

# Independent Planning Cost Review on costs relating to the Heathrow Expansion Programme covering the period 2016 and 2017



**Published by the Civil Aviation Authority, January 2019**

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On 25 October 2016, the Government announced its support for a third runway at Heathrow to expand airport capacity in South East England. We have consistently said that more airport capacity will benefit passengers and are taking steps to develop a framework for the economic regulation of capacity expansion that will incentivise Heathrow Airport Limited (HAL) to deliver new capacity in a way that is affordable, efficient and financeable.

As part of our work on developing the framework for economic regulation, we published a policy statement (CAP 1513) in February 2017 (supplemented by further guidance (CAP 1651) in April 2018) on the recovery by HAL of costs associated with obtaining planning permission for the capacity expansion. These costs are known as Category B costs and largely relate to the period post-25 October 2016 when the government made its decision to support the third runway at Heathrow. HAL is required to provide an annual statement setting out the Category B costs incurred in the prior year, with sufficient detail to allow for effective scrutiny.

In April 2018, we engaged PwC - as the Independent Planning Cost Reviewer - to undertake an assessment of the Category B costs identified by HAL as being incurred for the period 2016 and 2017. Specifically, they were instructed to consider:

- whether the Category B costs identified were supported by appropriate evidence;
- whether the costs identified were correctly categorised as Category B costs; and
- whether there was evidence to indicate the Category B costs had been incurred in an efficient manner.

This review took place between May 2018 and August 2018 and the associated report is published here: [www.caa.co.uk/cap1750](http://www.caa.co.uk/cap1750)

The key findings of PwC's initial report included:

- HAL provided a statement of Category B costs to enable PwC to undertake its review. It also provided a breakdown of these costs by cost category. However, HAL was unable to provide comprehensive supporting information that reconciled to the statement and, following a further request from PwC, provided a large number of invoices and other accounting records (including payroll information) in support of its statement;
- Nonetheless, PwC was unable to fully reconcile this evidence to the statement of Category B costs provided by HAL, with only 60% of the costs (including operating costs) identified by HAL as Category B costs being supported by evidence; and
- PwC also noted that the information provided by HAL included duplicate invoices and referencing/naming inconsistencies, which made the allocation of invoices to the cost categories particularly challenging.

As a result of the significant variance between the Category B costs identified by HAL and the initial total values derived by PwC from the evidence that HAL had provided to support its estimates of costs, HAL requested that we extend the period of the review and allow it to provide further information. Bearing in mind that this is a new process, we decided to agree to HAL's request and we asked PwC to produce a supplementary report that would expand its original assessment to cover this new additional information.

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PwC undertook the further review in the period between August 2018 and November 2018 and its supplementary report is published here: [www.caa.co.uk/cap1751](http://www.caa.co.uk/cap1751)

Taken together the key findings of the initial and supplementary reports include:

- Through this further information, HAL was able to provide evidence for the large majority (96.5% or £79.3 million of a total of £82.2 million) of the Category B costs identified. The variance of £2.8 million between HAL's suggested Category B costs and the evidence provided consisted of the following:
  - £1.4 million of low value invoices for which HAL advised that it would have been inefficient to dedicate the necessary resources to provide the invoices given the relatively small values and percentage of the overall amounts claimed. No schedule of these invoices was provided;
  - £1.4 million comprising of multiple accruals, each of which was below £100,000. *Note the CAA guidance note CAP 1651 requires that supporting calculations are only required for accruals greater than £100,000.*
- The review found that, while the large majority of costs were correctly classified, there were some costs for which evidence had been provided but may not have been properly classified. In particular, in relation to 2016 PwC noted that £0.3 million of costs categorised as having been incurred after 25 October 2016 appeared to have been incurred earlier in 2016 and so might be Category A<sup>1</sup> rather than Category B costs. Further in relation to the 2017 cost statement it was not clear that £1.2 million of staff costs related solely to seeking planning consent and a further £0.5 million of costs appeared to have been incurred in 2018 rather than 2017; and
- In considering whether Category B costs had been incurred in an efficient manner, the review notes that it considers the expansion programme in the early stage of its lifecycle and that as the programme develops and matures, certainty should increase, allowing HAL to provide better information on costs and efficiency. It notes that there is evidence to suggest that activities undertaken in 2017 were delivered later than originally anticipated, but that the overall expansion programme underspent against budget during the year. However, it notes that the consequential impact of the delays on the overall schedule and cost forecast are unclear.

Taking account of the IPCR reports, and in the context of our statutory duties, the CAA needs to consider what Category B costs HAL should be entitled to recover for 2016 and 2017. To inform this decision, the CAA is seeking views on the IPCR reports. The CAA's final decision on how much Category B costs HAL is allowed to recover would ultimately be given effect through a licence modification.

While the CAA has not reached any final decisions on how much Category B costs to allow HAL to recover for 2016 and 2017, our initial views are that:

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<sup>1</sup> Category A costs are defined as Airports Commission-related and associated lobbying costs incurred before the Government's decision on 25 October 2016, as set out in CAP 1469 (published in November 2016).

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- in relation to 2016, HAL suggested its post-25 October Category B costs were £4.4 million and provided evidence to support £3.9 million of these costs. PwC has noted that £0.3 million appear to relate the period before 25 October 2016. **We are initially minded to allow £3.6 million as Category B costs for post-25 October 2016 costs given the analysis and views of PwC. This means that £0.9 million of Category B costs originally claimed by HAL for post-25 October 2016 costs are at risk of disallowance, but the CAA will not make a final decision until we consider responses to this consultation.** HAL has made a separate submission on the £0.3 million of pre-25 October costs and also suggested certain other pre-25 October 2016 costs should be reclassified as Category B costs. We will deal with pre-25 October 2016 costs in our consultation in Spring 2018;
- in relation to 2017, HAL suggested its Category B costs were £77.8 million and provided evidence in relation to £75.4 million, with PwC suggesting that £1.7 million of these costs may not be properly justified. **We are initially minded to allow £73.7 million as Category B costs for 2017 given the analysis and views of PwC. This means that £4.1 million of Category B costs originally claimed by HAL for 2017 costs are at risk of disallowance, but the CAA will not make a final decision until we consider responses to this consultation;**
- We note that our initial approach described above includes disallowing the £2.8 million of low value invoices and accruals:
  - In respect of the low value invoices, had HAL put the systems in place to properly record these costs it would have been relatively straightforward for HAL to provide better supporting information on these costs (e.g. a schedule of these costs that provides a breakdown by invoice). In the absence of such systems and information it is not clear that there is sufficient evidence to support regulatory costs allowances, and so these costs remain at risk of disallowance. Nonetheless, we will consider any further representations we receive in relation to these matters.
  - In respect of the accruals, while we note the CAA's policy note to only provide calculations for accruals greater than £100,000, we have concerns at the overall level of these accruals. Given the timing of the supplementary review (circa 8 months after the end of 2017) we would have expected only a de minimis level of accruals. In the absence of further information on these matters, these costs remain at risk of disallowance. As above, we will consider any further representations we receive in relation to these matters.
- We have concerns over the quality of the information which was initially provided to facilitate the review and the time subsequently taken by HAL to provide appropriate evidence to support its Category B costs. HAL has actively engaged in a lessons learnt exercise and we expect HAL to provide better information on costs and efficiency for future years (including 2018). When we review our regulatory policy for the treatment of Category B costs (discussed below), we will also consider whether any additional measures are needed to promote appropriate governance and monitoring of Category B costs by HAL.

In October 2018 it emerged that HAL's forecasts of Category B costs for future years have increased very significantly. Our February 2017 policy statement said that we would

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review the regulatory treatment of Category B planning costs if the expected level of these costs were to exceed £265 million in 2014 prices. In the light of HAL's forecast increase in these costs, we will issue a consultation paper on these matters in Spring 2018.

We would welcome comments from stakeholders on any of the matters discussed above or raised in the PwC reports by Friday 8 February. Responses should be emailed to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk).

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex.

Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Anna Bowles ([anna.bowles@caa.co.uk](mailto:anna.bowles@caa.co.uk)).