Economic Regulation of Heathrow Airport Limited: working paper on capital expenditure efficiency incentives

Response from Richmond Heathrow Campaign
9 October 2020

INTRODUCTION

1. This is a written response of the Richmond Heathrow Campaign (RHC) to the CAA's consultation titled *'working paper on capital expenditure efficiency incentives, CAP 1951, August 2020'.*

2. This working paper follows on from the June 2020 Consultation (CAP 1940) and provides further details of the CAA's proposed approach to capital efficiency incentives for Heathrow Airport Limited (HAL)), including:
   - a recap of the CAA's previous work in this area, including the initial views of stakeholders;
   - the CAA's proposed criteria for developing new incentives; and
   - further details on the CAA's broad approach to developing capital efficiency incentives.

3. RHC represents three amenity groups in the London Borough of Richmond upon Thames: The Richmond Society, The Friends of Richmond Green, and the Kew Society, which together have over 2000 members. The members of our amenity groups are adversely affected by noise from Heathrow Airport's flight paths, poor air quality and road and rail congestion in west London. We acknowledge Heathrow's contribution to the UK economy and seek constructive engagement in pursuit of a better Heathrow. We are an active participant in the Heathrow Community Noise Forum.

4. Our premise is that it would be preferable to aim for a better Heathrow rather than bigger Heathrow and to capitalise on the world beating advantage of London's five airports, in particular by improving surface accessibility to all five airports, which would be a major benefit to users. Our approach is to continue supporting the case for no new runways in the UK and we believe this is well supported by the evidence produced by the Airports Commission and the DfT in relation to the Airports National Policy Statement.

5. Over recent years we have undertaken extensive research on Heathrow and submitted a large number of papers to the Airports Commission, the DfT, CAA and others - all of which can be found at www.richmondheathrowcampaign.org

6. RHC has responded to twelve CAA consultations on economic regulation - CAPs 1510, 1541 in 2017, CAPs 1610 and 1658 in 2018 and CAPs 1722, 1769, 1782, 1812 and 1832, in 2019 and CAPs 1871, 1876 and 1940 in 2020. The responses and other material are on the RHC website.

7. Yesterday on 8 October the Supreme Court concluded a two day hearing of an appeal by HAL to an Appeal Court judgement that ruled the Airports National Policy Statement (APNS) approved by parliament in June 2018 is unlawful because it does not adequately take into account the UK's commitment to the Paris Agreement on Climate Change.

8. HAL had previously advised RHC and others that it expects the appeal will defer the DCO application by 18 to 24 months from the previous target of end 2020.

9. Whatever the outcome of the Supreme Court hearing on legal grounds, there can be no doubt that the climate change 'ceiling' continues to reduce thus making it harder to justify aviation growth. **RHC urges the Government, CAA & Heathrow airport to abandon plans for a 3rd runway and instead advance a new aviation strategy that allows & encourages other UK airports to take a greater share of recovery & economic growth.** Our response to CAP 1940 included an Annex that provided the grounds for RHC's proposal.

10. RHC continues to seek a successful 2-runway Heathrow with improved access and reduced environmental impact and we continue to have an interest in economic regulation of the airport, and in turn capital efficiency incentives. In our response in August to CAP 1940 Chapter 3 on the subject, we provided a limited response because we are not privy to Heathrow's procurement and cost and management accounting processes and governance. However, we take this opportunity to add to our previous response.

Contact details:
Peter Willan, BSc Eng(Hons), MBA, ARSM, FCMA, FEI, HonRCM
Chair, Richmond Heathrow Campaign
action@richmondheathrowcampaign.org

Continued/

RICHMOND HEATHROW CAMPAIGN RESPONSE TO CAP 1951

Introduction and Chapter 1 Work to date and stakeholder views

11. We note that implementation of the developing incentives will be the H7 price control period commencing 1 January 2022. We also note that the Q6 price control period has provided a test ground for incentives and that the CAA seeks to build on the experience.

12. RHC continues to support the broad categorisation of capital expenditure (capex) into core and development; we suggest attention be paid to avoiding the potential blurring of opex and capex.

13. We broadly support the CAA's approach to Proposed Improvements (Introduction paras. 7 to 12) [concerning incentives] but subject to our reservations on use of incentives for Heathrow's capex, which we explain below.

14. We note that HAL has experienced some substantial cost over-runs in Q6 price control period as summarised in the following table extracted from the Arcadis Report *"Heathrow Q6 Capex Efficiency Review September 2020".* Ten projects were examined.

Project	Last Approved Budget £m	Final cost £m	Variance £m
B051: T3 Integrated Baggage	92.2	136.1	43.9
B238: T5 Western Baggage Upgrade	20.7	25.9	5.2
B131: Main Tunnel Refurbishment	86.0	146.3*	60.3
B131: Cargo Tunnel Refurbishment	44.9	197.0*	152.1
B066: Energy & Utilities Management	51.3	48.2	3.1
B101: T3 Pier 7 Roof Works	29.9	29.78	0.2
B101: T4 Rooflight Replacement	13.1	11.3	-1.8
B101: T4 Toilets & Finishes	14.5	15.2	0.7
B316: T3 IDL Refurbishment & Enhancement	18.6	18.5	-0.1
B009: T5 Northern Perimeter Parking	3.1	4.9	1.8
*Forecast			

15. We also note that HAL experienced substantial cost over-runs in regard Heathrow expansion - category B and early category C costs, as discussed in previous RHC responses to the CAA.

16. By our calculations, HAL accumulated substantial excess profits in Q6, at least prior to the CV19 pandemic and this is evidenced by the substantial dividends paid to shareholders.

17. We have not had time to study in full the above mentioned Arcadis report or indeed the CEPA Report *"Possible ways of implementing ex ante efficiency incentives for Heathrow's capital expenditure March 2019"* but the latter content is largely reflected in CAP 1951.

18. Our comments focus on a 2-runway Heathrow and might need to change in the event of expansion.

Chapter 2 Criteria for implementation

19. RHC broadly supports the CAA's criteria and reasoning set out in Table 2.1 but with the following caveat.

20. As we see it, HAL already has an incentive under the economic regulatory system to add capex to the RAB because it earns the prescribed rate of return for the price control period, irrespective of whether or not any benefit is achieved. We are not suggesting that HAL deliberately games the system. The airlines as proxy for their customers (passengers and freight) pay the price through an increased aeronautical charge. In a competitive world, which the economic regulation of HAL seeks to simulate, this would not "fly" since the customers would go elsewhere depending on the price elasticity. **There is mention of symmetry in CAP 1951 but we believe there is substantial inherent bias towards overspend.**

21. The CAA's proposals emphasise the need to assess the benefits and this we support. We believe the ultimate test of efficiency in these circumstances is the benefit to cost ratio.

22. The benefit for example may be a reduction in operating costs. The net benefit in NPV or other terms should be required to more than cover HAL's cost of capital - it should reduce the aero charge.

23. Another example might be the improvement in service level and quality of service but again the benefit/cost ratio needs to be positive by some margin.

24. **A further example, especially relevant to RHC's interest in reducing the environmental harm, is where the beneficiary is other than the customer - it is the community. This is a case of the polluter pays, i.e. the customer pays through higher aero charges. At the moment we do not see the CAA's proposals incorporating this externality and we believe the proposals should do so.**

25. To some extent projects for airspace design and modernisation involve communities and not just HAL's airline customers and their ultimate customers as potential beneficiaries.

26. Another area requiring attention is that of surface access to Heathrow. There are key projects such as Western Rail Access (although currently deferred) where the project manager may not be HAL and the subject of project management and incentives may be different to that at Heathrow itself.

27. The point we make here is that the controls should seek to compensate for the inherent bias mentioned above and focus on the benefits to customers and the community and not depend on comparing project budgets or baseline costs with an actual project total-cost-to-complete. Clearly budgets and baseline costs have an important role to play but are a means to an end.

28. The above examples raise the question as to what might be the project target benefit/cost ratios. We are not in a position to suggest benchmark returns for the variety of core and development capex projects HAL may undertake but it should be possible to establish these in conjunction with HAL and the airlines.

29. We now come to the design of incentives. We are not close enough to the lead up to H7 to have a full picture on how the weighted average cost of capital and aero charge will be arrived at. But presumably they will be based on HAL's plans extending over the price control period and

that these plans will include the individual project capex budgets. Presumably there will be some mechanism for including or excluding capex projects running into the control period from Q6 and projects running beyond the control period at the end of H7. We assume that the plans will include expected HAL performance and management of uncertainty and risk for each project in terms of assessed project risk, mitigation and cost contingencies and their release.

30. Broadly speaking HAL is rewarded through the allowed rate of return for the price control period and we are apprehensive about incentives adding to HAL's rate of return and paid for by the customer through the aero charge. We would rather add provision for penalties, especially given the RAB expenditure bias referred to above and the history of HAL's cost over-runs and the excess profits made in Q6. In a competitive world HAL would have difficulty passing any under - performance on to the customer and would itself be penalised for under-performance. Any reward for over-performance would need to recognise the balance struck between reward included in the allowed rate of return and incentives. **We are not ruling out incentives but put simply: if HAL is licensed to operate Heathrow then it should be expected to do a good job for which it is being allowed a rate of return and it should not rely on incentives to boost its return.** Furthermore, application of incentives can be ineffective and prone to error in complex capital projects lasting several years, especially when HAL itself relies on most of the work being undertaken by contractors.

31. We note that application of control against baseline will include a floor and cap on incentives but nevertheless we remain sceptical with regard to excessive use of incentives to reward HAL. Whether the reward is through a relatively high allowed rate of return or through incentives, it will be the customer who pays for the incentives which thereby offsets the project benefits, albeit improved through the efficiencies gained.

Chapter 3 Further detail on our broad approach

32. We broadly support the CAP 1951 Figure 3.1: Principles for the design of capital efficiency incentives and the concepts of cost, timing and quality.

33. The proposal to breakdown capex into smaller units of expenditure should help design appropriate incentives relevant to each project and seems a reasonable approach.

34. Broadly we support ex ante incentives replacing ex post reviews.

35. We said in our response to CAP 1940 that some risks might be shared between customer and HAL. We are concerned that the CAA proposal might end up with a higher proportion of the risks being absorbed by the customer than we would regard as appropriate. We think it reasonable for the customer to bear some of the demand and ticket price risk but not much else. HAL is the project manager and should be in control of the project capex and out-turns. However, capex projects and their costs can suffer from scope changes and drift and hence benefits, which to some extent may arise from customer choices for which they might be expected to bear the risk. In the same vein, there may be a cost of flexibility in deliverables, which the customer might be expected to bear.

36. Broadly we support the CAA's approach on project and incentive timing and on governance.

END