



SPECIFICATION

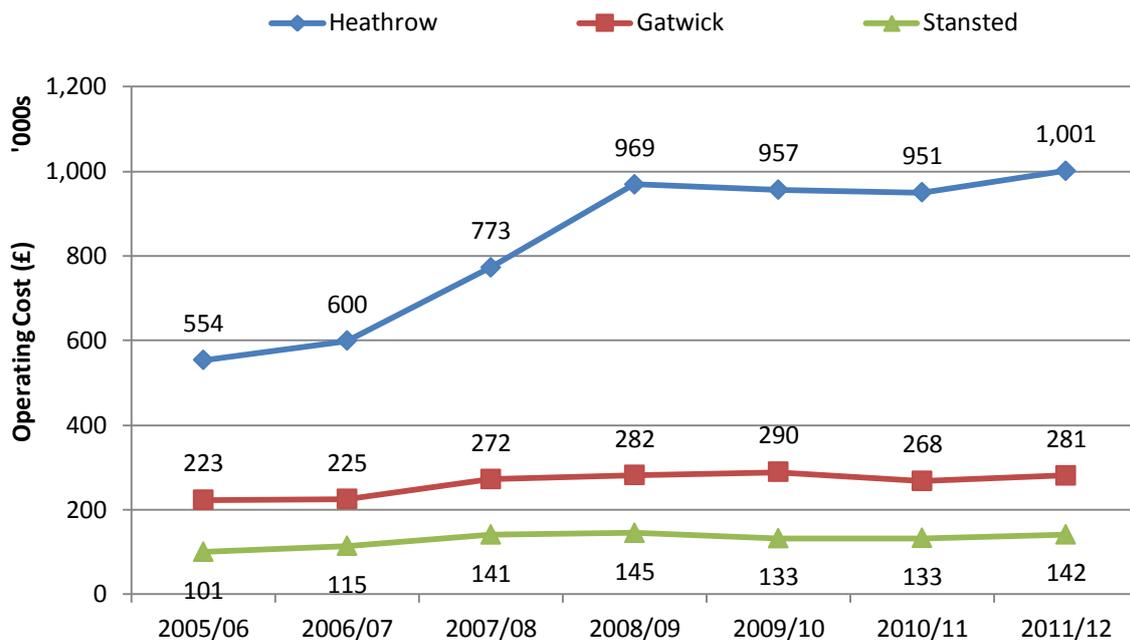
Terms of Reference – Scope for future efficiency gains at Heathrow, Gatwick and Stansted airports

Background

The CAA is currently considering the most appropriate regulatory arrangement to put in place at Heathrow, Gatwick and Stansted airports when the present price controls expire. As part of this work, the airports and airlines at Heathrow, Gatwick and Stansted, are undertaking a process of constructive engagement (CE) on potential price caps for the next regulatory period (Q6) using the airports initial business plans.

It is possible that the CAA will seek to continue the RAB based approach to airport regulation during Q6. One of the key elements of a RAB based price control is an operating cost projection. Airport operating costs are driven by a variety of factors, including input prices, productivity growth and changes in levels of service provision including new terminals or changes to security requirements for example. Figure 1 below provides a summary of the airports historical operating cost performance since 2005/06 based on the regulatory accounts.

Figure 1 Heathrow and Gatwick Historical Operating Costs Excluding Depreciation (Nominal Prices)



Source: Airport Regulatory Accounts

The CAA is currently undertaking a range of work to assist its understanding of the airports historic operating costs, the future projections contained in the airports initial business plans (IBPs) and the level of efficiency improvement which each airport could reasonably be expected to achieve over the Q6 period. This work includes the following elements:

- An employment cost study for Heathrow, Gatwick and Stansted being undertaken by IDS with expected completion in late December.
- Bottom-up benchmarking of airport central service costs including IT, finance and HR functions, being undertaken by Helios with expected completion in March.
- Bottom-up benchmarking of airport other costs including rent and rates, utilities, police and ANS costs, being undertaken by Steer Davies Gleave with expected completion in March.
- Bottom-up benchmarking of airport maintenance and asset renewal costs being undertaken by Steer Davies Gleave with expected completion in March.

Requirements

In addition to the work described above, the CAA requires an independent assessment of the potential scope for future efficiency savings at Heathrow, Gatwick and Stansted airports. This study will assist the CAA's understanding of the potential scope for efficiency improvements over the Q6 period and provide an estimate of both catch-up and frontier shift efficiency gain at each airport. In summary the study will need to undertake the following tasks:

- A literature review of previous regulatory policy decisions and the estimated scope for efficiency gains across other regulated sectors;
- An update of productivity analysis work previously undertaken by the CAA and Competition Commission.
- A definition, assessment and selection of additional relevant productivity indicators;
- Historical benchmarking of the airports productivity performance against a range of suitable comparators.
- An assessment of the scope for future catch-up and frontier shift efficiency gains at each airport based on the preceding tasks.

The study will draw on existing and historical studies (including regulatory studies and consultancy reports) to provide context and understanding of the decisions of other regulators. This information should be summarised in a 'literature review' drawing out the key points of relevance and discussing the path of efficiency gains at the airports against those achieved in other regulated sectors across comparable price control periods.

The study must also provide an update of the historical analysis previously undertaken by the CAA and CC related to productivity growth at the airports, including the extension of historic efficiency metric analysis to the current period. This should include a breakdown of staff productivity by type (security and non-security functions at a minimum) and an assessment of volume effects on productivity metrics. Previous work can be found at the following links:

- CC airport efficiency analysis -

[http://www.caa.co.uk/docs/5/ergdocs/ccreportbaa/app7\(7\).pdf](http://www.caa.co.uk/docs/5/ergdocs/ccreportbaa/app7(7).pdf)

- CAA airport efficiency analysis –
<http://www.caa.co.uk/docs/5/ergdocs/airportsdec06/annex.pdf> (See section C)

The study should define and provide an analysis of the available productivity metrics and make an assessment of their suitability for the analysis of airport productivity. This should include metrics such as:

- Real unit operating expenditure (RUOE);
- Total factor productivity (TFP);
- Capital, labour, energy, materials and service cost measures (KLEMS); and
- Any other metrics that the Contractor believes may be of relevance to the study.

Using the selected metrics, the study should seek to benchmark the airports historical performance against a range of comparators at the company and industry level over the Q5 period. The basis of comparability and selection of companies / industries should be explained in detail. Any methodological problems and the assumptions necessary for the benchmarking comparison should also be explained – for example the separation of operating costs into different categories for comparison and the definition of variable and controllable costs.

The study should seek to examine the effect of economies of scale on the level of productivity achievable at Heathrow, Gatwick and Stansted. The study must also assess the level of catch up and frontier shift efficiency gain achievable at each airport. The study will provide an assessment of the range of potential efficiency improvements at each airport over the Q6 period with a central recommendation.

The Contractor will be provided with a copy of each airports business plan containing operating cost projections across cost lines. The analysis must be undertaken separately for Heathrow, Gatwick and Stansted, with a separate efficiency projection for each.
