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**British Airways Response to CAP1996**  
**Working paper on Q6 capital expenditure and early expansion costs**

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

### Executive Summary

The CAA has stated that that **no capital expenditure other than an "efficient estimate of the required expenditure** to deliver outputs required by airlines and consumers"<sup>1</sup> should be incorporated into any price control; we are therefore disappointed with the result of the Q6 ex post capex efficiency review<sup>2</sup> and the CAA's final policy on Category C expansion costs.

We **reiterate our existing position that Category C costs were incurred at Heathrow's own, sole risk** and that since the Airports National Policy Statement ("ANPS") now has legal force, the environment has changed since the June 2020 consultation.

It is our observation that significant inefficient expenditure has occurred over the course of Q6, and that with the passage of time, it is impossible to accurately identify inefficiencies in an ex post review; **nevertheless we continue to support the CAA's ongoing work in this area to cover expansion costs**, noting the significant deficiencies the CAA has observed in Heathrow's budgeting and control of programme costs.

**The RAB should only represent historic, logged-up and efficient capital expenditure**; based upon our experience of this ex post review, and we continue to support the CAA's proposals for the introduction of ex ante capital efficiency incentives for the H7 price control to rectify the limitations of ex post reviews in general.

Our main points are as follows:

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<sup>1</sup> [Civil Aviation Authority, CAP2139 para 2.58](#)

<sup>2</sup> [Civil Aviation Authority, CAP1996](#)



- a) We welcome the CAA's initial downward RAB adjustment in the range **£12.3m to £12.7m in relation to the cargo tunnel project**, and further assessment in future given the interim status of the project
- b) We are disappointed that the CAA has been unable to find any other evidence of inefficient expenditure, particularly on the main tunnel project **given the significant cost over-runs, tendering in advance of project definition, and lack of any progress towards delivery**
- c) We are **disappointed that the CAA has made a final decision to treat Category C costs using the same, simplified policy as for Category B costs**, removing risk sharing arrangement for all costs in the process
- d) We **reserve our final judgement on this treatment of expansion costs until such time as the costs themselves are fully defined** and any efficiency adjustments implemented as part of the H7 price control are finalised
- e) In relation to costs incurred since March 2020 on expansion, the legal force of the ANPS has now been restored, therefore **Heathrow's close-down activities are suggestive of an apparent unilateral withdrawal from expansion**; it is therefore difficult to understand what consumers benefit from being burdened by these costs
- f) Consumers should not have to pay for Heathrow's inefficiencies, and the RAB should not be used to mop up all Heathrow's expenditure risks; we **continue to support the CAA in carrying out its crucial work on establishing efficiency of any expansion expenditure**

## 1. Q6 capex efficiency review

- 1.1. We agree with the CAA that the **Demonstrably Inefficient and Wasteful Expenditure ("DIWE") approach provides an explicit and structured set of criteria to ex-post efficiency assessment**, building on the current framework, and recognising that Heathrow cannot contract out responsibility
- 1.2. We recognise that this approach is based upon that endorsed by the **Competition and Markets Authority ("CMA")** in the context of its work on NATS En-route Ltd ("NERL") rather than any other approach, recognising the wider advantages of doing so with precedent having been established by the CMA in this area
- 1.3. We **welcome further assessment of the cargo tunnel project in future given the project remains interim at present**; we agree with the CAA that the factors identified suggest inefficiency, particularly in the surveying, design and planning works, in addition to further costs of a stand-back review
- 1.4. We therefore **welcome a potential initial downward RAB adjustment in the range £12.3m to £12.7m in relation to the cargo tunnel project during the Q6 period**,



- though remain disappointed that this remains less than what we consider to be the inefficiencies experienced on this project
- 1.5. Similarly, we are **disappointed that the CAA has concluded that it does not see sufficient evidence of inefficiency on the main tunnel project**; we welcome a future review of this project once completed, as we remained concerned over its progress and cost estimates
  - 1.6. Finally, we are disappointed that the CAA does not see any evidence of inefficiency on the T3 Integrated Baggage and T5 WBU projects; nevertheless, **we agree with the CAA's comment on Heathrow's adherence to the agreed capital governance framework**, and believe that updating the framework should be a priority – particularly to ensure it integrates with the proposed capital efficiency framework
  - 1.7. As a result of the above experience of ex post capital efficiency assessment, we **continue to support the CAA's proposals and the introduction of capital efficiency incentives at Heathrow**; these remain proportionate, are in the best interests of consumers and will allow more efficient delivery of capital projects in future
  - 1.8. We **support the CAA's conclusion that there is no requirement for adjustments for exceptional performance** in relation to the Transport Study framework; we also support the CAA's review of capital overheads at the H7 periodic review
  - 1.9. As part of the H7 periodic review, it is **essential that the Capital Efficiency Handbook is updated to reflect both best practices in the construction industry, and the specifics of Heathrow's governance framework**, updated for capital efficiency incentives that will likely be introduced by the CAA; we are therefore supportive commit to engaging with Heathrow and the CAA on this update

## 2. Early costs incurred before March 2020

- 2.1. We are **disappointed that the CAA has made a final decision to treat Category C costs using the same, simplified policy as for Category B costs**, removing risk sharing arrangement for all costs in the process
- 2.2. We note that the June 2020 consultation on early costs **was undertaken at a time when Heathrow had paused work on expansion**, since the Court of Appeal had at the time ruled that the Airports National Policy Statement ("ANPS") was not legal, having not taken account of the Paris Accord on climate change
- 2.3. Heathrow appealed this ruling, and – as noted by the CAA – in December 2020 the Supreme Court reversed the decision of the Court of Appeal, **ruling that the Government's decision to designate the ANPS had been lawful**; as a result, the legal effect of the ANPS was restored

- 2.4. We are **therefore now in a different environment than at the June 2020 consultation, since the ANPS holds legal force** yet Heathrow have not resumed work on runway expansion; the project has been closed down, with no substantive activity taking place, and no progress towards Development Consent Order (“DCO”) application
- 2.5. Whilst we see little prospect of runway expansion resuming in the near future due to the effect of Covid-19 on Heathrow’s balance sheet, **a decision not to resume work has been taken consciously by Heathrow; we are now exactly in the position described by the CAA in its letters with the DfT** prior to setting policy for expansion costs, and **prior policy should therefore apply to Category B and C costs incurred**, with Category C costs at Heathrow’s own sole risk before any policy was set and defined
- 2.6. We note Andrew Haines’ comments when writing to the Department for Transport (“DfT”) in 2016, where he cited the **“importance attached to long-term certainty, clarity around risk allocation**, and the benefits of competitive tension to establish efficient financing and construction costs”<sup>3</sup>
- 2.7. Within this letter, several strategic **risks were identified that have now come to pass**, and the CAA’s policy now results in consumers being **charged for costs that have been the subject of little oversight (particularly Category C) and result in no benefits to consumers** whatsoever
- 2.8. We are concerned that this decision over a portion of capital expenditure that did not follow any governance process, and was supposed to be a Heathrow’s own sole risk, creates a precedent – that **Heathrow spending “at risk” in any area they do not find airline agreement in governance is not truly “at risk”; this fundamentally undermines airline governance**, which will remain a core part of capital governance for H7, and facilitates application of capital efficiency incentives
- 2.9. The DfT’s response to this noted that **“the Government is also keen to ensure that any risks to delivery are mitigated robustly through the regulatory structure**, for example, by **including a delivery obligation in HAL’s licence”**<sup>4</sup>
- 2.10. Since the legal status of the ANPS has now been clarified, yet Heathrow are no longer actively proceeding to DCO, we ask what the CAA is doing to **hold Heathrow to account for its obligations in respect of our investment to date in its runway expansion project** through the Heathrow RAB
- 2.11. The CAA provided assurances to the DfT that it would “develop a balanced package of incentives and other regulatory tools to encourage HAL to deliver new

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<sup>3</sup> [CAA CEO Andrew Haines letter to DfT Permanent Secretary Philip Rutnam, 26th May 2016](#)

<sup>4</sup> [DfT Permanent Secretary Bernadette Kelly letter to CAA CEO Richard Moriarty 21st June 2016](#)

runway capacity efficiently and in a timely way, **including incentives for timely delivery and appropriate consequences for non-delivery**<sup>5</sup>

- 2.12. In relation to Heathrow unilaterally choosing not to pursue runway expansion, the CAA goes on to say "If this were to happen soon then **HAL would risk not recovering all of its planning costs**" and "once HAL has spent significant sums and we start to formulate proposals for a new price control, **hold out would become a riskier strategy for HAL to pursue. In particular HAL may have incurred significant early construction and compensation costs** and not completed the regulatory approvals process"<sup>6</sup>
- 2.13. Finally, the CAA suggest it will consider its "approach to regulating planning costs and we are also considering the possible development of price control incentives that could **include consequences for non-delivery. Nonetheless, Government action might also be appropriate if the circumstances were to arise such that HAL stopped pursuing capacity expansion**"<sup>7</sup>
- 2.14. We are now in a position whereby Heathrow have stopped work on runway expansion, closed down the project, and is not taking active steps to seek DCO; **the ANPS holds legal force, yet Heathrow not seeking to pursue DCO and appears to have unilaterally withdrawn from the project**
- 2.15. The CAA asserts that "Heathrow has not "unilaterally withdrawn" from the planning process"<sup>8</sup>; whilst this may have appeared to be the case in June 2020, it is not the case now in June 2021, therefore we **ask the CAA how it is has taken into account the renewed legal status of the ANPS and the lack of work by Heathrow in restarting work on expansion in arriving at this conclusion?**
- 2.16. Additionally, we **cannot allow a situation to develop where consumers are charged a third time** for Heathrow's (or any other promoter's) speculative attempts at expansion
- 2.17. We also comment on these matters in our response to CAP2139, however we must insist that the **regulatory framework for any further work on expansion is more fully-defined in advance of any spending**, is supported by clear and well-defined governance throughout, but in a way that does not prevent the underlying price control from being updated whilst seeking alignment with any DCO
- 2.18. We **reserve our final judgement on these matters until such time as the costs themselves are fully defined** and any adjustments implemented as part of the H7 price control are finalised

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<sup>5</sup> [Heathrow Airport expansion: letter from the CEO of the CAA to the DfT Permanent Secretary, 30th April 2018](#)

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> [Civil Aviation Authority, CAP1996, para 2.19](#)



### 3. Early costs incurred from March 2020

- 3.1. We reiterate our position on wind-down costs as set out in earlier consultations; **we have had no visibility of what Heathrow is spending money upon to wind down the programme, and what state exactly it is being left in** with a view to any future restart of work on expansion
- 3.2. As a result, **we cannot make a judgement on the efficiency or not of this spending**; the legal status of the ANPS changed as a result of the Supreme Court ruling, which suggests a different approach might now be appropriate given expansion at Heathrow is supported in law
- 3.3. Heathrow continues to publicly support expansion yet has made no further progress to deliver since December, and continues to spend on close-down costs; whilst this might be due to their current financial pressures, this is **not relevant to determining the treatment of spending within the context of a lawful ANPS, which is suggestive of unilateral withdrawal**
- 3.4. Consumers should not be burdened with costs of Heathrow's actions that indicate unilateral withdrawal from the expansion project, and we continue to be **frustrated by the lack of accountability for Heathrow's spending** in this regard
- 3.5. In relation to Supreme Court costs, we are **concerned that the policy as set out would set a precedent to burden consumers with costs of any action that Heathrow might choose to undertake**, which could result in a perverse incentive
- 3.6. As proposed, this **policy would leave no risk on Heathrow's shareholders** – either a scenario that costs were awarded, or alternatively one in which costs were not awarded; in line with costs incurred before the start of expansion, costs of advocacy should fundamentally be at Heathrow's own sole risk
- 3.7. In relation to blight, as a result of the ANPS's legal designation being restored, homeowners affected by expansion are again able to service statutory blight notices on the Secretary of State; it is therefore appropriate as the CAA suggests to add the cost of purchasing such properties to the RAB, in order to **support the existing contractual commitments between the DfT and Heathrow to do so**<sup>9</sup>
- 3.8. In addition, the **Interim Property Hardship Scheme ("IHPS")**, whilst discretionary, **formed part of these commitments to the DfT in relation to blight**, and we understand is therefore inseparable
- 3.9. We **support the CAA's proposed treatment should appropriate governance arrangements and cost management take place**, rental revenue maximised, and future sale proceeds be deducted from the RAB

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<sup>9</sup> [Department for Transport; Statutory blight and Heathrow expansion, updated 4 February 2021](#)



- 3.10. Nevertheless, these should also be considered in light of our earlier points on the legal status of the ANPS; now the legal force of the ANPS has been restored, the **application of this in respect of blight does not appear to reflect reality** – that being Heathrow’s apparent unilateral withdrawal from expansion

#### 4. Assessing the efficiency of early costs

- 4.1. We note the CAA’s approach in reviewing early expansion costs, and the overarching principles applied; we recognise that this assessment has not yet concluded, and findings have yet to be set out as a result – we **support the CAA’s continued due diligence of these costs** to ensure values added to the RAB represent neither inefficient nor wasteful expenditure
- 4.2. The work being performed to assess the correct **categorisation between expansion activities and normal business operations is critical to ensuring that the 2019 operating expense baseline is appropriate** for the H7 periodic review; we cannot accept a double count of expenses
- 4.3. Furthermore, we remain uncomfortable that operating expenses might be capitalised and added to the RAB as a result of expenditure on expansion activities; our position remains that the **RAB should only represent historic, logged-up capital expenditure**
- 4.4. We welcome the work the CAA has performed to date on expansion costs, and **note that initial findings appear to bear out many of our concerns on Heathrow’s management of the programme**; we note a number of potential inefficiencies identified, and expect to see full justification for any expenditure added to the RAB
- 4.5. It is **particularly concerning that Heathrow has not implemented PwC’s recommendations relating to timesheets** in order to allocate staff costs; we agree with the CAA that Heathrow has an incentive to over-estimate the proportion of staff time allocated to expansion activities, but also not the same applies to any expenditure that could potentially be capitalised under the expansion banner
- 4.6. Heathrow **must provide evidence that expenditure was efficient, and also clarity over the nature of activities and their allocation** between Category B and C costs; it is concerning that a number of reallocations took place with limited obvious controls over their conduct
- 4.7. It is also **concerning that the baseline plan was under such constant revision that there was no apparent stable budget in place**, and we agree with the CAA that a more mature baseline would have been expected at that stage of development in the expansion programme; it would **appear that spending was out of control on the expansion programme, and we remain deeply concerned over the efficiency of much expenditure as a result**



- 4.8. This is **particularly the case where the CAA is unable to establish any clear link between expenditure and specific outputs**; a lack of financial controls is suggestive of corporate governance issues that limit the CAA's ability to rely on Heathrow's own information in determining the scale and efficiency of expansion costs
- 4.9. The manner in which changes to baseline budgets has been managed in conjunction with late scope alterations is concerning for the practical implementation of capital efficiency incentives, whereby Heathrow is obliged to provide this information at a relatively mature level in order to implement the incentive effectively; it also **suggests capital efficiency incentives would have ideally been introduced earlier in order to control expenditure on expansion during its early phases**
- 4.10. We note that Heathrow's procurement and tendering strategy used suppliers from Heathrow's existing tendered frameworks (rather than re-tendering), each with already agreed rates, with each supplier able to pitch for inclusion in task orders; given pre-defined and agreed rates, it is **hard to reach the conclusion that this model drove competition and cost efficiency** supported by a competitive bidding environment
- 4.11. If time were – as suggested<sup>10</sup> – the focus of the procurement strategy, this would not suggest extensive use of contract models<sup>11</sup> that **best ensure capital efficiency and promote a target cost with an activity schedule, sharing out-turn financial risks between the client and the contractor** in an agreed proportion
- 4.12. It is therefore hard to escape the conclusion that – in the rush to start construction, budgeting, procurement and execution of the expansion project are likely to have lacked sufficiently strong corporate governance to control expenditure, and that a **large proportion of expenditure is likely to have been inefficient as a result**
- 4.13. Consumers should not have to pay for Heathrow's inefficiencies, and the RAB should not be used to mop up all Heathrow's expenditure risks; we **continue to support the CAA in carrying out its crucial work on establishing efficiency of any expansion expenditure**

Yours sincerely,



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<sup>10</sup> [Civil Aviation Authority, CAP1996, Appendix C para 8](#)

<sup>11</sup> [NEC3: Engineering and Construction Contract Option C](#)