

# Economic regulation of Heathrow Airport Limited: working paper on Q6 capital expenditure and early expansion costs (CAP1996)

Heathrow's response  
CAA-H7-483

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## Executive Summary

1. We welcome the CAA's working paper on Q6 capital expenditure and early expansion costs, which draws on the work carried out by Arcadis and the Independent Fund Surveyor (IFS).
2. We remain confident that all Q6 capital expenditure has been delivered efficiently and support the outcomes of the CAA review that judged that the majority of projects subject to review were carried out efficiently and there is no evidence of inefficiency.
3. It is in the interests of all stakeholders that any remaining reviews of Q6 projects are completed before the start of H7. We urge the CAA to ensure it does not create double jeopardy by creating backstop dates for reviews on Q6 projects in the H7 period and request the CAA acts swiftly in its process to provide clear timescales for its review.
4. The CAA's decision to move the goal posts for its approach to the assessment of capital efficiency is unacceptable. By adopting a new 'Demonstrably Inefficient or Wasteful Expenditure' (DIWE) framework in the final year of an eight-year regulatory period without appropriate consultation, and moving away from the established Capital Efficiency Handbook agreed between the Heathrow and airlines, the CAA casts doubt on not only the key principles of stability and certainty of the regulatory framework but also the validity of any assessment of efficiency. The DIWE framework should only be applied from a time when it would be reasonable to expect Heathrow to have complied, not retrospectively.
5. With regards to the Heathrow Expansion programme, Heathrow was working in a timely and efficient manner to deliver one of the most complex planning applications and construction programmes ever seen in the UK. Multiple estimates demonstrated the billions in value to consumers from Heathrow Expansion. As with any major infrastructure project of the size and complexity of Heathrow expansion, this required extensive planning, iteration and engagement. Experience from other complex programmes also demonstrated the importance of ensuring momentum to maximise benefits.
6. Heathrow was given a clear challenge by the Secretary of State to open the runway in 2026. This timescale necessitated securing a Development Consent Order (DCO) for the scheme in 2021. The 2019 schedule was developed to deliver these targets and Heathrow continued to make substantial progress in 2019 with the key milestones being achieved as planned.
7. The 2026 runway opening date was predicated on the delivery of activity prior to DCO consent to create the space for Expansion and support phase 1 construction activities. The CAA and airline community requested that these costs be reviewed, and that a series of counterfactual cost and schedule scenarios be developed. This culminated in the release in December 2019 of the CAA's draft policy, CAP 1871, which identified the CAA's preferred scenario to be taken forward with a target delivery date of 2028.
8. The ANPS was suspended following the Court of Appeal ruling in February 2020, resulting in the expansion programme being paused and immediately efficiently demobilised.
9. It would be wrong for the CAA to penalise Heathrow for pursuing a 2026 runway opening date as this was the challenge set by the Secretary of State. We therefore agree with the CAA's decision that Heathrow should not be retrospectively punished for the timetable being pursued at the time.
10. We consider that all early costs associated with expansion under review by the CAA have been efficiently incurred. These costs have been benchmarked, assessed and reviewed through governance with stakeholders. We remind the CAA that its appointed Independent Planning Cost

Reviewer, PwC, reviewed Category B costs from 2016 to 2018 and concluded that predominately all the expenditure was incurred efficiently.

11. We are very frustrated by the CAA's lack of urgency on its early cost review of expansion. The rapid demobilisation of the expansion programme resulted in the majority of people working on the project leaving the organisation within weeks of the Court of Appeal decision. As a consequence, Heathrow requested that the CAA progress the review quickly to maximise its capacity to respond. The CAA has taken almost one year to conduct its initial review and it has still not provided an initial proposal for consultation. The delay has made the process more difficult than it should have been, but most importantly has created unnecessary regulatory uncertainty.
12. More widely the CAA needs to avoid the situation in future where there is lack of overall policy on recovery of costs. The CAA needs to set out a clear policy for the recovery of early expansion costs before they need to be incurred in the future. Without this confirmation, the delivery of benefits to consumers brought by expansion could be delayed. We therefore request that as part of the current work the CAA sets out a clear process and timeline for how it will confirm policy on the recovery of any future planning and early constructions costs in a timely manner.

## Q6 capital expenditure

### The DIWE framework

13. It is concerning that the CAA has concluded that it will retain its proposal of using the Demonstrably Inefficient or Wasteful Expenditure (DIWE) framework as outlined in its September 2020 Working Paper (CAP1964). We made a number of points in our response to CAP1964 which the CAA has not addressed, most importantly that it is not appropriate to retrospectively apply a new framework for the assessment of the efficiency of Heathrow's capital expenditure during Q6 that Heathrow had no knowledge of, and therefore no ability to comply with, at the time expenditure was incurred. The DIWE framework should only be applied from a time when it would be reasonable for Heathrow to have complied.
14. As we set out in our response to CAP1964, it is clear that the use of the DIWE framework is an additional layer on top of the established approach of using the Capital Efficiency Handbook. While there may be some similarities between the DIWE framework and the framework established in the Capital Efficiency Handbook, the introduction of an additional framework creates unnecessary duplication and confusion. The CAA should fully consult airlines and airport and define a single assessment framework for H7. It remains our view that this should be based on the Capital Efficiency Handbook as agreed between Heathrow and airlines.
15. The CAA has not demonstrated how the retrospective introduction of the DIWE framework is in line with its duties, including acting in a consistent manner<sup>1</sup>; introducing additional assessment criteria long after an approach has been agreed and implemented is clearly not acting consistently.
16. In CAP1996 the CAA has still not addressed the definition of key words such as "material", "avoidable" and "proportionate" and how it intends to apply them, which are all considered by the CAA as implicit in the Capital Efficiency Handbook.
17. Lastly, we do not consider that precedent from other regulators is a strong basis for retrospectively amending assessment criteria agreed by the airlines and Heathrow and submitted to the CAA, without due consultation or prior notice of the change.

### Cargo tunnel

18. We are disappointed in the CAA's identification of a likely adjustment in the range of £12.3m - £12.7m. The cargo tunnel has been a challenging project, and Heathrow has managed the project proactively with the best information available at the time. There is no clear evidence that the actions of Heathrow may have directly attributed to wasted spend or lost benefits and we therefore do not consider that any adjustment should be made.
19. The suggested areas of inefficiency are made up of Surveys, Design and Planning spend of £12.25 million and the Standback Review of £0.49 million. These were demonstrable positive measures taken by Heathrow to manage the project and rectify the emerging situation. In addition the £12.25 million includes £0.75 million of asbestos-related removal and assurance costs that should be considered separately from the other survey, design and planning spend.
20. As noted by Arcadis "The value, if any, that has and can in the future be gained from the work carried out was not readily available at the time of the Arcadis review. This would require a detailed breakdown of the figures identifying those works which have been taken forward to provide a benefit against those works now considered to be abortive. Until such a stage has been reached

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<sup>1</sup> CAA12 "regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent"<sup>1</sup>

it would not be possible to develop any meaningful assessment of the quantum of any inefficiency”<sup>2</sup>. Therefore it is not possible to properly assess this project and the value that the additional work has delivered.

21. The Cargo tunnel originally went through a G3 in Q5 alongside the Main Tunnel. Following a Standback Review, a number of issues were identified and it was decided to take the project through the project gateway lifecycle again, and this process is described as the pseudo process. One of the success criteria during the pseudo gateway process is to enable the “Reuse of existing materials and design where appropriate.” A general principle is that the existing design will be retained unless it is determined that it would diminish the benefit of the updated Design for Manufacture & Assembly (DfMA) delivery strategy.
22. On the Standback Review element Arcadis appear to be applying hindsight – “if the project was being delivered efficiently the need to stop the project and undertake the Standback Review would not have been necessary and this could also be included in the pot for inefficient spend”<sup>3</sup>. Heathrow had to manage the issues as they developed and did not have the benefit of hindsight.
23. We welcome the proposal to continue monitoring and reviewing the progress of the Cargo Tunnel and the reports issued by the IFS. The work leading up to the pseudo G3 is promising and we expect to successfully deliver the project on the completion of the replanning.
24. As noted in some of the airline responses the issue of making the decisions in a timely fashion when the history is relatively recent is a consideration that needs to be factored in. We would not expect a substantial re-examination of the historic Q6 spend to be undertaken at the end of H7, rather a focus entirely on only the new elements of investment.

## Main tunnel

25. We welcome and support the CAA’s view that there is no sufficient evidence of inefficiency. As previously stated, substantial amounts of evidence has been supplied, with at least 18 Heathrow documents and 50 IFS reports.
26. We continue to work through this challenging project in a safe manner while ensuring it is undertaken in a way which does not disrupt the consumer journey. The real time reporting from the IFS and project summary document will be a key consideration for the CAA to review.

## T3IB and T5WBU

27. We welcome the finding that the issues with these two projects were not sufficient for any finding of inefficiency. Furthermore, it is recognised that the projects were complex and challenging and involved innovative technology.
28. In the main, governance in Q6 has been very successful. There have been considerable efforts made to engage with the airline community and agree the investments, and in the recent past to replan and reprioritise the portfolio; the success of this approach is evidenced by the fact that 668 projects have been delivered and no major decisions required escalation to the CAA. The learnings from Q6 will be taken forward into jointly developing the new governance arrangements for H7, alongside the new capital efficiency measures.

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<sup>2</sup> CAP1964A 4.4.7.3 final para

<sup>3</sup> CAP1964 4.4.7.3 p56

## Non IFS projects

29. We welcome the finding from Arcadis that all six projects were delivered efficiently.
30. Regarding the issue related to unforeseen ground conditions, as described in the Arcadis report it was an existing car park and the judgement was that the subsurface should have been satisfactory. A proportionate and appropriate balance needs to be struck as to how much time and cost are invested in surveys in advance of commencing any project.

## Other issues

### **Extrapolating findings across Heathrow's capex portfolio**

31. We agree with the approach that extrapolation from the small number of projects across the whole entirety of the capital programme would not be appropriate – the projects selected were those which had experienced some challenges. Arcadis did not identify any inefficiency in the sample of non-IFS projects.

### **Capital overhead costs**

32. As noted the approach to capital overhead costs will be developed during discussions with airlines through the development of the H7 capital plan and the capital incentives.

### **Risk allowance**

33. We agree that risk allowance should be considered as part of the work on the H7 price control alongside the capital efficiency arrangements.

## CAA further recommendations

34. We note the CAA's statement on continuing to monitor the situation with regard to stopped and paused projects. Paused projects are already held within the Portfolio data set and are subject to the Portfolio review and reporting process which is conducted on an ongoing basis as the overall Portfolio develops.
35. We note the CAA's concerns about delivery of more complex projects and the issues identified in the Main and Cargo Tunnels. The initial Main and Cargo Tunnel contract was tendered and let in Q5. Since then we have actively responded to events as extensively documented. On the Cargo Tunnel this is demonstrated in the Standback Review and reassessment of the works required and the approach to complete the Cargo Tunnel. The IFS commentary on the pseudo G2 was supportive and we expect a positive result from the pseudo G3 and completion of the works.
36. We agree with the importance of good planning in the project delivery process and that the resources involved should be proportionate.
37. The Arcadis point that certain projects lacked definition at the time Heathrow entered into contract is noted. On certain projects time is the key constraint with fixed end points (such as compliance deadlines) and a balance needs to be struck between having enough definition to commence and meet such deadlines, against delaying delivery to achieve further clarity but failing to achieve compliance in time.
38. We agree that the Capital Efficiency Handbook and other relevant governance documents will need to be updated as part of the works for H7.

39. We note the points raised by the CAA on reviewing projects that have finished/will finish in 2019-21 and those which continue into H7. If further reviews are required, we would support them being done in a timely manner when the people involved in them on all sides are available. It is in the interests of consumers and all parties to have certainty on the opening position for H7. We encourage the CAA to plan on the basis to avoid reopening the H7 RAB position at the end of H7 as this leads to significant uncertainty and increased risk, and ask that the CAA confirms the scope and timing of any further reviews on later than its Initial Proposals.

## Early expansion costs

### Final policy decisions

40. In line with our response to CAP1940, we agree with the CAA's final decision to simplify its policy approach for the recovery of early expansion costs. The CAA's confirmation of recovery from 2022 of efficiently incurred early expansion costs is consistent with ensuring regulatory stability and financeability. The CAA's recognition of the extreme change in circumstances we now find ourselves in and the simplicity and clarity of this approach should inform the CAA's thinking in other areas of the H7 framework.
41. As the CAA notes, Heathrow was pursuing the expansion programme in line with a clear plan to ensure that the benefits of capacity expansion were delivered to consumers as soon as efficiently possible. This was in line with commitments made to Government and within the delivery timescale set out by the ANPS. The CAA's December 2019 decision to change the timetable for the programme targeting delivery in 2028 does not show that Heathrow was incurring costs inefficiently or pursuing an unrealistic plan. We therefore agree with the CAA's decision that Heathrow should not be punished for the timetable being pursued at the time.
42. We welcome the CAA's confirmation that the current circumstances do not constitute a 'unilateral withdrawal' from the planning process and that its previous, broader, risk sharing approach for the recovery of Category B costs will not apply in this circumstance. As the CAA notes, we have been forced to pause our expansion plans through no fault of our own and therefore implementing incentives which were designed to incentivise a *"high-quality planning application"* are no longer relevant. Airline comments that the expansion programme has 'failed' and that Heathrow should therefore be penalised are both factually incorrect and mischaracterise the CAA's policy.
43. The CAA's decision to remunerate capital invested in 2020 and 2021 at a WACC of 4.83% is inconsistent with the decision made by the CAA in setting Heathrow's iH7 licence. The CAA did not carry out full consultation or set a policy decision on the use of the 4.83% WACC for the iH7 period. Instead, this number comes from an illustrative exercise carried out by the CAA in assessing the potential outcome of an interim H7 price control review.<sup>4</sup> This process was ultimately superseded by the commercial deal agreed between Heathrow and the airline community.
44. As we have set out in our responses to CAP1871 and CAP1940, the CAA's proposal is also not consistent with market data and therefore not representative of the prevailing WACC for Heathrow. Therefore the prevailing WACC of 5.35% should be applied for 2020 and 2021.

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<sup>4</sup> The CAA first calculated the 4.83% figure for WACC in CAP1610, where it described it as a sensitivity which adjusted only for changes in tax and the cost of new debt to show the potential impact on Heathrow's revenue requirement in different interim price control scenarios. In CAP1658 the CAA again showed the 4.83% in the same context. In paragraph 5.26 of CAP1658 when talking about its price control sensitivities, the CAA stated *"All these assumptions will need to be reviewed and updated later in 2018 and 2019, taking account of the latest information from HAL and consultation with stakeholders. They should therefore be treated with significant caution."* The CAA did no further work to this assumption which in its own words *"should be treated with significant caution"*, before proposing to apply it to early expansion expenditure in 2020 and 2021.



## Wind-down costs

45. We agree with the CAA that efficiently incurred costs should be added to Heathrow's RAB. We also welcome that the CAA has confirmed that it intends to keep policy for all capital expenditure aligned to regulatory precedent, however we disagree with the CAA that these costs should be subject to a lower cost of capital than the prevailing 5.35% from 2020.
46. The demobilisation of the expansion programme was a significant task and Heathrow acted swiftly and efficiently in the interests of consumers. We assessed all the activities within the programme and stood down many immediately, and the majority of our Client partners were released within a short space of time. We then carried out a significant organisational restructure from March 2020 which also addressed the impact of Covid-19 and made decisions to ensure the airport would survive. This resulted in an unprecedented redundancy programme for directly employed Heathrow colleagues who left the business over this period.
47. We welcome the CAA carrying out an efficiency assessment of the wind down costs later in 2021, and urge that this is conducted swiftly and efficiently to provide clarity before the start of H7. We are planning to use our existing governance forums to discuss these costs with airlines.

## Supreme Court costs

48. We agree with the CAA that the costs incurred by Heathrow in the Supreme Court proceedings should be treated in the same manner as any other capital spend. Accordingly, efficiently incurred costs should be added to Heathrow's RAB and attract a return, though the return should be at the prevailing 5.35% cost of capital.
49. We note the CAA's statement at paragraph 3.14 of CAP 1996 that in finalising its policy it intends to take into account the Supreme Court's judgment on awarding costs, and that the Court has yet to hand down its judgment on these matters.
50. At the time CAP 1996 was published the Supreme Court had in fact ordered the two respondents to pay Heathrow's costs, capped at £5,000 each because the proceedings were an "Aarhus convention claim" meaning the respondents benefited from cost protection. The order for costs was made on 16 December 2020 (the same day the judgment was handed down). Heathrow chose not to enforce the costs order against one of the respondents given that the costs would have fallen to an individual. We therefore ask that the CAA confirms and implements its decision before the end of the Q6 price control period.

## Costs relating to blight and the Interim Property Hardship Scheme (IPHS)

51. We welcome the CAA's swift action on its 'minded to approve' decision to allow costs efficiently incurred in connection with the blight and IPHS compensation schemes to be added to Heathrow's RAB, and look forward to this policy being confirmed in the CAA's Initial Proposals.
52. The CAA acknowledge that this is clearly an important matter for our local communities and provides assurance to people in genuine hardship that assistance will be available. We are in the process of reinstating the hardship panel following CAA confirmation. This is supported by the airline community.
53. However, we question what activity the CAA will carry out to assess whether costs have been efficiently incurred, given that these costs will be incurred following assessment by the Independent Panel (in the case of the IPHS) or arise from statutory requirements (in the case of blight). We ask the CAA to provide clarification on this as a matter of urgency.

## Assessing the efficiency of early costs

54. Heathrow was working in a timely and efficient manner to deliver one of the most complex planning applications and construction programmes ever seen in the UK. Multiple estimates demonstrated the billions in value to consumers from Heathrow Expansion. That is why ensuring momentum was so important to maximise benefits to consumers and the UK.
55. The Airports National Policy Statement (ANPS) confirms the need for the new runway at Heathrow to be delivered. Heathrow was given a clear challenge by the Secretary of State to open the runway in 2026 for £14 billion (2014 prices), and aiming for close to 2016 charges in real terms. A 2026 runway opening date necessitated securing a Development Consent Order (DCO) for the scheme in 2021. Heathrow put in place a programme team to ensure we could maximise consumer benefits as soon as practicable by targeting to open the runway by the end of 2026.
56. We had a well developed and fully costed plan. Each activity was costed which had an appropriately sized team with the right expertise to execute our plans. This was evaluated and covered at great length through dedicated expansion governance forums including representatives of the airline community, the CAA and the IFS.
57. We also faced external pressures that drove cost. The DfT had set the CAA a mandate to assess how effectively Heathrow was engaging with stakeholders. The CAA imposed reporting requirements which went well beyond normal requirements; this resulted in Heathrow having to develop significant additional capabilities and increase resources to meet this challenge.
58. Despite the challenges outlined above, we were diligent in our planning and challenged all expenditure. The goal was to deliver an operational runway by 2026, but it became clear during 2019 that there were many emerging challenges affecting the deliverability of this date. This led to extensive discussions with stakeholders on possible alternative scenarios.
59. Up to this point there was no firm CAA policy on early expansion costs. The CAA had developed a policy on Category B which continued to evolve. No policy was in place for Pre-DCO Category C expenditure, however Heathrow had to continue to progress the delivery of the existing plan and 2026 runway opening date. A lack of policy clarity on early expansion expenditure caused delays and uncertainty. There are clear shortcomings that the CAA must address to support future Expansion plans.
60. It is unacceptable that the CAA has taken nearly one year to review Heathrow's submissions<sup>5</sup> on Category B and Category - and it has yet to come to a fully developed assessment. The CAA delay has also created additional cost as we were forced to retain colleagues with the specific knowledge required to respond to the CAA's review. We urge the CAA to conclude the review swiftly and efficiently.
61. We also point to previous IPCR reports commissioned on behalf of the CAA by PwC. Its reports have covered the periods 2016 to 2018 on Category B expenditure and have found on the whole that all costs were efficiently incurred. For the CAA to now come to any other view would appear to be misguided and ignore available evidence from their own consultants.
62. Heathrow is unambiguous and clear that all spend incurred on early expansion costs related to Category B and Category C was efficiently incurred. We undertook planned activities with the right teams at the right time. We had the appropriate expertise from our client partners that was required for this unique and complex programme, all focussed on delivering consumer benefits as soon as possible to meet the requests of government.

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<sup>5</sup> Category B in May 2020 and Category C in July 2020

63. We will provide further information to the CAA on each area it has questioned.