



Specification

Terms of Reference assessment of maintenance and renewal costs at Heathrow and Gatwick airports

Background

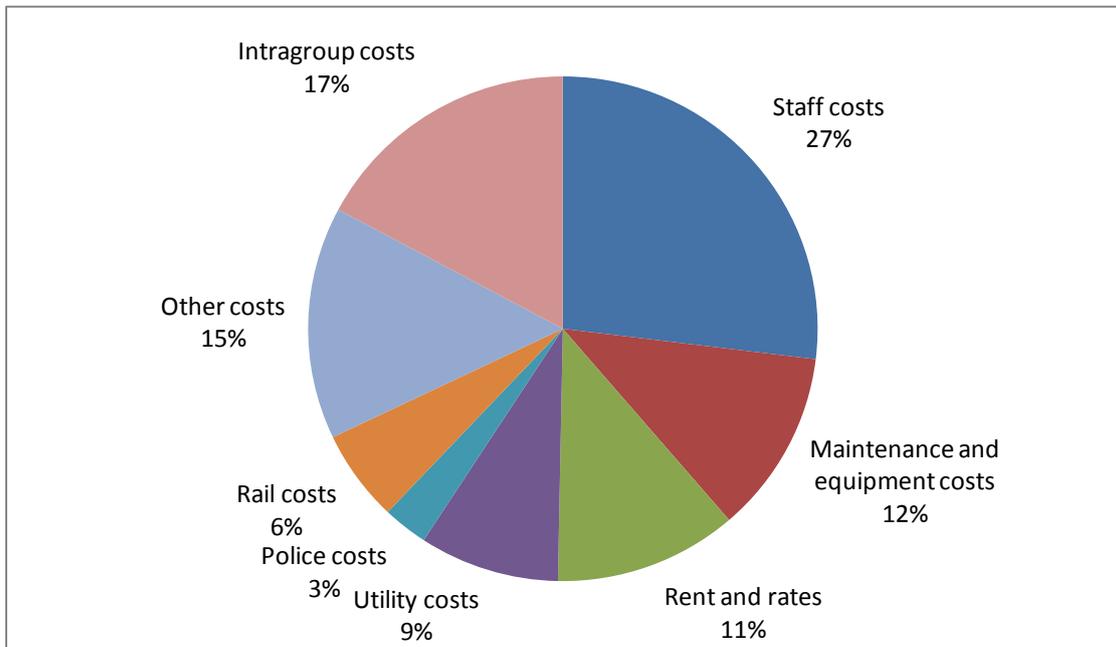
The CAA is currently considering the most appropriate regulatory arrangements to put in place when the present price controls expire in March 2014. As part of this work the airports and airlines at each of the three airports subject to economic regulation: Heathrow, Gatwick and Stansted, are undertaking 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 and Gatwick airports operating expenditure for 2011/12. The airports forecast renewals expenditure for the next control period to be around £260m per year for Heathrow and £70m per year for Gatwick¹.

Figure 1: Breakdown of Heathrow airports operating expenditure (£1,001m)

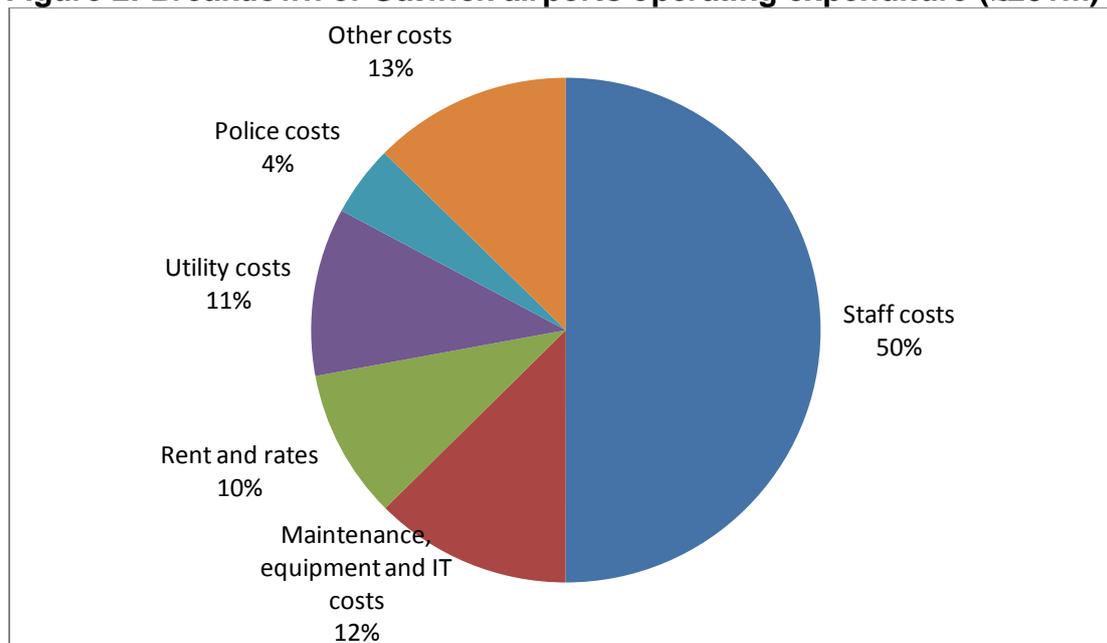
¹ For Heathrow renewals expenditure is taken as asset maintenance and compliance (source Heathrow Airport Q6 Initial Business Plan, July 2012). For Gatwick it is asset stewardship (source Gatwick Airport initial business plan to 2020, April 2012)

Ref. 1387 (Services Order 34) – 7 November 2012
Maintenance and renewal costs at Heathrow and Stansted airports



Source: Heathrow 2011-12 regulatory accounts

Figure 2: Breakdown of Gatwick airports operating expenditure (£281m)



Source: Gatwick 2011-12 regulatory accounts

The CAA is intending to undertake a variety of work to assess operating expenditure²:

- Employment cost study for Heathrow, Gatwick and Stansted, being undertaken by IDS, with expected completion in November 2012³;
- 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 airport⁴.

Requirements

This request for advice requires an assessment of maintenance operating costs and renewal capital costs at Heathrow and Gatwick airports. For operating expenditure this covers maintenance and equipment expenditure at both Heathrow and Gatwick. It also covers cleaning and directly employed labour used for maintenance. For capital expenditure it covers asset stewardship for Gatwick and asset replacement for Heathrow.

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

² The invitations to tender for the other pieces of work will be issued in due course

³ The terms of reference for this work are at:
<http://www.caa.co.uk/docs/78/1387SO26Spec.pdf>

⁴ 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>

- A review of the principal drivers of changes in maintenance operating costs (as described above);
- Assessment of the levels and changes in maintenance operating costs at Heathrow and Gatwick airports with relevant benchmarks;
- A review of Heathrow and Gatwick's forecasts of maintenance and renewals costs; and
- An evidenced assessment of the scale of efficiencies that might be achievable over Q6 for maintenance and renewal costs.

Staff costs could be an important contributor to maintenance costs. This project should build on the results of the employment cost study being undertaken by IDS which has examined the actual and forecast unit employment costs. This project 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 maintenance operating costs costs at Heathrow and Gatwick airports

For each of the above cost lines the assessment will consider the principal drivers of the changes in Heathrow and Gatwick airports maintenance 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 maintenance operating costs from the broad drivers such as passenger traffic volumes, resilience, service quality, input prices and underlying contractual arrangements. The contractor will consider the airport's approach to maintenance including the degree of contracting out. 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 maintenance 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 maintenance operating costs at Heathrow and Gatwick airports with relevant benchmarks;

This task will compare maintenance operating cost lines with relevant benchmarks. Relevant benchmarks could include other comparable airports, market rates and costs from other industries. The contractor 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, for example on service quality. The CAA does not anticipate an in-depth analysis of all items within maintenance 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 engagement⁵.

⁵ 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.

Review of capex renewals (asset replacement/stewardship)

This task will review capex renewals, that is asset replacement capex at Heathrow and asset stewardship capex at Gatwick. There is a reasonable degree of agreement between the airport and airlines on asset replacement capex costs at Heathrow. At Gatwick the airlines are undertaking their own consultancy work into asset stewardship (completion expected early December). The contractor is expected to review future asset replacement/stewardship capex costs at Heathrow and Gatwick. This review should consider the scope and costs of capex renewals, historic outturn versus forecast renewal costs, the trade off between asset renewals, asset maintenance opex and new facilities and whether the airports are consistent with best practice asset stewardship (PAS55 or equivalent). The review should draw heavily on the airport's own estimates and the review undertaken by airlines consultants at Gatwick. Where there is agreement between the airport and airlines, for example in areas at Heathrow, the contractor's review can be lighter touch, although the contractor should carry out their own independent checks in this area to ensure the results are robust.

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 maintenance and renewal 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.

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

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 initial business plan, for Gatwick it is the April 2012 initial 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

