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Re: Response to Economic Regulation of Heathrow – CAP1964: Q6 Capital Efficiency Review

Thank you for the opportunity to respond to the CAA's consultation CAP1964, updating on the latest developments at Heathrow with regards to the CAA's capital efficiency review for Q6 (the "Consultation").

This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address. Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

This submission should be read alongside previous submissions from the Airline Community, notably our feedback regarding the Arcadis Q6 Efficiency Report, submitted 30th April 2020¹ ("Airline Community Arcadis Feedback")

In responding to the Consultation, we have broken our response down into three sections as follows:

1. General Comments with regards to capital efficiency and Airline Community submissions so far;
2. Feedback on the specific matters requested under Chapter 1 of the Consultation; and
3. Feedback on the specific matters requested under Chapter 2 of the Consultation.

1.0 General Comments

1.1 Context

The capital efficiency review process is a key activity for the Airline Community. Not only does it ensure that airlines, and ultimately consumers, are paying for capital that has been efficiently incurred, it should act as a clear regulatory incentive mechanism on HAL and provide an overall level of confidence in the regulatory capital process. Should inefficiencies be permitted onto the RAB it would undermine these core principles and mean a WACC return for HAL that is not commensurate with the risk actually being borne by them, and ultimately consumers paying higher charges.

¹ Letter to Jon Clyne and Mantas Aleksa (CAA), "Airline Community Feedback re Arcadis CAA Report Q6 Capital Efficiency Review", dated 30th April 2020

Airlines have long been clear that they, and consumers, cannot be expected to underwrite the risk of HAL materially failing in delivering projects to budget, particularly where already noted HAL are already being compensated for such risks. Furthermore, the capital process which has been established at Heathrow is designed to: (i) provide a balance of ‘overs and unders’ of projects across a portfolio and managed within a risk framework; (ii) ensure airlines have an approving role in the process; and (iii) ensure HAL remains accountable for the delivery of agreed projects and all additional risk above that agreed at G3 project approval.

Given the points already raised above and in further detail previously², whilst we can expect a certain degree of inaccuracy in the P80 / P50 approach, we note several projects in particular, as set out further in Section 2, where the costs are significantly above the margin of error that could be deemed reasonable, acceptable or efficiently incurred.

The Airline Community previously estimated a level of inefficiency of £219m for Q6 (as at April 2020) across a number of projects. The findings of the Arcadis report and the initial consideration of this within the Consultation are particularly disappointing and an unacceptable position from a key stakeholder perspective.

We hope the points raised within this response will provide further evidence in which to support the CAA in a full and robust assessment of both the approach and projects for assessment.

We recognise there are challenges within the ex-post review process but believe these can be addressed and look forward to building on the future regulatory capital framework being considered by the CAA (as per CAP1951 and as responded to by the Airline Community³).

In the meantime, setting out a transparent approach to reviewing inefficiencies for Q6 is a sensible and welcome approach.

1.2 Overall Approach

The Airline Community have been engaging with the CAA and HAL throughout the development of the efficiency review process up to this Consultation and have provided input over this time. This includes feedback submitted through the Airline Community Arcadis Feedback, which we incorporate herein, including comments on the Arcadis review and report referenced within the Consultation.

In terms of the overall approach being proposed in the Consultation, we are broadly supportive and develop this further under Section 2 and 3 below.

The Airline Community do however have three key issues that we do not believe have been sufficiently addressed in the Consultation that require further consideration and application, namely:

² Context, Airline Community Arcadis Feedback

³ Airline Community Response to CAP1951: Working Paper on Capital Expenditure Efficiency Incentives, dated 16th October 2020

1.2.1 Capital Efficiency Handbook and Efficiency

Whilst the cross reference of the Capital Efficiency Handbook (“Handbook”) against the proposed DIWE framework⁴ is very useful and shows a high degree of linkage, it is important to note the references within the Handbook to defining *efficient*⁵ capital expenditure as well as *inefficient*.

This distinction is important as it sets a clear position that capital must be *efficiently* incurred. There are several examples under Section 2 where the burden of proof lies solely in identifying *inefficiencies* and even then, when inefficiencies have been recognised, challenges in apportioning have in our view led to unsatisfactory conclusions.

As the primary reference to capital efficiency under the agreed capital governance process, the role and this *efficiency* aspect of the Handbook must have greater consideration as part of this process.

1.2.2 Arcadis Review

We note a degree of inconsistency within the approach taken and subsequent conclusions in the Consultation as to which projects are proposed to be further reviewed. The conclusions appear to be, in part, based on the extent to which Arcadis has determined *inefficiencies*, yet Arcadis themselves noted the purpose of their review was to look at the extent of *efficiency*⁶.

“Purpose of the Q6 CAPEX Efficiency Review

- *Arcadis was commissioned by the CAA to determine whether HAL has been efficient in how it has spent Capital Expenditure (CAPEX) during the Q6 regulatory control period.*
- *The scope of our report was to test whether HAL has been efficient with their spending of CAPEX, on the ten selected projects, during the Q6 regulatory period to date.*
- *Arcadis was not asked to determine the actual detailed financial impact of any potential inefficiency identified as part of this review.”*

In addition, whilst Arcadis used a number of criteria in their judgement, the DIWE framework being proposed in the Consultation was not explicitly considered.

Given this, and based on the further evidence set out later in this response, we believe that the projects identified in Section 2 require further analysis and must be subject to a fuller review and determination to ensure such inefficiencies are not passed onto airlines and consumers, as would otherwise be the case in not doing so.

1.2.3 The Importance of the Capital Governance Process and Airline Agreement

As set out further under 3.3.2, whilst we welcome the CAA comments airline views will be considered as part of its assessment of projects, the Airline Community are concerned that the extent to which the need for *agreement* is required has not been sufficiently reflected within the Consultation when considering the potential for disallowing capital expenditure.

A core principle of the capital governance arrangements is the need for HAL to seek *agreement* from the airlines. There are several examples in Section 2 where such agreement has either not been

⁴ Appendix C, CAP1964

⁵ Section 16, Capital Efficiency Handbook, April 2015

⁶ “Heathrow Q6 Capital Efficiency Review” Arcadis presentation to HAL and Airlines, March 2020

sought or given, yet the prominence of this requirement does not appear to have been reflected in the consideration of the extent of potential inefficiencies.

Failure to sufficiently take this core aspect of the framework into account would both seriously undermine the confidence airlines' have within the capital process and furthermore remove a key incentive on HAL for seeking agreement on appropriate capital expenditure.

We would very much welcome and encourage a greater prominence on this aspect within the review.

2.0 Chapter 1: Assessing the Sample Projects for Inefficiencies

2.1 Use of the DIWE Framework

The Airline Community believe that the CAA have explained and justified their rationale for using the DIWE within the Consultation and are broadly comfortable in its application for the efficiency review, subject to the comments made under Section 1.

The Airline Community fully support in particular the explicit reference that HAL cannot contract out responsibility for project development and delivery to third parties. We welcome this inclusion and agree that third party performance, for which HAL are ultimately responsible for managing, must form part of the overall efficiency assessment.

Notwithstanding the above however it is important to recognise the comments made under Section 1 above. As such, the use of DIWE should be used in parallel with both: (i) consideration of demonstrating *efficiency* and (ii) the extent to which selected projects followed the capital governance process and had the approval (or otherwise) of airlines for such expenditure or removal of scope.

2.2 Approach to Cargo Tunnel

The Airline Community submitted in its Airline Community Arcadis Feedback evidence why we strongly believe there are inefficiencies within the Cargo Tunnel project and welcome the Consultation has recognised this too. In particular, we note an expenditure to date of nearly £40m against an overall agreed sum of £44m to which HAL have failed to provide any evidence of value; a clear failing under any assessment of capital efficiency.

Given the above, the Airline Community fully concur with the CAA's view on the potential for inefficiencies and that this project must be subject to a full efficiency review.

Given the incomplete nature of the project, such a review should be both: (i) interim as per the end of Q6; and (ii) final upon its full completion (as per governance rules to be decided in iterations to CAP1951).

We do note however a disagreement with the CAA's statement that they do not expect the top end of the inefficiency range to increase above the £12.7m⁷ identified by Arcadis. We do not believe it is appropriate nor possible at this stage to determine the extent of the inefficiency within the project, nor convinced that the Arcadis review has considered all the criteria the CAA are considering testing against, as noted under 1.2.2 above. Furthermore, we would also dispute that the level of possible

⁷ Paragraph 1.43, CAP1964

inefficiently of £12.7m is “*relatively modest*”⁸, particularly when considering this against the approved budget of £44m.

2.3 Efficiency / Inefficiency of the Main Tunnel

The Airline Community are strongly of the view that the Main Tunnel meets the requirements for assessing inefficiencies in accordance with the assessment criteria set out within the Consultation, particularly in relation to the performance and management of third parties.

The Airline Community submitted in its Airline Community Arcadis Feedback a comprehensive summary of the issues we saw on the Main Tunnel and why we strongly believe there are inefficiencies within that should be considered further. These notably include several points picked up within the Consultation with regards to:

- (i) the level of overspend against the agreed budget which surpasses any reasonable balance of efficiency / inefficiency;
- (ii) significant delays to the project; being four years past its Trigger date, and with a further three years anticipated until completion⁹;
- (iii) the late timing of HAL’s realisation and reporting of the fundamental issues with the project, which raise questions on the initial management of the project; and
- (iv) the overall poor supplier performance and requirement for re-work; with HAL ultimately being accountable for delivery by third parties as recognised under the DIWE framework.

The above clearly highlights areas of inefficiency and cannot be disregarded. The CAA must include the Main Tunnel and consider further these issues as part of its efficiency review.

2.4 Overall Conclusions on Other Projects

2.4.1 T3IB and T5WBU

The Airline Community remain strongly of the view that inefficiencies exist within both the T3IB and T5WBU projects and that they must form a part of the efficiency assessment.

The remaining works required on T3IB during Q6 were towards the end of the project (having already incurred significant overspend within Q5 and being subsequently ‘reset’ for Q6). The budget for Q6 was set at £90m but the final figure still ended up being another £40m over. The Airline Community cannot agree with the assessment that this *further* overspend was ‘modest’¹⁰ and believe this material increase: (i) is a clear demonstration of inefficiency under the DIWE Framework; and (ii) was explicitly noted by the Airline Community as not agreed, as per our Airline Community Arcadis Feedback¹¹

The Consultation noted that the CAA would be cognisant of the risk of using hindsight in its judgements¹². Taking this principle, it is our view that hindsight should not also be used to justify failings where a project was more challenging than what should have *reasonably* been anticipated.

⁸ Paragraph 1.64, CAP1964

⁹ ‘September 2020 Portfolio Performance Report’ as presented at the Capital Portfolio Board, October 2020

¹⁰ Paragraph 1.58, CAP1964

¹¹ Paragraph 2.2, Airline Community Arcadis Feedback

¹² Paragraph 17, CAP1964

Such an approach undermines the incentive structure that exists to promote efficiency and ultimately shields HAL from any risk.

Following on from the above, the proposal not to progress with the review of T3IB appears to be based, in part, on the premise of comments from Arcadis that in looking back there were inefficiencies identified due to a number of issues but due to the ultimate complexity of the project and apportioning such issues, these inefficiencies would not be considered further.

Given the project was nearing completion at the start of Q6, HAL should have been well aware of the challenges being encountered. The fact that a full review was required only six months into the start of Q6 shows a fundamental failing to correctly plan or take learnings from the previous Q.

Whilst the T3IB project did involve innovative technology, HAL were fully aware of this, yet fundamentally treated this as a 'building project' as identified within the IFS T3IB Close Out Report¹³. Furthermore, HAL's failure to sufficiently establish and manage an appropriate schedule clearly had implications as noted by the IFS in their key comments on T3IB in that that "*...schedule management was consistently in need of improvement. This will have been a constraint to achievement of cost and time performance.*"¹⁴ Had greater effort been put into the initial planning then it is highly likely that these unnecessary costs, and therefore inefficiencies, would have been avoided

Whilst we note the limited evidence of inefficiency for T5WBU, we reiterate our comments from the Airline Community Arcadis Feedback that both: (i) the failings of T3IB; and (ii) HAL's removal of agreed scope that is now seeking to be addressed through alternative projects, and therefore the consumer 'paying twice' means that this must be considered further by the CAA.

For both projects the Arcadis review identified areas of inefficiencies but the challenge they noted was in apportioning such inefficiencies to HAL. In turn, the CAA note that Arcadis were not entirely convinced that the projects were delivered efficiently¹⁵.

In addition to the above, we also understand part of the failings of T3IB and T5WBU was HAL's supplier being unable to sufficiently resource both T3IB and T5WBU, a clear failing under the DIWE assessment criteria which does not appear to have been given sufficient weight or consideration in Arcadis' assessment.

The Airline Community Arcadis Feedback also gave clear examples of failed governance for both T3IB and T5WBU¹⁶ which must also be taken into account when considering the disallowance of capital expenditure.

Given the issues raised around:

- (i) the level of cost overrun;
- (ii) poor project set up (even in 'resetting' for Q6);
- (iii) inefficiencies noted within both projects; given the balance here and in line with the Handbook an assessment of *efficiency* must be undertaken before any conclusion can be drawn;

¹³ Point 3, Section 3.3 IFS Key Observations, IFS Close Out Report on T3IB, dated June 2017

¹⁴ Section 3.3 IFS Key Observations, IFS Close Out Report on T3IB, dated June 2017

¹⁵ Paragraph 1.55, CAP1964

¹⁶ Paragraph 2.1 – 2.3, Airline Community Arcadis Feedback

- (iv) use of DIWE criteria in line with the Consultation proposals not considered by Arcadis; and
- (v) issues around governance and agreement with airlines,

the Airline Community strongly urge the CAA to consider its position with regards to both T3IB and T5WBU.

In addition to the above points, as stated in our Airline Community Arcadis Feedback¹⁷ we would note that £35m of T3IB costs from Q5 were to be reviewed as part of the Q6 process but we have not seen evidence that this has been addressed within this review which needs to be addressed.

2.4.2 Wider CAA Concerns

We concur with the wider concerns raised by the CAA¹⁸ and believe consideration of these matters should be considered when conducting its efficiency review on specific projects, as well as being an area to build on as part of the future governance arrangements.

3.0 Chapter 2: Broader Issues

3.1 Extrapolating Samples Results for Further Adjustments

Whilst there are a number of matters the Airline Community are keen to address within the capital framework including the assessment determination of efficiency¹⁹, our concerns for this Q6 efficiency review sit primarily with those specific projects highlighted under Section 2 above.

3.2 Capital Overheads

The Airline Community welcome the CAA's acknowledgement on the need to review the current approach to capital overheads and the expectations on HAL in that regard²⁰.

3.3 Wider Issues

3.3.1 Transport Study and Demonstrating Outperformance

The Airline Community note the questions the CAA have drafted²¹ and that they appear sensible with merit in considering.

The Airline Community are concerned regarding the comment within the Consultation that if HAL does exceptionally well in addressing the questions that the CAA may choose to revise down any disallowance for inefficiency²².

The overall portfolio balance is based on a project P50 approach and HAL have noted²³ that, bar a number of projects where there are significant failings and clear inefficiencies, the portfolio has

¹⁷ Paragraph 2.2, T3IB

¹⁸ Paragraphs 1.65 – 1.67, CAP1964

¹⁹ For further details please see the Airline Community Response to CAP1951: Working Paper on Capital Expenditure Efficiency Incentives, dated 16th October 2020

²⁰ Paragraph 2.9, CAP1964

²¹ Paragraph 2.16, CAP1964

²² Paragraph 2.17, CAP1964

²³ 'Project Performance' (Slides 10 – 14) Constructive Engagement Capital Efficiency – Session 8, 24th September 2020

broadly balanced. Given the efficiency review is primarily focused on a number of particular projects, as set out in Section 2 above and the CAA has indicated in the Consultation it is not intending to look further, it does not seem reasonable that HAL now bring forward particular projects that may offset any identified inefficiencies in those specific projects being reviewed. Any such an approach would require a full portfolio review to be undertaken, particularly given some of the wider underlying concerns noted by the CAA under 2.4.2 which the CAA are not seeking to address.

3.3.2 Level of Stakeholder Support

The Airline Community very much welcome the CAA's intention to assess any evidence of the level of support from key stakeholders for HAL's capital programme and spending on projects being assessed²⁴. As covered under Section 1.2.3 above, this is a key aspect that the Airline Community feel requires greater prominence with regards to the Consultation and the CAA's assessment of capital allowance.

3.3.3 Other Considerations for the H7 Period

The Airline Community fully agree with the CAA's comments for an improved approach to business case development, the early defining and ongoing tracking of benefits²⁵.

We also note that the example given of the Cargo and Main Tunnels benefit erosion and cost increases²⁶ can and should be equally applied to T3IB and T5WBU.

We thank you for your consideration on the matters raised within this submission. Should you have any questions on any of the points made within please do not hesitate to contact us.

Yours sincerely,



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²⁴ Paragraph 2.18, CAP1964

²⁵ Paragraph 2.20, CAP1964

²⁶ Paragraph 2.19, CAP1964