



## SPECIFICATION

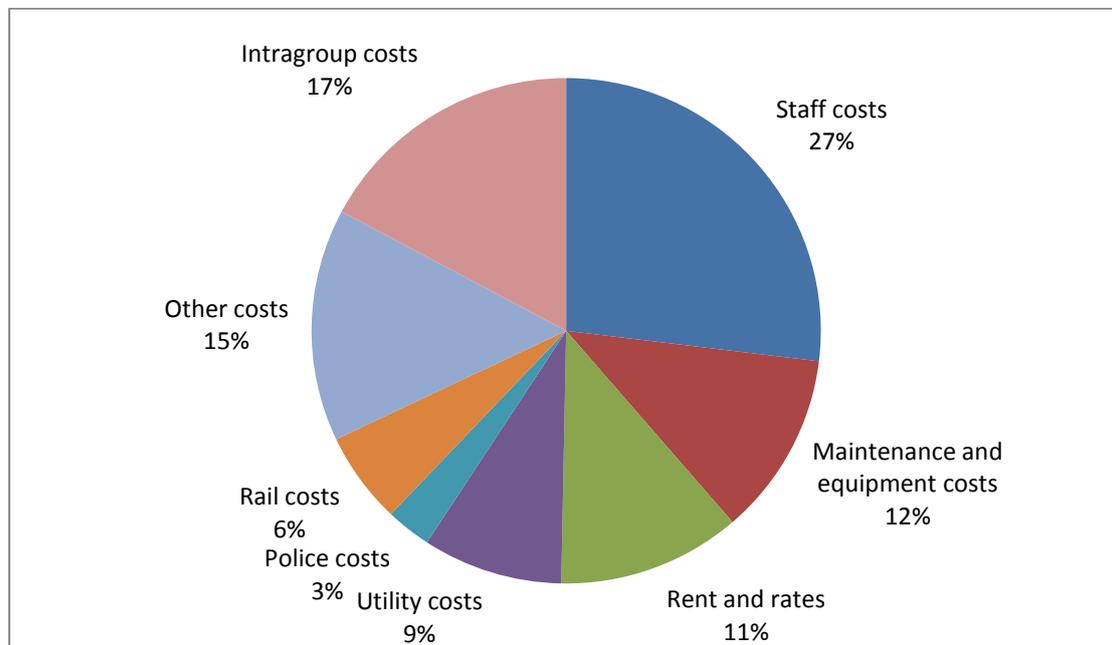
### **Terms of Reference assessment of central support costs at Heathrow and Gatwick airports**

#### **Background**

The CAA is currently considering the most appropriate regulatory arrangements to put in place when the present price controls expire in March 2014. As part of this work the airports and airlines at each of the three airports subject to economic regulation: Heathrow, Gatwick and Stansted, are undertaking a process of constructive engagement (CE) on potential price caps for the next regulatory period (Q6) using a RAB-based framework.

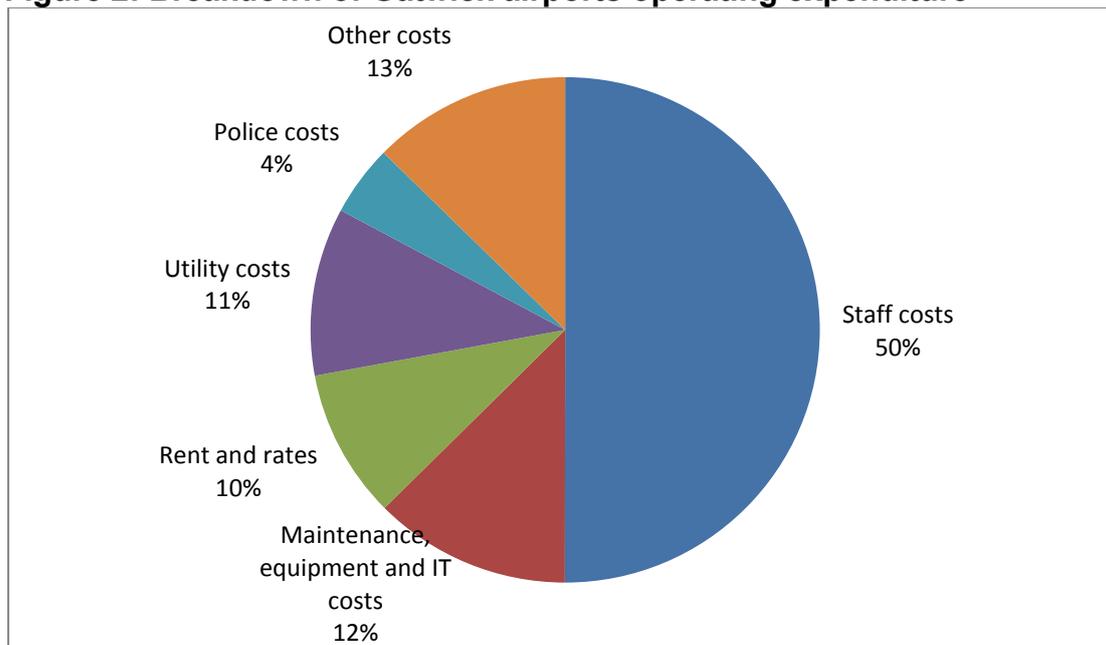
One of the key building blocks of a RAB-based price control is operating costs. Operating costs cover a variety of costs as illustrated by the breakdown of Heathrow airports operating expenditure for 2011/12.

**Figure 1: Breakdown of Heathrow airports operating expenditure**



Source: Heathrow 2011-12 regulatory accounts

**Figure 2: Breakdown of Gatwick airports operating expenditure**



Source: Gatwick 2011-12 regulatory accounts

The CAA is intending to undertake a variety of work to assess operating expenditure<sup>1</sup>:

- Employment cost study for Heathrow, Gatwick and Stansted, being undertaken by IDS, expected completion in October 2012<sup>2</sup>;
- Assessment of airport central support costs;
- Maintenance and renewal costs;
- Assessment of other operating costs; and
- Top down operating expenditure benchmarking

In addition the CAA has also undertaken a mid-control period review of operating expenditure at Stansted airport<sup>3</sup>.

## Requirements

This request for advice covers assessment of airport central support costs. Within the Heathrow cost split these are mainly included in intra-group charges. For Gatwick they are split between staff costs, IT costs and other costs. Central support costs include:

- Finance department costs;
- Business support costs;
- Legal;
- Marketing and communications;
- Strategy, regulation and government affairs;

<sup>1</sup> The invitations to tender for the other pieces of work will be issued in due course

<sup>2</sup> The terms of reference for this work are at:  
<http://www.caa.co.uk/docs/78/1387SO26Spec.pdf>

<sup>3</sup> Review of operating expenditure and investment consultation (Annex D): Mid term Q5, Steer, Davies and Gleave, May 2012. This document can be accessed at:  
<http://www.caa.co.uk/docs/5/SDGStanstedReport.pdf>

- Human resources;
- Information technology;
- Management and Board;
- Insurance and other costs.

For each of these cost lines the following tasks should be undertaken:

- A review of the principal drivers of changes in central support costs;
- Assessment of the levels and changes in central support costs at Heathrow and Gatwick airports with relevant benchmarks;
- A review of Heathrow and Gatwick's forecasts of central support costs; and
- An evidenced assessment of the scale of efficiencies that might be achievable over Q6.

Staff costs are likely to be an important part of central support costs. This consultancy should build on the results of the employment cost study undertaken by IDS which assesses the actual and forecast unit employment costs. This consultancy should not seek to duplicate the IDS work but should instead focus on staff productivity and total costs.

#### Review of the principal drivers of changes in central support costs at Heathrow and Gatwick airports

For each of the above cost lines the assessment will consider an assessment of the principal drivers of the changes in Heathrow and Gatwick airports central costs in Q5, which, for context, will look at trends between 2005-06 and 2011-12. Contractors will clearly identify what costs they would expect to vary with traffic, inflation and other factors. Where possible, the contractor will assess the contribution to changes in central costs from the broad drivers such as passenger traffic volumes, input prices and underlying contractual arrangements. The Contractor should consider the degree of consultancy and/or agency staff on individual cost lines. An assessment will be made of the impact of the sale of Gatwick and Edinburgh and the expected sale of Stansted on the allocation of central costs to Heathrow airport, the reasonableness of these costs given the services provided to Heathrow and whether the cost allocated to Heathrow include any central re-structuring costs arising from the sale of the airports. The assessment will also include the reduction in intragroup charges at Gatwick airport following the sale by BAA and the impact on IT and other opex costs. The assessment will also include a comparison with the assumptions made at the time of the Q5 decision. The output of this task is envisaged to be a breakdown of changes in operating costs at Heathrow and Gatwick airports split by main cost type with, as far as possible, a clear explanation of the drivers of these changes.

#### Assessment of the levels and changes in operating costs at Heathrow and Gatwick airports with relevant benchmarks;

This task will compare the other operating cost lines with relevant benchmarks. Relevant benchmarks can include other comparable airports, wholesale or market rates and costs from other industries. The contractor

should will identify which benchmarks are most relevant and why, the source of any potential data and any constraints on its use. Where relevant the contractor should adjust benchmarks to ensure comparability. The CAA does not anticipate an in-depth analysis of all items with central support costs but rather a mixture of high level review combined with some detailed scrutiny and benchmarking where applicable. The Contractor will draw on the airports own benchmarking where available. Where applicable the contractor will draw on the output of previous efficiency reviews undertaken by the CAA, Competition Commission and the airports and also the outputs from constructive engagement<sup>4</sup>. Where appropriate, the contractor will also assess the allocation of intragroup costs, the reasonableness of these costs given the services provided and the constraints imposed by underlying contracts.

### An evidenced assessment of the scale of efficiencies that might be achievable over Q6.

Based on the analysis carried out above and the airports business plans, the contractor will identify the scope for efficiencies in central costs over the five years from 2014/15. Efficiencies will be based on the scope for cost reductions compared to leading best practice. Where appropriate this should be supported by an analysis of the speed of change. Findings must be supported by a clear evidence base. The Contractor will also consider the impact of the reduced size of BAA and whether the central costs have been reduced accordingly.

The Contractor should identify what further benchmarking could be undertaken and how this could be incorporated by Heathrow and Gatwick airports in their business plans.

### **Structure of the study**

The study is being separately contracted in two and potentially three phases:

Phase one: Initial Business Plan analysis. Assess the drivers of changes in historical operating costs. Undertake benchmarking of costs and identify the scale of efficiency that might be achievable over Q6 compared to the airports initial business plan forecasts. For Heathrow this is the July 2012 business plan, for Gatwick it is the April 2012 business plan.

Phase two: January Business Plan. Refresh the Phase two analysis based on the airports January 2013 Business Plan. The airports January business plan will reflect the airports updated views following constructive engagement. It should be assumed that the airports will be submitting this business plan on 31 January 2013.

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<sup>4</sup> Last time the CAA commissioned a variety of work on operating costs. Most of these studies were undertaken at the time of the initial proposals.  
<http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=7162>. The competition commission analysis is described at: <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/heathrow-and-gatwick-quinquennial-review/final-report-and-appendices-glossary>

