



SPECIFICATION

Terms of Reference

Q6 Capex Review: Heathrow and Gatwick Airports

Context

The CAA is currently considering the most appropriate regulatory arrangements to put in place at each of the three airports subject to economic regulation: Heathrow, Gatwick and Stansted. The present price controls expire in March 2014. As part of this work the CAA is establishing the potential level of any price cap under a RAB based framework. The CAA is also undertaking work on alternative forms of regulation such as price monitoring, long run incremental costs and pegging prices to charges at comparator airports.

One of the key building blocks of a RAB-based price control is capital expenditure (capex). Capital expenditure can be thought of as made up of three elements:

- Capex renewals, where existing assets are renewed or replaced with assets generating similar outputs;
- Compliance, where capex is required to meet health and safety standards or government regulations; and
- Capex Enhancements, where capex provides increased outputs, for example improved service quality or greater reliance.

In its initial business plan Heathrow forecast capex assumed a capex strawman of £3bn¹. Annex A sets out the potential projects included in the strawman. Of the £3bn capex, around £1bn relates to capex renewals, £0.3bn to compliance and £1.7bn to capex enhancements.

In its initial business plan Gatwick identified potential projects assumed £1.2bn of capex². Annex B sets out the projects included in the business plan. Of the £1.2bn capex, around £0.4bn relates to assets renewals, less than £0.1bn to compliance and £0.8bn to capex enhancements.

¹ Q6 Initial Business Plan, Heathrow Airport Limited, August 2012. This document can be accessed at:
http://www.heathrowairport.com/static/Heathrow/Downloads/PDF/Q6_Heathrow_Initial_Business_Plan.pdf

² Initial Business Plan to 2020, Gatwick Airport Limited, April 2012. This document can be accessed at:
[http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2012/Beyond%20Q5%20business%20plan%20\(public%20version\)%20-%20issued%2019%20April%202012.pdf](http://www.gatwickairport.com/Documents/business_and_community/Public%20Regulation%20Pages/Economic%20regulation/2012/Beyond%20Q5%20business%20plan%20(public%20version)%20-%20issued%2019%20April%202012.pdf)

One of the potential innovations being considered by the CAA for Q6 is a two-tier approach to capex, where capex is split into:

- core capex: projects that are well defined which are likely to be subject to capex triggers³; and
- development capex: projects that are less well defined, which could be included in the initial price cap, or included in the price cap during the control period following consultation/agreement from airlines.

The Q6 policy update document provides further details of the core and development capex approach⁴.

Requirement

This request for advice is split into two parts:

- A review and projection of Heathrow's Q6 capex allowance for Q6; and
- A review and projection of Gatwick's Q6 capex allowance for Q6.

Tenderers can bid for the work at Heathrow or Gatwick or Heathrow and Gatwick combined. Where tenderers are bidding for work at both airports, separate prices should be provided for each airport.

This review is limited to an assessment of capex relating to enhancements and compliance. Capex relating to renewals is being considered as part of a separate consultancy study which is examining maintenance and renewals expenditure.

The review is split into three phases:

- Phase one: review of cross project issues;
- Phase two: initial assessment of enhancement and compliance project allowances;
- Phase three: full assessment of enhancement and compliance project allowances.

The assessment of project allowances should include an evidenced assessment of the scale of capex efficiency.

The assessment should draw on the following existing and on-going studies:

- Mid Q5 review of capex at Heathrow and Gatwick Airport, Currie and Brown⁵;
- Heathrow Q5 capex review, Alan Stratford and associates, completion end December 2012;
- Gatwick Q5 capex review, URS, completion end December 2012;

³ Capex triggers remove the capital expenditure allowance for a project if the outputs are not delivered on time.

⁴ Q6 policy update, CAA, May 2012. This document can be accessed at: <http://www.caa.co.uk/docs/5/Q6PolicyUpdate.pdf>

⁵ These reports can be accessed at: <http://www.caa.co.uk/docs/5/ergdocs/HeathrowCapexReport.pdf> and <http://www.caa.co.uk/docs/5/ergdocs/GatwickCapexReport.pdf>

- Review of maintenance and renewal expenditure, SDG, Interim report January 2013, draft final report March 2013, update report August 2013;
- Deliverables from constructive engagement at each of the airports, Heathrow report completed 3 December, Gatwick and Stansted reports due end of December 2012. These deliverables may include airline prioritization for Q6, although airlines views on the overall capex programme may be subject to affordability constraints.

The work should also draw on the work undertaken by the airports themselves, particularly on benchmarking expenditure..

Phase One: Review of the cross project issues

This part of the research should consider the cross cutting issues that can impact on the costs across projects. This consideration should include:

- Benchmarking of project costs, where available the Contractor should assess the benchmarking of unit costs to identify the efficient costs of capital schemes going forwards. This should draw on the work undertaken by the airport and include an assessment of whether appropriate benchmarks and adjustments have been used (for example in relation to risk) and comparisons with other benchmarks available to the contractor.
- On-costs, whether the adjustment for on costs is appropriate, for example in relation to other airports and other sectors;
- Contingency and risk, whether the allowances for risk and contingency is appropriate given the stage in the projects development and the relationship between project and portfolio risk adjustments,
- [is the allowance for input price inflation appropriate, for example given the historic relationship between construction and retail prices and the outlook for the economy going forwards.

The output of Phase 1 should be an interim report setting out the analysis and assessment for each of the topics list above (and any other issues the contractor considers relevant).

Phase Two: Initial assessment of enhancement and compliance capex expenditure

Based on the analysis undertaken as part of Phase One, the review of existing and on-going studies and the contractors own assessment of the overall capex programme and a sample of Q6 projects, the contractor should provide an initial assessment of the capex allowance for Heathrow and/or Gatwick airports (as appropriate).

The assessment should be based on the Airport's Full Business Plan, published at the end of January 2013, and the outputs of constructive engagement.

This should involve:

- An assessment of whether individual projects are justified given the needs of current and future airlines and their customers and, where appropriate, the promotion of competition;

