisaged for Stansted, given the different approach to setting price caps that the CAA adopted in its March 2009 Q5 price control decision). The assessment will consider relevant evidence from April 2008 through to summer 2010, including specifically evidence on cost efficiency and consultation from the consultation on draft capital investment plans in each spring of 2008, 2009, and 2010.
8. With regard to consultation performance, the CAA will consider each airport's track record against the standards set out in the Annex G consultation protocol to the CAA's March 2008 price control decision. Heathrow is currently discussing with airline users the scope for extending and strengthening this protocol, in light of the Competition Commission's recommendations in its final report on the BAA market investigation. If such an enhancement were agreed and implemented by spring 2010, when the assessment is due to commence, then the CAA would assess consultation performance at Heathrow from that point forward against this enhanced measure. It would not attempt to apply this measure retrospectively.
9. With regard to capital expenditure efficiency, the assessment will take account of a number of existing analyses, including the Currie & Brown study for IATA at Heathrow of February 2006, the CAA's November 2007 assessment of the capital investment plans for Q5 for each airport (also produced by Currie & Brown), and any relevant evidence from the Competition Commission's most recent airport price control and BAA market investigation reports.

*Proposed conduct of the assessment*

10. The CAA intends to conduct the assessment during the spring and summer of 2010, consulting on preliminary conclusions over summer 2010, before reaching final conclusions in the autumn. The CAA intends to conduct an open assessment, drawing on as far as possible the views and evidence provided by airline users and airport operators. It will provide opportunities for all interested parties to contribute, through workshops, interviews and submission of written material.
11. The CAA plans to conduct the two aspects of the assessment (capital expenditure efficiency and consultation performance) as parallel work streams for each airport.

Each will draw on a prior contextual analysis of how the capital investment plan at each airport has evolved over Q5: what has been delivered against previous plans and what is projected to be delivered in the remainder of Q5. The CAA will lead evidence gathering and assessment of each airport's consultation performance. The CAA will engage specialist consultants to assist in the analysis and assessment of each airport's investment efficiency (project cost benchmarking and risk management), and to provide the CAA with an independent perspective on airport consultation performance. The CAA itself will lead communications with interested parties.

12. The proposed timetable for the assessment of capital expenditure and consultation is set out below:

Date	Action
July 2009	CAA writes to interested parties to consult on terms of reference for assessment
Oct	CAA consultation on assessment terms of reference ends
Nov	CAA announces terms of reference and process for assessment
Dec	CAA tenders for airport capital development consultancy support
Jan 2010	CAA appoints capital expenditure consultants
Feb	Capital expenditure efficiency: consultants download data from airports Consultation performance: CAA downloads documentary evidence from each airport
Mar	CAA holds first stakeholder workshop
Apr	Consultation performance: CAA evidence gathering through interviews and documentary analysis Capital expenditure efficiency: consultancy scrutiny
May	Airport CIPs 2010: due to be published
Jul	CAA holds second stakeholder workshop – presentation of emerging findings for consultation over summer
Aug	Any further data gathering and analysis over the summer
Sept	Consultation closes
Oct	Final CAA assessment
Nov	CAA publishes results of assessment

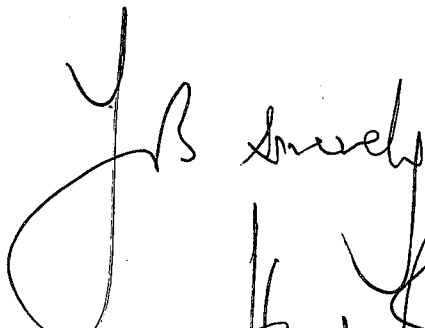
*Views requested*

13. The CAA would welcome views from interested parties on the proposed terms of reference and conduct of the assessment of capital expenditure and consultation at Heathrow and Gatwick. In particular:
- Are the terms of reference correctly specified? Are there any other questions that might helpfully be addressed by the proposed study?
  - Is the proposed conduct of the assessment an efficient and effective approach to address the issues under review?
  - Is the proposed form of engagement with stakeholders sufficient and likely to be an efficient and effective means of two-way communication with the CAA?

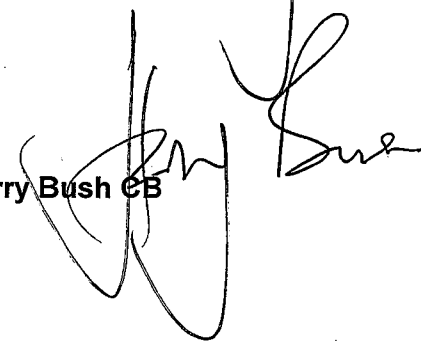
14. The CAA would welcome written responses to this consultation letter by 2 October 2009. Comments should be sent, if possible by e-mail, to [kathryn.hodgson@caa.co.uk](mailto:kathryn.hodgson@caa.co.uk) or by post to:

Kathryn Hodgson  
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15. In light of its assessment of views received, the CAA would then expect to announce the terms of reference and proposed plan for the conduct of the assessment in November.
16. Any comments or questions regarding this letter should be addressed in the first instance to Mike Goodliffe on 020 7453 6226 or [mike.goodliffe@caa.co.uk](mailto:mike.goodliffe@caa.co.uk).



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