



## SPECIFICATION

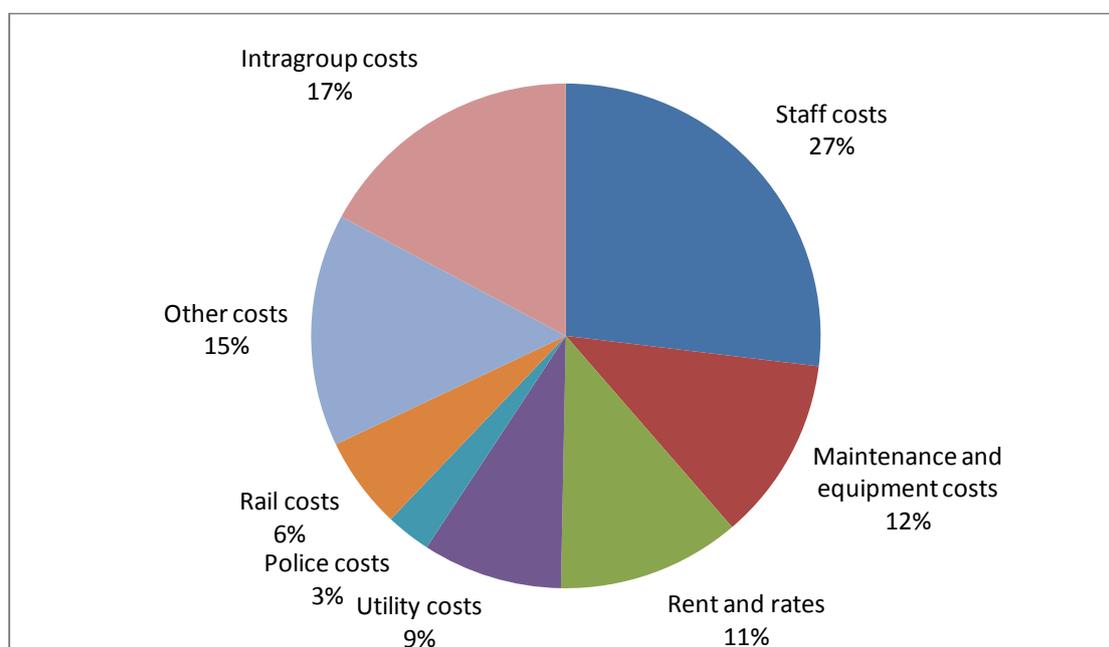
### **Terms of Reference review of other operating expenditure at Heathrow and Gatwick airports**

#### **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

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

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

- Employment cost study for Heathrow, Gatwick and Stansted, being undertaken by IDS, expected completion in October 2012<sup>2</sup>;
- Benchmarking of airport central costs;
- Maintenance and renewal 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 the following cost lines for Heathrow and Gatwick airports:

- Rent and rates;
- Utility costs;
- Police costs;
- Rail costs; and
- Other costs.
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For each of these cost lines the following tasks must be undertaken:

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

### Review of the principal drivers of changes in operating 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 operating costs in Q5, which, for context, will look at trends between 2005-06 and 2011-12. The Contractor must clearly identify what costs it would expect to vary with traffic, inflation and other factors. Where possible, the Contractor must assess the contribution to changes in operating costs from the broad drivers such as passenger traffic volumes, input prices and underlying contractual arrangements. The assessment must 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.

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<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>

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 must clearly identify which benchmarks are most relevant and why, the source of any potential data and any constraints on its use. When undertaking benchmarking the Contractor take into account key drivers that might lead to underlying differences in costs between comparators such as complexity. The CAA does not anticipate an in-depth analysis of all items with other operating costs but rather a mixture of high level review combined with some detailed scrutiny and benchmarking where applicable. The Contractor must draw on the airports own benchmarking where available. Where applicable the Contractor must draw on the output of previous efficiency reviews undertaken by the CAA, CC and the airports and also the outputs from constructive engagement<sup>4</sup>. Where appropriate the Contractor must also assess the allocation of costs and 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 must identify the scope for efficiencies in other operating expenditure over the five years from 2014/15. Efficiencies must be identified separately for each of the five cost lines identified above (rent and rates, utilities, police costs and other costs) and, if desired, individual costs within these categories. Efficiencies must be based on the scope for cost reductions compared to leading best practice. Findings must be supported by a clear evidence base.

The Contractor must 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. Assessment of drivers of the changes in historic operating costs. Undertake benchmarking of costs and identify the scale of efficiency that might be achievable over Q6 compared to

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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 CAA also undertook further work on utility costs at: [http://www.caa.co.uk/docs/5/ergdocs/ccref\\_sp1.pdf](http://www.caa.co.uk/docs/5/ergdocs/ccref_sp1.pdf). 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>

