

## Opening Q5 regulatory asset base

### Introduction

1. This appendix discusses BAA's calculation of Stansted's RAB and explains our recommendation to the CAA for the appropriate value of Stansted's opening RAB in Q5.
2. We set out the main components of the RAB, and how the value has changed over the last two quinquennia. The appendix begins with the derivation of the opening balance for Q3, on 1 April 1997, and considers how this balance has been rolled forward by BAA to estimate a value of £1.3 billion as at 31 March 2009.
3. We also compare the actual rolled forward balances of the RAB with the projected balances set at the beginning of Q3 and Q4. Because of the size and uncertainty involved with large capex projects, there will usually be a difference between the actual and projected RAB, and we describe the procedure for dealing with these differences.

### Function of the RAB

4. The RAB is a proxy value of the airport's regulated operating assets, upon which the owner of the airport earns a return. The RAB represents the capital invested rather than being a list of the assets acquired at a certain valuation (the term of regulatory capital value (RCV) may be more useful, but we have continued to use the conventional RAB terminology). This concept underpins the treatment of disposals, the inclusion of capex and the indexation methodology.
5. Once an asset has been included in the RAB by the CAA, and a return allowed upon it, there is a form of 'regulatory contract' created, which sets the parameters for valuing the RAB. Several ideas have been put to us regarding possible changes to the way assets are excluded from or included in the RAB, and methods of valuation once assets are included. However, we believed that there is a risk that changing the rules for assets which have already been included in the RAB, and so breaking this regulatory contract, might cause wider distortions to airport incentives.
6. The RAB is one of the major building blocks of a traditional price cap determination. The airport is allowed a yield on the RAB (at the rate of the cost of capital) and is allowed a return of the RAB through depreciation. The higher the RAB, the greater the level of airport charges that the airport is allowed to levy.
7. Due to the method of updating the RAB (see paragraphs 9 to 13), the RAB will inevitably differ from the value of assets in Stansted's statutory accounts. However, as the RAB acts as a unit of regulatory value, it does not need to correspond with reported asset values.
8. At each quinquennial review the CC and the CAA have to determine:
  - (a) the opening RAB balance for the beginning of the first year of the control period (also known as the opening rolled forward balance)—for Q5, this is the balance as at 1 April 2009; and
  - (b) the closing RAB balances for each year of the new control period—these balances are calculated by taking the opening balance from (a) and adding

forecast capex and deducting forecast depreciation and forecast disposals for each year, until the end of Q5 at Stansted (31 March 2014).

### Calculating the opening RAB value

9. In Q1 and Q2, there was no calculation of an opening RAB figure when setting airport charges. Rather, the level of X was linked to the need for returns on projected net operating assets to be broadly comparable to an appropriate cost of capital for BAA.<sup>1</sup>
10. Following the recommendations from the Q3 Monopolies and Mergers Commission (MMC) report, the CAA implemented an opening RAB value of £550 million for Stansted for the beginning of Q3 (1 April 1997). This value reflected the airport's accounts (prepared on a current cost accounting basis) for the year ended 31 March 1991,<sup>2</sup> updated for actual capex, depreciation and RPI movements for the following five years to 31 March 1996, and projected capex, depreciation and the RPI movements for the year ended 31 March 1997.
11. The CAA and CC continued with this indexed historical cost-based methodology in Q4. By indexing the asset values for the effects of inflation, this approach limits the degree to which values of large airport assets with long service lives are understated. Indexation by RPI is also consistent with the application of a real (rather than nominal) cost of capital (see paragraphs 26 and 27).
12. In setting airport prices for Q5, an opening RAB value needs to incorporate the capex undertaken by Stansted during Q4 (extended by one year). This calculation involves taking the opening RAB balance at the beginning of Q4 and updating it for actual capex and RPI movements during the period. This will result in an opening RAB balance for Q5 that will more closely reflect the actual value of Q4 capex, rather than the capex projected at the previous review. However, for the reasons outlined in paragraphs 19 to 22, the RAB is updated using projected depreciation during Q4, rather than actual depreciation.
13. As well as establishing the opening RAB, estimates are required for the closing RAB balances for the five years of the Q5 control period. Calculating these estimates involves projecting the capex (net of disposals) and depreciation for each year over the period. Given the relative uncertainty involved with large capex projects (both in terms of scope and the ultimate cost), there will be a variance between actual and projected capex over the quinquennium, which means that the actual and projected RAB balances at the end of Q5 are likely to differ. However, assuming the same regulatory framework were still to be in place, there would be another ex-post review at the end of Q5 to determine the opening RAB balance for the start of Q6.

### Criteria for inclusion of capex

14. The regulatory contract is that capex that has been agreed with the regulator will not at a later date be excluded from the RAB by future regulators. It is this 'contract' that provides certainty and creates a context in which there can be incentives to invest. However, during the course of a quinquennium, the capex programme changes: some projects do not occur, some new projects arise, and the scope and cost of many pre-agreed projects change. It is the role of the CC to recommend, and the CAA to determine, whether the capex over the course of the quinquennium should be included in the RAB.

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<sup>1</sup>BAA plc: *A report on the economic regulation of the London airports companies*, June 1996, paragraph 4.25.

<sup>2</sup>Capital employed values (unaudited) as shown in Tables 3.14, 3.15 and 3.16 of the 1991 MMC report.

15. As explained in paragraph 12, we only recommend including in the opening Q5 RAB (closing Q4 RAB) the actual capex that was spent in Q4 rather than the amount which was forecast at the start of the quinquennium. However, we test the actual amount spent against two criteria, which were set out by the CAA in its 2003 determination, when it said that, in order for capex to be included in the RAB, there must be:
- (a) adequate consultation with airport users, as specified by BAA's agreement with CAA on enhanced information disclosure and consultation (Annex 4 to the CAA's 2003 February decision); and
  - (b) efficient management of the investment projects undertaken.
16. With regard to consultation, the CAA interpreted its requirement to mean that BAA should include all large projects in its annual CIP and use this document as the basis for consultation. The airlines strongly disagreed and believed that further information was required, including the provision of a much more comprehensive airport business plan. In this appendix we are concerned with the extent to which BAA complied with the criteria, as set out by the CAA, in order to determine what capex to allow into the RAB. Our considerations of whether any failures in the consultation process were against the public interest are set out in Section 13 of the main report and in Appendix M.
17. As regards SG2, the CAA published a number of papers during the course of Q4 on the treatment of the preliminary expenditure (pre-spend) which refined the CAA's position. Its final position (set out in its March 2006 statement: Regulatory treatment of preliminary expenditure on new runway capacity—A CAA follow up document) was expressed as follows:
- The CAA currently takes the view that there is a case for allowing net preliminary expenditure, including an annual return of 7.75% to be added to the Stansted RAB at 1 April 2008, having regard to the extent to which:
- (a) as far as practicable, BAA consulted users (including both airlines and passengers) on the level of preliminary expenditure before it was incurred;
  - (b) BAA had followed best practice management and operated proactively the enhanced information disclosure and consultation agreement, consulting effectively with well informed users;
  - (c) the expenditure was genuinely additional and related to the development of new runway capacity with any additional return being included in the Stansted RAB based on the excess of total outturn capex over and above the projections made at the time of the last price control review, up to a maximum return equal to the return on net preliminary expenditure.
18. In determining what Q4 capex should be included in the RAB, we concluded that we should have regard to the criteria set by the CAA for Q4, and as interpreted by the CAA in Q4. We considered each project in this light.

## Depreciation

19. In its initial Q4 recommendations, the CAA proposed<sup>3</sup> that projected rather than actual depreciation was to be used when rolling forward the RAB from one quinquennium to the next, ie the projected depreciation for Q3 would not be adjusted when setting the opening RAB for Q4. The CC, in its subsequent recommendations to the CAA, differed from this approach, and argued that the CAA's treatment created an inconsistency between capex and depreciation. The CC added that there was no suggestion in the previous Q3 MMC or CAA reports that the RAB should be rolled forward in any way other than using actual depreciation. Accordingly, the CC recommended using actual depreciation.<sup>4</sup>
20. Despite the CC's recommendations, in its final decision the CAA applied projected depreciation when rolling forward the Q3 RAB to the beginning of Q4. It argued that this amount reflected what customers had paid for, and that projected depreciation lowered the scope for gaming (ie BAA could overstate projected depreciation in order to obtain a higher revenue requirement, but if the RAB was subsequently rolled forward using this overstated depreciation, there would be lower prices in future periods (due to a lower RAB) and this effect would reduce any incentive to overstate depreciation in the original projections).
21. The CAA also argued that the use of projected depreciation would remove the disincentive for BAA to carry out additional non-revenue-earning capex (eg improving service quality) over and above that included in the projection, since BAA would not be penalized with a lower RAB in future reviews from rolling forward using the higher-than-projected depreciation.
22. In its 2003 determination, the CAA decided that projected depreciation would be used for calculating the rolled forward RAB numbers in Q4.<sup>5</sup> We accepted the reasons given by the CAA in its 2003 determination and recommend that projected depreciation continues to be used in Q5.

## Method of indexation

23. The RAB includes assets at cost and increases these costs in line with RPI. As explained in paragraph 4, the RAB represents the amount of capital invested, rather than a valuation of individual assets.
24. In its reference to us, the CAA noted:<sup>6</sup>

The 'standard' building-block price cap calculation is based on a measure of historical costs incurred, rather than necessarily reflecting the replacement cost of the airport's assets. There are a number of factors that might be expected to lead to a divergence between the historical costs incurred—as measured by the Regulatory Asset Base—and the relevant measure of replacement cost, including ... the price index applied to the RAB and whether this accurately reflects the increase in cost of airport expansion.

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<sup>3</sup>Heathrow, Gatwick and Stansted Airports' Price Caps, 2003–2008: CAA reference to the Competition Commission February 2002.

<sup>4</sup>BAA plc—A report on the economic regulation of London airport companies, October 2002.

<sup>5</sup>Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003–2008 CAA Decision February 2003, Annex 6.

<sup>6</sup>Paragraph 8.99ff.

25. The CAA noted that it had not undertaken any detailed analysis in this area. However, it believed that the replacement cost of investment projects of a similar size to those of the current Stansted operations would be above the current accounting value of the Stansted RAB, which was £969 million in the airport's 2006/07 regulatory accounts.
26. We considered what method of indexation should be applied to the RAB. The point of principle for regulators is that, in setting the allowed return, the return in question is a real rate of return (ie the return that lenders and shareholders actually require minus RPI inflation). Investors have to be compensated for the missing RPI somehow and the standard approach is to add it to the RAB. It is for this reason that the RAB is multiplied by RPI-measured inflation.
27. We believed that RPI is an appropriate measure of inflation, on the basis that the purpose is to maintain the purchasing power of the capital invested. The relevant rate of inflation should reflect the change in prices of some agreed basket of goods and services in order to reflect the idea that the investment in the airport is sacrificed consumption. We concluded that RPI is a broad measure of consumer inflation and, therefore, that it is an appropriate measure to reflect the effect of sacrificed consumption. Therefore, we recommend the continued use of RPI to inflate the value of the RAB each year.

### **Asset disposals**

28. The alternative ways to account for disposals in Q4 when rolling forward the RAB are to subtract either the net book value (NBV) or the proceeds.
29. In the Q3 and Q4 reviews, the MMC/CC rolled forward the RAB by deducting the proceeds rather than the NBV. The CAA accepted this recommendation as, under this approach, the airport should be relatively indifferent to retaining or disposing of the assets if the 'right' cost of capital has been set (ie they would earn similar returns investing the proceeds in other uses). The CAA added that the treatment was also consistent with the single till, as any gain on sale (the amount of proceeds in excess of the NBV) would adjust the RAB in the next review and have the same effect on future charges as the continuation of the stream of net revenue from the disposed asset.
30. However, under the approach of deducting proceeds, the airport does not have any incentive to dispose of assets when the proceeds exceed the capitalized value of expected future revenue (ie if, by assumption, the future allowed rate of return is equal to the cost of capital, the capitalized value of expected future revenue associated with an asset is equal to the asset's RAB). Under this approach, the airport does not have an incentive to transfer assets to non-aeronautical uses when the non-aeronautical value is greater than the value in the RAB but less than the economic value derived from aeronautical uses.
31. When an asset is sold, the effect on airport charges will depend on the asset's current revenue (net of costs and any depreciation) as a percentage of the proceeds. As long as the net yield on the asset is lower than the cost of capital, airport charges will be lower after the next review as a result of the disposal. Under this approach, the airport also has an incentive to defer any disposals until after a regulatory review, since it continues to receive higher airport charges for the rest of the quinquennium.
32. We considered the arguments for the different treatment of disposals. We concluded that the existing policy should continue, ie using the value of the proceeds rather than

the NBV. We believed that airport users should be entitled to the gains arising from the sale of airport assets.

33. We also considered whether we should deduct the proceeds of a disposal gross or net of capital gains tax (CGT). In our 2007 Heathrow and Gatwick review we found evidence to suggest that deducting the gross proceeds of disposals from the RAB, rather than the proceeds net of CGT, would be detrimental to BAA and could also be detrimental to the airlines if it discouraged BAA from making disposals. Accordingly, we recommended that the CAA should use the net proceeds when deducting asset values from the RAB and the CAA accepted our recommendation. We recommend the same treatment, using net proceeds, for rolling forward the RAB at Stansted.
34. In our 2007 Heathrow and Gatwick review we also considered whether BAA was entitled to a return on assets which were sold early in Q4. The CAA argued that the revenue allowance in Q4 would have been calculated assuming that rental income from these assets would be received by BAA over the whole period, so the loss of rental income (due to the asset disposal) would, to some extent, have offset the return BAA received on the assets. The CAA accepted our recommendation that there should be no adjustment to the return. We recommend that, for Stansted, there should be no adjustment to the return on the RAB for asset disposals early in the period.

#### ***Actual asset disposals at Stansted in Q4***

35. We reviewed Stansted's asset disposals in Q4 and we queried the valuation applied to property interests, which were initially transferred from STAL to BAA Partnership Ltd, a wholly-owned subsidiary of BAA, and subsequently transferred to Airport Property Partnership (APP), a joint venture.
36. In September 2004, BAA valued these properties at £72 million. In February 2005, Stansted sold them to BAA Partnership Ltd but used the September 2004 valuation for the transfer, even though property prices had increased in the intervening period.
37. The CAA commissioned Atisreal to consider the property valuations used by BAA. Although Atisreal looked at the reasons for the increase in property values between September 2004 and February 2005, it did not suggest that BAA should have used a more up-to-date valuation.
38. We considered whether a higher valuation should have been used. However, given the advice of Atisreal to the CAA, we accepted that there should be no further reduction to the RAB. In doing so, we noted that, particularly after taking account of CGT, the difference in value was not significant.
39. Therefore, we recommend that the net proceeds from the disposal of the properties, using the September 2004 valuation, should be deducted from the RAB.

#### **Profiling adjustment**

40. In its 2003 determination, the CAA deferred revenue from Q4 to Q5 so that Stansted achieved a 7.75 per cent return over ten years. At the start of Q5, this deferred income is projected to have a net present value of £55 million (in 2007/08 prices). As a result, the opening Q5 RAB is increased by £55 million. During the first four years of Q5, this cumulative profiling balance is reduced to nil as the deferred revenue is recovered.

41. We recognized that to disallow this amount at the start of Q5 would be to break the regulatory contract, and create significant regulatory uncertainty.
42. Therefore, we recommend that £55 million is included in the Q5 opening RAB, as envisaged in the CAA's 2003 determination.

### **Excluding assets from the RAB**

43. Ryanair argued that assets which were included in the RAB in previous quinquennia but which are not now required or used by current users should be deducted from the RAB.
44. We considered this argument but concluded that this treatment would breach the regulatory contract and create a significant risk that future investment would not be undertaken, due to concerns about a lack of regulatory commitment. In addition, we noted that it would be difficult to identify a value at which to remove items, as there would be no disposal proceeds and individual assets are not readily identifiable within the RAB.
45. We noted that the RAB approach is based on the premise that investments made by the regulated utility should be considered in terms of their constant purchasing power. The regulator recognizes that the value of the capital invested in the business is a form of deferred consumption, the buying power of which is to be preserved, so once the regulator has accepted that the capital has been appropriately invested, there is no logic for disallowing some part of it in the future. Equally, a change to some form of replacement cost valuation of the assets would represent a new approach and would be inequitable if it produced a return lower than that calculated on the basis of the RAB.
46. We recommend that any assets which were previously included in the RAB prior to the start of Q4 should not be excluded from the opening Q5 RAB.

### **Pensions adjustment**

47. As set out in Appendix J, we recommend that an adjustment should be made to the RAB for the Q3 pension fund contribution holiday at Stansted. This adjustment will avoid customers effectively having to contribute again towards pension costs that they have already funded and avoid any need for further adjustments in future price reviews.
48. We recommend that the Stansted opening RAB is reduced by £16.9 million (in 2007/08 prices). We noted that this adjustment is consistent with the adjustments made to the RABs for Heathrow and Gatwick.

### **RAB—Q3**

49. The opening Q3 value of the RAB, £550 million, was derived from BAA's accounts in 1991, updated for actual capex, depreciation and RPI adjustments. The rolled forward value of the RAB over Q3 is shown in Table 1. (The Q3 period was extended by one year in order for the review to take into account the T5 planning decision at Heathrow.)

TABLE 1 Roll forward of RAB—Q3

	<i>£ million, out-turn prices</i>					
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Opening RAB	549.8	570.1	604.7	653.6	752.3	824.0
Net capital expenditure	19.8	46.1	46.6	104.5	83.0	37.9
Depreciation charge	-16.8	-17.0	-18.6	-22.1	-24.2	-29.9
Adjustment for investment properties	2.3	3.2	3.2	2.3	2.6	0.0
Property transfers to Lynton	-5.9	-22.4	0.0	0.0	-0.9	0.0
Adjustment for non-RAB transfers	0.0	14.0	0.0	0.0	0.0	0.0
RPI adjustment	20.9	10.6	17.7	13.9	11.3	21.9
Closing value	570.1	604.7	653.6	752.3	824.0	854.0

Source: CC 2002 report on economic regulation of the London airports companies.

50. The RAB value increased from £550 million to £854 million over the Q3 period, (based on forecast capex for 2002/03). Using the actual capex and proceeds in 2002/03, the RAB value at the end of Q3 was £864 million.

## RAB—Q4

51. The rolled forward Q4 value of the RAB, as provided by the CAA in its reference to us, is shown in Table 2. The capex and depreciation figures for the years ended 31 March 2008 and 31 March 2009 are based on projections provided by BAA (the CAA made its reference before the actual figures were available). These figures are on the basis of allowing into the RAB all actual capex in Q4, including expenditure on SG2.

TABLE 2 Roll forward RAB—Q4

	<i>Out-turn, £ million</i>					
	2003/04	2004/05	2005/06	2006/07	2007/08 (projected)	2008/09 (projected)
Opening basic RAB value	863.6	873.7	862.0	912.1	1,028.3	1,134.0
Capital expenditure	19.4	51.4	65.9	111.4	118.2	131.8
Proceeds from disposals	0.0	-59.4	0.0	-0.1	0.0	0.0
Depreciation charge	-31.7	-31.8	-36.4	-40.5	-45.8	-41.7
RPI adjustment	22.4	28.1	20.6	45.4	33.3	27.9
Closing basic RAB	873.7	862.0	912.1	1,028.3	1,134.0	1,252.0
Profiling adjustment (cumulative)	12.5	19.3	31.2	43.2	51.4	56.7
<b>Closing RAB value</b>	<b>886.2</b>	<b>881.3</b>	<b>943.3</b>	<b>1,071.5</b>	<b>1,185.4</b>	<b>1,308.7</b>

Source: CAA report (ref 'source: BAA').

Note: The difference of £10 million between the opening Q4 RAB and the closing Q3 RAB is due to differences between actual and forecast capex in 2002/03.

52. We noted that the RPI adjustment in 2008/09 uses a lower RPI figure than we believed is actually appropriate, but this difference was due to the timing of the CAA report. We have not recalculated the figures provided above, which are shown as presented in the CAA's reference to us.
53. In 2007/08, the closing RAB balance of £1,185.4 million, forecast by BAA, was very close to the balance projected by the CAA at the start of the quinquennium. Despite underspending against its capex forecasts early in Q4, BAA spent more than forecast in the second half of the period.

## Actual Q4 capex

54. We set out in Table 3 the actual capex that was spent at Stansted during Q4. The amounts differ from the forecast capex shown in Table 2.

TABLE 3 Actual expenditure

							£000s	
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09 (forecast)	Total Nominal prices	Total 2007/08 prices
SG1 (and other capex)	19.1	23.2	28.0	71.5	76.8	83.0	301.7	308.4
SG2	-	29.4	35.2	42.8	33.9	46.1	187.3	193.0
Total	19.1	52.6	63.2	114.4	110.6	129.1	489.1	501.4

Source: BAA.

Note: 2008/09 is a forecast.

55. Any capex which was envisaged in the CAA's 2003 determination but which has not been spent is excluded from the RAB (approximately £218 million, in 2007/08 prices, for the first five years of Q4).
56. We noted that the amount of SG2 pre-spend, which was not envisaged, was very close to the underspend on SG1. However, BAA asserted that there was no linkage between the two numbers, and that the SG2 capex was agreed internally before it was apparent that there would be any underspend elsewhere. Nevertheless, we noted that the phrase 'available capital expenditure' was used widely in BAA's annual CIPs, which appeared to indicate that the capex amount allowed for in the CAA's determination may affect the total amount of capex undertaken. This phrase gave us the impression that BAA uses its B-list projects to maximize its spend against the available limits. We recognized that BAA refuted this suggestion.
57. There are two categories of capex which were spent in Q4, which we considered separately:
- (a) capex that was envisaged in the CAA's 2003 determination, worth £188 million (in 2007/08 prices) (see paragraphs 59 to 69); and
- (b) capex that was not envisaged in the CAA's 2003 determination, which is made up of:
- (i) *Additional SG1 capex.* In the first five years of Q4, BAA spent approximately £41 million (in 2007/08 prices) on SG1 projects, which were not envisaged in the CAA's 2003 determination. In addition, due to the extension of the quinquennium into a sixth year, none of the capex in 2008/09 was envisaged in the CAA's 2003 determination, forecast to be worth approximately £79 million (in 2007/08 prices) (see paragraphs 73 to 91).
- (ii) *SG2 capex.* The CAA's 2003 determination did not include any expenditure on SG2 but, over the six years of Q4, BAA is expecting to have spent approximately £193 million (in 2007/08 prices) on preliminary expenditure on this project (see paragraphs 92 to 190).
58. We discuss each of these categories in turn.

### **Capex envisaged in the CAA's 2003 determination**

59. Table 4 shows the large projects envisaged in the CAA's 2003 determination. (We consider minor projects separately in the following section.)

TABLE 4 Large projects included in the determination for Q4

		£ million, nominal prices	
		Actual capex Q4 (5 yrs)	Forecast spend Q4 (5 yrs)
<i>Capex actually spent</i>			
ST16	RATS and RETS	0.1	7.6
ST20	MSCPs	0.1	44.7
ST21	Core Terminal Enhancements		8.2
ST21 c	Ryanair kiosks	0.4	
ST21a	(*) TP—Additional Reclaim	0.1	
ST26	Aprons and Taxiways		30.5
ST26a3	ECHO Cul de Sac	12.2	
ST27	Long-Stay Car Parking	0.0	8.2
ST29	Surface Access		31.4
ST29	ST—RAIL (Section 106)	1.4	
ST29 b	Jct 3 Grade Sep/Dual Thremhall	0.0	
ST14	Cargo Development	0.0	7.2
ST22	Runway Resurfacing	28.8	18.7
ST24	Satellite 4	-0.1	21.1
ST28	Car-Parking Strategy	0.0	9.5
ST30	Arrivals Extension	40.7	39.0
ST31	Public Transport Interchange	3.8	10.3
ST32	Departures Extension	<u>0.0</u>	<u>12.2</u>
	Total	87.6	248.6
	Total (2007/08 prices)	90.2	
<i>Capex not spent</i>			
ST2	Standby Runway	-	33.1
	Other	-	14.8
	Total	-	47.9

Source: BAA.

Note: Where projects included but amount given is £0, some de minimis capex occurred.

60. Overall, there was a substantial reduction in the number and scale of projects which were undertaken in Q4 compared with the amounts in the CAA's 2003 determination. A number of projects did not occur, including the Standby Runway, which was cancelled following the ATWP in 2003, and the extension of the TTS to satellite 3, which reflected the requirements of Stansted's current airline users.
61. Only one of the envisaged projects cost significantly more than forecast: the Runway Rehabilitation/Resurfacing, which cost £29 million compared with a forecast of £19 million. In a report for the CAA on 'BAA's Performance in Capital Investment Project Management and Cost Efficiency at Stansted Airport during Q4'<sup>7</sup>, C&B found that that the amount spent by the CAA still represented an economic investment.
62. C&B also considered four specific projects in some detail: the Arrivals Extension, the Runway Rehabilitation, the Echo Cul de Sac North West Sector and the Hold Baggage Screening Upgrade (this project was not in the 2003 CIP but was included in the 2004 CIP).
63. C&B was critical of the information that was provided by BAA to the airlines and of the consultation process that occurred. In particular, C&B noted the poor quality of the cost information on the Echo Cul de Sac North West Sector project. However, C&B concluded that all of the four projects occurred broadly at the right scale and at the right time.

<sup>7</sup>Supporting paper I to the CAA reference, May 2008.

64. In reviewing BAA's current and future capex plans for us, ASA noted that the capacity provided by the Arrivals Extension was considerably greater than that needed and expressed some surprise that a smaller scheme had not been promoted. We noted that, in February 2006, BAA considered the option of building a half bay extension, which would have been capable of delivering a capacity of 35 mppa but would have cost approximately £10 million less than the full bay extension built by BAA. In principle, we thought that the smaller solution could have met the short- to medium-term capacity needs of the airport, but we understood BAA favoured the larger solution due to requiring significant process improvements in order to achieve its target service standards in 2014, and because the unit cost per sq metre was less. BAA has since told us that there were further reasons supporting its decision to build a full bay extension, but this information came late in our inquiry and we noted that it did not change our conclusion (see paragraph 68).

### *Minor projects*

65. In addition to the large projects in Table 4, there were a number of minor projects which were included, in total, in the CAA's 2003 determination. According to the CAA's criteria, there is no requirement for detailed consultation on small projects and so no requirement for these projects to be included in Stansted's annual CIP. We compared the forecast amount with the actual spend, as set out in Table 5.

TABLE 5 **Minor projects included in the determination for Q4 and actually spent**

	<i>£ million</i>	
	<i>Actual capex Q4 (5 yrs)</i>	<i>Forecast capex Q4 (5 yrs)</i>
Minor projects (nominal prices)	91.2	83.9
Total (2007/08 prices)	97.5	

Source: BAA.

66. The actual spend on minor projects in the first five years of Q4 was very similar to the amount envisaged.

### *CC recommendation*

67. For projects envisaged in the CAA's 2003 determination, we found that BAA appeared to have met the criteria set out by the CAA. Large projects were included in the CIP and all projects (including the total of small projects) were delivered within the amount included in the previous determination. Furthermore, the CAA's consultants found that the only project which exceeded its forecast cost still represented an economic investment. Overall, we concluded that BAA had met the CAA's requirement for consultation and we had some comfort that the projects had been managed efficiently.
68. We noted the reservations expressed by ASA with regard to the Arrivals Extension but we did not believe that we had sufficient reason to exclude this investment from the RAB.
69. Therefore, we recommend allowing into the opening Q5 RAB all capex projects which were included in the CAA's 2003 determination (at the actual amounts which were spent, rather than the amounts which were forecast).

### ***Capex not envisaged in the CAA's 2003 regulatory determination***

70. It is inevitable that some projects which are needed in a quinquennium will not have been anticipated at the start of the quinquennium. However, at Stansted in Q4, BAA spent approximately £313 million (in 2007/08 prices) on such projects (of which 62 per cent was preliminary expenditure on SG2), which makes this category of Q4 capex very material. It was also highly contentious, with the airlines disputing the necessity and efficiency of the vast majority of this amount. Therefore, we considered this area in detail.
71. At the end of the quinquennium, the regulator must determine whether the capex spent on these un-envisaged projects should be included in the RAB. In order to make this assessment, we assessed whether the CAA's criteria for inclusion, as interpreted by the CAA, had been met (as set out in paragraph 15).
72. In the following sections we set out the capex that was spent in Q4 but was not envisaged in the CAA's 2003 regulatory determination, and we present our findings on whether BAA satisfied the CAA's criteria for its inclusion in the RAB. This expenditure can be considered in three sections:
- (a) SG1 capex for the original five years of the quinquennium (£41 million in 2007/08 prices) (see paragraphs 73 to 83);
  - (b) SG1 capex in 2008/09 (£79 million in 2007/08 prices) (see paragraphs 84 to 91);  
and
  - (c) SG2 capex (£193 million in 2007/08 prices) (see paragraphs 92 to 190).

#### ***SG1 capex for the original five years of Q4***

73. Table 6 shows the capex on SG1, which was spent in the first five years of Q4 but which was not envisaged in the CAA's 2003 determination. The table also shows the year in which each project entered the CIP.

TABLE 6 **SG1 capex projects spent in the first five years of Q4 but not in the CAA's 2003 determination**

		<i>Actual capex Q4 (5yrs) (£m, nominal prices)</i>	<i>Which CIP did these enter?</i>
ST34	Short-Stay Car Parking Zone G	0.8	CIP 2004
ST35a	Fuel Farm tanks	0.1	CIP 2004
ST36	Hold Baggage Screening Replacement	8.1	CIP 2004
ST43	Security Compliance Projects	0.4	CIP 2004
ST44	Second Departures OOG	2.3	CIP 2004
ST46	Terminal Forecourt Dualling	2.1	CIP 2004
ST51a	Baggage System Replacement	0.5	CIP 2006
ST53	Short-Stay Car Parking Zones A–F	2.9	CIP 2006
ST65	Long-Stay Car Parking Upgrade	0.1	CIP 2007 (B list)
ST67	Check-In Island Sprinklers	0.1	CIP 2007
ST68	Central Security Enhancements	3.2	CIP 2007
ST69	CCTV Security	1.3	CIP 2007
ST72	Elev Approach Light Replacement	0.7	CIP 2007
ST74	Fixed Electric Ground Power	0.2	CIP 2007
ST75	Check-In Weigh Scales Replacement	0.2	CIP 2007
ST77	Satellite Capacity Pre Sat 4	0.5	CIP 2007
ST85	ST—Section 106 25mppa P&E	6.2	N/A
ST86	Consultants' Fees for 25+	<u>10.1</u>	N/A
	Total	39.9	
	Total (2007/08 prices)	41.4	

Source: BAA.

*Notes:*

1. Consultants' fees (ST86) comprised numerous individual amounts less than £2 million.
2. The section 106 agreement was signed in 2003 and contained 132 obligations including the reconstruction of the bus and coach station and regular monitoring and setting of environmental targets.
3. N/A = not applicable.

74. The principal costs were for the hold baggage screening replacement project, and the consultants' fees and section 106 costs, which related to an agreement signed in 2003 as part of the planning permission to develop the airport to 25 mppa.

*Consultation*

75. BAA ensured that all large SG1 projects were included in the relevant CIPs and issued these CIPs for consultation.
76. Therefore, we accepted that BAA had satisfied the CAA's requirement for consultation on these projects.
77. This decision did not mean that we believed that there had been an effective process of consultation, but simply that BAA had satisfied the CAA's criterion, as interpreted by the CAA. Indeed, we found there to be little evidence of really effective engagement between the airport and the airlines in Q4 about the projects included in the CIPs, but we set out our findings on this issue in Appendix M.

*Capital efficiency*

78. The CAA's second criterion for inclusion in the RAB was that the capex should be managed efficiently (see paragraph 15).

79. C&B undertook an analysis of Stansted's Q4 capex for the CAA in March 2008. The CAA's conclusions in its reference to the CC,<sup>8</sup> on the basis of C&B's assessment, were that:
- (a) all the projects which were assessed were being delivered at the right time from a planning perspective;
  - (b) the sample projects were all broadly of the right scale, capacity and unit cost; and
  - (c) the facilities provided met the needs of current users; but
  - (d) there were concerns about the way in which BAA originally formulated the Q4 CIP, some deficiencies in programme governance for the overall management of cost and risk, and some deficiencies in aspects of the consultation with the airport's current airline users.
80. C&B reviewed the hold baggage screening project as part of its review for the CAA and found that the 'investment was appropriate' and that 'the delivered project is consistent with the anticipated demand profile'. Although C&B did not consider the consultants' fees or the section 106 costs in detail, it noted that, for both these items, 'the timing of expenditure appears to be appropriate'.
81. On the basis of C&B's analysis, we believed that BAA appeared to have satisfied the criterion of efficiency, as set out by the CAA.

#### *CC recommendation*

82. For the additional SG1 projects, which BAA undertook in the first five years of Q4 but which were not envisaged in the CAA's 2003 regulatory determination, we accepted that BAA had satisfied the two criteria for inclusion as set out by the CAA.
83. Therefore, we recommend that these additional SG1 capex projects, as set out in Table 6, should be included in the opening Q5 RAB.

#### *SG1 capex in 2008/09*

84. The criteria for inclusion of capex incurred in 2008/09 are the same as those for capex that occurred in the first five years of the quinquennium: consultation and efficient management (see paragraph 15).
85. Table 7 shows the revised capex programme for 2008/09.

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<sup>8</sup>CAA reference to the CC, April 2008, paragraph 8.96.

TABLE 7 2008/09 capex

		<i>2007/08 prices</i>
		<i>£m</i>
<i>A list</i>		
ST21 c	Check-in Island Kiosks	1.5
ST28 a	Long-Stay Car Parking Phase 5	1.0
ST30	Arrivals Extension	8.5
ST51a	Baggage System Replacement	0.6
ST77	Satellite Capacity Pre Sat 4	0.4
ST89	Border Control	3.5
Other A list projects		<u>55.9</u>
Total A list		71.4
<i>B list</i>		
ST49	TTS Control System	0.5
ST94	HVAC Plant Equipment	0.4
Other B list projects		<u>6.9</u>
Total B list		7.8
Total		<u>79.2</u>

Source: BAA.

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86. We were concerned that minor projects in 2008/09 amounted to £63 million (in 2007/08 prices), which represented approximately 80 per cent of capex for the year. As these projects are outside the normal process of consultation, ie they are not included in the CIP, they are also excluded from the CAA's requirement for consultation, and we have no evidence on them.
87. We considered the large capex projects in 2008/09 as part of our review of BAA's capex forecasts for Q5 (as both sets of projects are in the 2008 CIP). This process included rekindling a process of constructive dialogue between the airport and the airlines (see Section 8 of the main report).

### *CC recommendation*

88. For the large projects in 2008/09, we found that consultation, as required by the CAA, had occurred.
89. For the minor projects in 2008/09, which fall outside of the CIP, consultation is not required for inclusion in the RAB. However, given the materiality of these projects, we recommend that the CAA reviews these projects again in greater detail.
90. With regard to the capital efficiency of the large and minor projects in 2008/09, we did not find sufficient evidence to exclude them from the RAB.
91. Therefore, with regard to the 2008/09 capex, itemized in Table 7, we accepted that BAA had satisfied the two criteria for inclusion in the RAB, as set out by the CAA, and we recommend that it should be included in the opening Q5 RAB.

### **SG2**

92. We considered SG2 separately, as the CAA had explicitly excluded from its capex forecasts at the start of Q4 any potential costs relating to new runway capacity. Through the course of Q4, the CAA also provided additional guidance on the treatment of SG2 pre-spend (see paragraph 17).
93. BAA's expenditure on SG2 in Q4 has included spending on design and planning, blight and land acquisition and the necessary preparations for a planning application, as shown in Table 8.

TABLE 8 SG2 actuals and forecast for Q4

							<i>£ million</i>	
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	Total Out-turn prices	Total 2007/08 prices
Blight	-	15.8	16.4	24.4	18.2	22.0	96.8	99.8
Land acquisition	-	-	-	-	-	2.1	2.1	2.0
Professional fees	-	11.4	16.7	15.7	13.3	19.9	77.1	79.5
Project costs	-	<u>2.1</u>	<u>2.0</u>	<u>2.7</u>	<u>2.3</u>	<u>2.1</u>	<u>11.3</u>	<u>11.7</u>
Total	-	29.4	35.2	42.8	33.9	46.1	187.3	193.0

Source: BAA.

*Notes:*

1. 2008/09 is a forecast.
2. Blight costs include all acquisition and ownership costs and are net of any income from disposal or rental of properties.

94. In nominal prices, the total anticipated actual expenditure on SG2 in Q4 is approximately £187 million (equivalent to approximately £193 million in 2007/08 prices).
95. We set out below our considerations on BAA's SG2 expenditure in some detail, due to the size of the expenditure in Q4, both relative to the RAB and relative to the size of SG1 capex in Q4, and due to it being the cause of considerable disagreement between the parties. None of this expenditure was forecast in the last regulatory determination and so, in order for it to be allowed into the RAB, we must be satisfied that BAA has met the CAA's criteria for inclusion, both its general criteria (see paragraph 15) and its specific criteria for SG2 (see paragraph 17).
96. We received evidence from a number of sources on BAA's SG2 capex, including from BAA, the airlines operating at Stansted, the CAA and the DfT. We also commissioned two reports from ASA and gained legal advice on BAA's blight scheme.
97. In the following sections we set out the background to the planning system, government policy, the CAA's guidance on SG2 and the views of the parties, before considering each of the items of SG2 cost in more detail.

*The planning system*

98. Airport developments are inherently controversial and the subject of significant local opposition, both before and during planning inquiries, which can result in extended processes and additional costs.
99. BAA's approach to airline consultation may, to an extent, have been influenced by the company's perception of these planning risks.
100. An internal BAA board paper<sup>9</sup> identified three issues which the company considered to be critical to its success in securing planning permission for the growth of Stansted:
- (a) The integrity of the case: all the information which underpins the applications must be capable of being relied on in terms of setting out BAA's most likely view, eg any changes to air traffic forecasts, resulting in a different opening date for SG2 or a materially different build-up of traffic, would change the case. In this event, the inquiry may have to be suspended and the work redone at significant cost to BAA.

<sup>9</sup>Paper for the Board of Directors of BAA Limited, 22 November 2007.

- (b) Reliance on government policy: in order to benefit from the strength of the ATWP, it is important that BAA treats the ATWP as a package.
- (c) Speed: the more recent government policy, the stronger the support it confers upon BAA's applications. Accordingly, the quicker BAA acts to secure planning permission for SG2, the more it is able to benefit from the strength of government policy. Conversely, the longer BAA takes, the greater the likelihood of the policy being put at risk, either by virtue of a change to government policy or by challenge from opponents.

### *Government policy*

101. In December 2003, the Government published the ATWP, which identified Stansted as the airport where the first new runway in the South-East of England should be built, and said that it should be delivered as soon as possible (around 2011 or 2012). The ATWP also specified the type of runway development supported by the Government (a wide-spaced parallel runway to the east of the current runway), though this aspect of the ATWP was reversed in a judicial review in early 2005.
102. The ATWP made it clear that the timing of any planning application would be a commercial decision for the airport operator. The Government added that it was up to BAA to take forward the development at Stansted in a way that was responsive to users.
103. ASA noted that, prior to the ATWP being published, the DfT had asked BAA to set out '... proposals for a voluntary scheme to provide protection and/or redress for residential property owners who would otherwise suffer informal blight following publication of the White Paper ...'. BAA replied with initial ideas, based on earlier experience, and reflecting examples and precedents from other major infrastructure projects, including large rail and highway developments, and other projects such as power generation. These ideas were necessarily tentative, since BAA did not have clear knowledge of what policies might be set out in the ATWP. Once published in December 2003, the ATWP set out government policy on this matter:<sup>10</sup>

The prospect of airport development will in many cases have a wider impact on property values in the period before statutory protection is available. This is often referred to as 'generalised blight'. There is no statutory remedy for this, but we accept that people should have access to some form of redress, for example to help them relocate before the development takes place, if they need to do so. Arrangements are therefore being made for non-statutory schemes to be brought forward locally by the airport operator to deal with the problem of generalised blight where runways are supported by this White Paper or where land is safeguarded for future development.

This policy was interpreted by BAA and other UK airports which were affected (eg Birmingham, where an additional runway outside of its existing operational boundary was also proposed) as a clear indication that it needed to consider blight in any planning proposal for major expansion in response to the ATWP.

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<sup>10</sup>ATWP, paragraph 12.16.

104. By the time the ATWP was published the Government had determined its preferred scheme for Stansted's expansion. The ATWP stated:<sup>11</sup>

On balance, taking into account all relevant factors, and in the light of the responses to consultation, the Government now supports the development of a second runway at Stansted as the first new runway to be built in the South East. ... The new runway would be the wide-spaced runway option presented in the consultation document.

From BAA's perspective, the ATWP clarified the Stansted development option, confirmed a requirement for blight schemes to address generalized blight and allowed BAA to confirm the preparation of an application for the additional runway.

105. BAA also noted that, at the time of the ATWP, the local community at Stansted was expressing considerable concern about generalized blight. Consequently, BAA felt it necessary to respond by implementing an enhanced blight scheme very quickly.
106. Following legal action by the Stop Stansted Expansion (SSE) group, the ATWP was subject to a judicial review, with a judgment in February 2005. As a result of that judgment, the appropriate development scheme for Stansted, including the location of the second runway, was reopened and BAA began to reconsider alternative airport layouts other than those in the ATWP. However, this outcome had not been anticipated at the time of the ATWP or when BAA had created its blight schemes on the basis of the ATWP. Consequently, BAA had incurred costs which needed to be recovered irrespective of which development option was now chosen.
107. In December 2006 the Government published its ATWP review,<sup>12</sup> which noted that the blight schemes introduced by BAA at Stansted were supported by the Government and reflected the policy set out in the ATWP. The review stated:

The prospect of airport development can have an impact on property values in the period before statutory protection is available, leading to generalised blight. The Future of Air Transport White Paper recognised this and proposed that nonstatutory schemes be brought forward locally by airports where necessary. We welcome the fact that master plans have, in most part, acted as a catalyst for airports to bring forward schemes to address generalised blight. We encourage other airports to follow the examples already set by some airports: Stansted BAA has introduced voluntary non-statutory schemes to address the blight associated with the proposed development of Stansted. The first scheme enables homeowners within the proposed expanded airport boundary to sell to BAA for the full, unblighted market value of their property. The second aims to stabilise the housing market and provide financial support to homeowners close to the proposed expanded airport boundary where the prospect of increased aircraft noise is greatest.

108. The DfT drew our attention to the fact that the ATWP encouraged BAA to develop a blight scheme for Stansted quickly, recognizing the effects of the government policy at that time on local properties.

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<sup>11</sup>ATWP, paragraph 11.40.

<sup>12</sup>*The Future of Air Transport Progress Report: DfT 2006.*

## CAA approval

109. The CAA's 2003 price control determination was published at the end of February 2003. At that time, it was still unknown whether the Government would support development of an additional runway in the South-East and, if so, how specific the policy would be, in terms of the location of the new runway or the expected timing for its delivery. The CAA chose explicitly to exclude from its capex forecasts for Q4 any potential costs relating to new runway capacity at Stansted, though it did indicate that it was willing to consider proposals from BAA as to how any such investments should be handled consistent with the Act.
110. Table 9 shows the time frame of the CAA's consultation process in Q4 on SG2 expenditure.

TABLE 9 Chronology of dates relevant to SG2 programme

Date	
February 2003	Publication of CAA's price determination on London airports (including Stansted)
December 2003	Publication of 'Future of Air Transport' White Paper; BAA announces first blight scheme
June 2004	CAA consultation document on regulatory treatment of initial expenditure
September 2004	BAA introduces second blight scheme (HOSS)
November 2004	BAA introduces third blight scheme (SCS)
January 2005	CAA statement on regulatory treatment of initial expenditure
February 2005	High Court judgment on legal action by coalition of local authorities and campaign groups; withdrawal of CAA decision document
July 2005	Further CAA consultation on regulatory treatment of initial expenditure
December 2005	BAA three-month public consultation on different runway options
March 2006	End of public consultation on BAA's proposed runway options; CAA's final statement on regulatory treatment of initial expenditure
December 2006	Publication of the DfT's <i>The Future of Air Transport Progress Report</i>
January 2007	BAA report of consultation and proposed location of second runway announced
March 2008	BAA planning application submitted
July 2008	Planning application called in by Secretary of State

Source: BAA and the CAA.

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111. In June 2004, the CAA issued a consultation document on the regulatory treatment of initial expenditure on new runway capacity. It put forward three options but proposed to adopt one of them, which was to add preliminary expenditure to the RAB and to allow a return of 7.75 per cent.
112. The CAA suggested four safeguards, including the requirement that, as far as practicable, BAA should consult users (including both airlines and passengers) on the level of preliminary expenditure before it is incurred. However, the CAA noted that this safeguard would be difficult to achieve in practice for two reasons: first, the ATWP called for prompt action by BAA; and second, part of the purpose of the preliminary expenditure was, in itself, to generate options, and to that extent might reasonably be regarded as the price that must be paid for effective subsequent consultation. The CAA told us that this statement merely drew attention to the fact that some cost must necessarily be incurred in order to enable any meaningful consultation, but also that it should be recognized that this statement was made as part of a proposal for dealing with preliminary expenditure.
113. We reviewed minutes from a BAA meeting regarding the CAA's view of SG2 pre-spend. The minutes stated:<sup>13</sup>

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<sup>13</sup>Minutes of the SG2 Executive Committee, 28 October 2004, point 6.

The Group Planning and Regulatory Affairs Director updated the Executive on progress with the CAA to review the regulatory treatment of G2 and specific requirement for airline approval of the capital programme. It was confirmed that the CAA recognise the risk of this requirement to the G2 programme and that they had agreed to publish revised guidelines that provide the G2 project with an exception to this requirement.

These minutes suggested that it was BAA's understanding that the CAA envisaged that any SG2 pre-spend would be exempt from the normal capex approval mechanism. However, neither the CAA nor BAA has been able to provide any more detailed explanation.

114. In January 2005, the CAA published its decision, taking into account responses received from BAA, a number of airlines and the Air Transport Users Council. It decided to adopt its proposed approach. However, the CAA noted that there were differing views between BAA and some of its airline users on the nature and purpose of consultation. The CAA clarified that the obligation to consult did not mean that the agreement of all, or any predefined proportion of, current airline users was required prior to an investment being rolled forward into the Stansted RAB.
115. Following objections, the CAA withdrew its January decision, in order to give further consideration to representations from the SACC. Following these representations, and representations from the Heathrow Airport Consultative Committee, the CAA decided to consult afresh on this issue. It issued a new consultation document in June 2005, which was subsequently slightly altered, and reissued in July 2005. In relation to the need to consult airlines, the CAA commented that:<sup>14</sup>

Some initial spend ... may be necessary to allow an informed consultation to take place, particularly to assess all the ramifications of particular runway options. Indeed the need to explore fully alternative options for the configuration and layout of the airport development was reinforced by the judicial review decision of the White Paper.

The CAA added that:

[The CAA] would expect BAA to keep users informed of changes to its plans on a regular basis, including the extent of preliminary expenditure and the assumptions, costs, benefits and options informing the wider development project and to take note of the views of users. To the extent that BAA, having followed such a process, failed to win airline support for a particular investment proposal, a much greater onus would be placed on BAA to demonstrate that the proposed investment was efficiently incurred, and that it was in the long-term interests of users of Stansted.

116. In October 2005, the SACC set out its views that the July 2005 decision by the CAA was unlawful (even though the July 2005 decision itself had been revised in light of earlier procedural complaints by the SACC and complaints by BAA on the process).
117. The CAA finally issued a statement in March 2006, which stated that there was a case for allowing net preliminary expenditure, including an annual return of 7.75 per

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<sup>14</sup>CAA July 2005 consultation document, paragraph 4.6.

cent, to be added to the Stansted RAB at 1 April 2008, having regard to the extent to which:

- (a) as far as practicable, BAA consulted users (including both airlines and passengers) on the level of preliminary expenditure before it was incurred;
  - (b) BAA had followed best practice management and operated proactively the enhanced information disclosure and consultation agreement, consulting effectively with well-informed users;
  - (c) the expenditure was genuinely additional and related to the development of new runway capacity, with any additional return being included in the Stansted RAB based on the excess of total out-turn capex over and above the projections made at the time of the last price control review, up to a maximum additional return equal to the return on net preliminary expenditure.
118. We noted that, throughout this protracted period of consultation, in order to determine the conditions for BAA's expenditure on SG2 to be recognized in the RAB, BAA continued to spend substantial amounts and the CAA received quarterly reports on what BAA was spending. We saw no evidence to suggest that the CAA investigated BAA's SG2 expenditure or gave BAA any guidance on how this expenditure would be treated prior to its final March 2006 statement.

#### *Views of parties*

119. The SACC told us that the SG2 pre-spend should have been the subject of extensive consultation and pre-approval by the users but it was not. The SACC complained that the regular information provided by BAA to the airlines relating to SG2 often came too late to be relevant and did not constitute effective consultation.
120. In order for BAA's process of consultation to be effective, the SACC argued that BAA should have provided a business plan as described in Annex 4 to the CAA's 2003 regulatory determination. However, neither the CAA nor BAA appeared to believe that the requirements of Annex 4 included the provision of a separate business plan. The CAA has asked BAA repeatedly for a clear business case, which sets out the economic justification for SG2, but we have seen no evidence of such a document in any detail.
121. The SACC submitted that, due to BAA's ineffective consultation, no SG2 pre-spend should be included in the opening RAB.
122. The CAA acknowledged that BAA's consultation processes had, at times, fallen short of best practice. However, the CAA told us that it currently did not have further views as to whether BAA did, or did not, consult adequately on preliminary expenditure on SG2 beyond its March 2006 statement. Rather, the CAA said that it was awaiting the recommendations of the CC and would make its final decision as part of its Q5 regulatory determination.
123. BAA told us that the CAA should have confirmed the indications which it had previously given, ie that the SG2 pre-spend in Q4 would be included in the Q5 opening RAB. BAA said that the failure of the CAA to do so was a dereliction of its duty. BAA submitted that, though it was appropriate to challenge the efficiency of its expenditure, the CAA should have acknowledged that it was reasonable for BAA to undertake such expenditure on SG2.

124. BAA also defended its actions with regard to consultation. BAA submitted that it did provide timely and relevant information to the airlines during the process, as required by the CAA's criteria. BAA drew our attention in particular to the quarterly reports on expenditure covering historical capex, its December 2005 consultation document (although approximately £50 million had by then been spent) and the discussions which followed this paper, and extensive correspondence between BAA and the SACC.
125. We considered BAA's internal procedures, which allowed substantial SG2 pre-spend to be 'signed off' (£187 million by the end of Q4). However, BAA could only provide us with a brief appraisal model showing overall costs and revenues, with limited descriptions or assumptions. BAA said:<sup>15</sup> 'BAA does not need a detailed business case at this stage. This summary is appropriate to allow BAA to continue to process its application. It is not until the company has to commit to the project, say 2010, that a detailed business [plan] will be provided for Board approval.'
126. We were surprised that such considerable expenditure could be incurred with so little evidence of its net benefit to BAA. The CAA told us that 'BAA has yet to establish a business case [for SG2] that demonstrates when you strip out all the impacts on the RAB and so forth that the incremental benefits exceed the incremental costs'. The CAA continued that it has 'not seen any evidence yet about when the business case [for SG2] will be established'.

### *CC assessment*

127. We considered the individual elements of SG2 pre-spend separately, in each case applying the three criteria for inclusion in the RAB as set out by the CAA in its March 2006 statement (see paragraph 117), and the CAA's two general criteria for all capex (see paragraph 15).

### *Blight and land acquisition*

128. In reviewing blight and land acquisition, we considered how BAA had managed the efficiency of its spend in two ways:
- (a) whether the appropriate amounts had been spent; and
  - (b) whether these amounts had been spent at the right time.
129. There are two types of planning-related blights:
- (a) statutory blight, which affects properties following the formal announcement by the developer that the property will be acquired by compulsion; and
  - (b) generalized blight, which is typically taken to describe any actual or assumed depreciation in the value of property which may be attributed to a proposal for an infrastructure scheme and which may arise because of the perceived risk that the property will be acquired for the scheme and/or because of the perceived risk that the use of the works may have an adverse effect on the property, its surroundings or any business carried on in it.

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<sup>15</sup>BAA letter to the CAA, dated 28 May 2008.

130. Under the Compulsory Purchase Act 1965 the law provides for compensation in respect of the lowering of value arising from certain indirect effects of future development (including airport development) during construction, such as noise or dust. In addition, under Part 1 of the Land Compensation Act 1973, those affected by future airport development can claim compensation for loss in the value of their property directly attributable to the operation of the development. However, this compensation does not apply until 12 months after the development is brought into operation, as there is a need to assess objectively the impacts of the development, both negative and positive.
131. In 1997, the then Department of the Environment Transport and the Regions' (DETR) Interdepartmental Working Group on Blight produced two publications which explored issues associated with generalized blight and provided guidance on appropriate schemes designed to minimize disruption to the local housing market.<sup>16</sup>
132. The DETR suggested that a possible scheme might operate as follows:
- (a) Statute will provide that, if and when a property is acquired compulsorily, the owner-occupier will receive the unaffected open market value (OMV) of their interest in the property, premiums and compensation for various costs associated with the acquisition.
  - (b) If the owner of a property to which the statutory guarantee applies needs or wishes to move, the promoter will be obliged to provide a full transferable guarantee, which will guarantee to the new owner the same rights to compensation described in (a).
133. Owners of properties which may be affected by the proposed development, but not actually threatened with compulsory acquisition, would be able to demand from the promoter a fully transferable guarantee that any future loss of value caused by physical effects arising from the use of the development would be compensated in full one year after the development is completed. In such circumstances, the compensation would be not less than an amount stated in the guarantee (which would be the promoter's best estimate of the likely devaluation caused by the physical effects arising from the proposed development).
134. There is no statutory requirement relating to generalized blight. However, the ATWP stated that BAA would need to put in place a non-statutory scheme to address the problem of generalized blight at Stansted. More generally, the Government expected airport operators to develop as soon as possible (and preferably within 12 months of the ATWP) master plans which would include, where appropriate, measures to address blight.
135. The DfT did not provide guidance on the scope of such schemes in relation to airport developments. It merely commented that 'people should have access to some form of redress, for example to help them relocate before the development takes place, if they need to do so'.
136. BAA introduced three voluntary blight schemes at Stansted in the course of 2004:
- (a) On 18 December 2003, two days after the publication of the ATWP, BAA announced the forthcoming Home Value Guarantee Scheme (HVGS), under which BAA offered to purchase homes needed for the development of the airport.

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<sup>16</sup>Interdepartmental Group on Blight: Final Report and Draft Property Purchase Guarantee and Compensation Scheme.

It became operational in April 2004, once the expected boundaries of the development were announced in the ATWP.

- (b) In September 2004, after public consultation, BAA introduced the Home Owner Support Scheme (HOSS), aimed at those who own property beyond the proposed expanded airport boundary (but within the 66 dBA Leq boundary, as defined in the scheme<sup>17</sup>).
  - (c) In November 2004, BAA launched a Special Case Scheme (SCS) for those close to the proposed boundary of the expanded airport, but outside the defined boundary of the HOSS, who had a severe medical condition, which made it necessary for them to move at the earliest opportunity.
137. BAA recognized that the boundaries which defined eligibility might change, as work on the scheme progressed, but it decided that it would honour the commitment given to those who were within the boundaries as they were originally defined.
138. In December 2005, BAA stated that it expected to publish revised HVGS and HOSS boundaries at the same time as announcing the second runway development proposal. BAA also reiterated its promise to honour the commitment to those who were within the originally defined boundaries, no matter how the design developed.
139. BAA's subsequent proposals for a two-runway airport, including the changes in runway location and the change in operating mode, affected the boundaries of the HVGS and the HOSS. The new proposals did not include any new properties under the HVGS, but there were a number of new properties under the HOSS, due to the position of the proposed runway moving to the south-west of the original location in the ATWP. The change to operating in segregated mode also slightly increased the area of the 66 dBA Leq contour to the north-east of the new runway.
140. We considered a selection of blight schemes, which were proposed by the DfT as relevant comparators:<sup>18</sup>
- (a) The Interdepartmental Group on Blight identified the Central Railway Property Protection Scheme as coming closer than any other scheme to addressing generalized blight issues. This scheme acted as an insurance policy, which gave householders a transferable option to sell their property at an agreed, index-linked price to Central Railway. This right could only be exercised once construction work had started in the owner's area. In 2004, the company reported that 1,100 homeowners had taken up the option and that, to its knowledge, 35 per cent of properties which had an option had been put on the market and were subsequently sold or remortgaged.<sup>19</sup>
  - (b) Under Union Railways Limited's Discretionary Purchase Scheme, the company offered to buy people's properties if it considered that the owner's enjoyment of the property would be seriously affected by either the construction or the use of the Channel Tunnel Rail Link (CTRL), if the owner could demonstrate that efforts had been made to sell the property, that there were pressing reasons for selling, which were, in most cases, unrelated to the CTRL scheme and that severe hardship would occur if the owner was unable to sell. All applications would be considered on their individual merits.

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<sup>17</sup>The predicted area within which the level of noise generated by the airport by 2030 will be at least 66 dBA Leq, thus leading to medium to high noise annoyance.

<sup>18</sup>For further information see: [www.dft.gov.uk/foi/responses/2005/may/voluntaryblightschemes](http://www.dft.gov.uk/foi/responses/2005/may/voluntaryblightschemes).

<sup>19</sup>[www.central-railway.co.uk/resources/cr\\_PPS\\_2004\\_03.pdf](http://www.central-railway.co.uk/resources/cr_PPS_2004_03.pdf).

(c) The Highways Agency guidelines for discretionary purchase are similar to those of Union Railways.

141. The SACC told us that it was not consulted on the SG2 blight schemes. The SACC opposed the blight schemes because it believed that the costs were too high, the area covered was too large and that BAA had put the schemes in place too early. In addition, the SACC believed that the blight schemes introduced by BAA prejudiced the final location of the second runway and terminal.
142. The DfT told us that, in its view, BAA had been right to put into action a generalized blight scheme within days of the publication of the ATWP. The DfT said that this action by BAA was in line with the statement in chapter 12 of the ATWP to the effect that such schemes should be put in place quickly. In the DfT's view, blight was by far the most important concern for those living within the boundaries of the proposed airport expansion. The DfT also noted that not allowing BAA's blight costs into the RAB would send a harsh message to operators elsewhere, which may also be planning to increase capacity.
143. ASA noted that:
- In any major infrastructure project (railways, highways, power stations, as well as airports) fundamental to the successful award of a Planning Permission is the demonstration of measures to minimize and mitigate adverse environmental effects of the construction and operation of the project. ... The need to demonstrate a responsible and sympathetic approach to the concerns of the communities in the vicinity of any such project is essential in the implementation process.
144. We asked ASA to assess whether the blight schemes offered by BAA were too generous in comparison to similar developments. ASA acknowledged that the DfT had stated that the BAA schemes conformed to its recently published policy on blight compensation, although it did not comment any further. ASA also confirmed that a similar blight scheme (within the 66 Leq noise boundary) had also recently been adopted by Birmingham International Airport in respect of a second runway. ASA's overall view was that it 'cannot find any evidence to support the view that the blight schemes are, per se, too generous'.
145. We sought legal advice and were told that there had been no legal requirement for BAA to introduce voluntary schemes and so, to that extent, it had gone further than it was legally obliged to do. However, the Government had laid out its expectations clearly and BAA, acting responsibly, had responded accordingly. We were advised that, from the standpoint of planning law, it was reasonable for BAA to have introduced these schemes and that what BAA had done could be considered entirely laudable, rather than something to be criticized. Nevertheless, from a commercial perspective, we were told that, in starting the process early and by purchasing, rather than taking options over, the relevant land, BAA might have gone further than was necessary at the time.

### *CC views on blight*

146. We recognized that the ATWP expressed an expectation by the Government that airport operators would put in place voluntary schemes to deal with generalized blight, where needed and relatively promptly. BAA also told us that, following the publication of the ATWP, a great deal of concern was being expressed locally about evidence of generalized blight beginning to emerge over a much wider area than was covered by BAA's development schemes. We thought that it was also understand-

able that an airport developer would seek to keep the local community 'on board' when preparing for a forthcoming public planning inquiry. Under such circumstances, we believed that it was reasonable that BAA sought to put in place voluntary blight schemes, despite the opposition expressed by the airlines.

147. However, in our view, the HVGS seemed to have been brought forward particularly early (even by reference to the expectations set in the ATWP) and without adequate consultation with the airlines. It appeared to us that BAA may have taken unnecessary commercial risk, particularly given that the judicial review of the ATWP had become public by March 2004, ie a month before the scheme became operational.
148. We also noted BAA's offer to purchase properties within the boundaries of the ATWP scheme from owners unconditionally<sup>20</sup> and with only limited conditions from owners within the 66 Leq defined boundary, and to honour these commitments even if the boundaries changed. It appeared to us that BAA could either have applied strict conditions on eligibility, similar to those applied by other operators, and/or could have simply offered a guarantee (or option), exercisable by all property owners within the area affected by BAA's scheme once construction work began.
149. It seemed to us that offering protection (similar to that offered by Central Railway) could have met the DfT's requirements, at a significantly lower commercial risk. However, we noted that it could also be argued that, given the precedent set by schemes put in place by the Highways Agency and Union Railways, at least a proportion of the properties affected by generalized blight would have had to have been acquired before the start of construction.

#### *CC recommendation*

150. We recognized that a judgement is required in order to determine what proportion of BAA's SG2 blight costs should be included in the Q5 opening RAB.
151. We accepted that the ATWP strongly encouraged BAA to put in place effective blight schemes quickly. We also recognized that to disallow BAA's expenditure on blight could significantly discourage future development, at Stansted or elsewhere.
152. We believed that BAA's blight schemes were more generous than might have been the case for a commercial operator in an unregulated competitive market. However, we found no grounds for excluding the costs from the RAB.
153. Therefore, we recommend that all BAA's SG2 blight costs incurred in Q4 should be included in the opening Q5 RAB.

#### *Professional fees*

154. Table 10 shows a breakdown of the professional fees which BAA has incurred on SG2 at Stansted over Q4.

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<sup>20</sup>Provided the owner has owned the property and lived there for at least six months before the publication of the scheme. If the property is empty, it must not have been empty for more than 12 months and the owner must have lived there during the six months prior to it being empty.

TABLE 10 SG2 professional fees pre-spend

	£ million						
	2004/05	2005/06	2006/07	2007/08	2008/09	Total	Total 2007/08 prices
	Out-turn prices						
Design and civil engineering	2.0	3.2	2.9	1.0	3.1	12.3	12.7
Surface access	5.3	6.2	6.3	7.4	5.2	30.4	31.5
Environmental and economic impact	2.0	2.5	4.7	1.9	3.1	14.2	14.7
Airspace design	0.2	0.0	0.5	0.3	-	1.0	1.0
Legal planning financial	<u>1.9</u>	<u>4.8</u>	<u>1.4</u>	<u>2.7</u>	<u>8.4</u>	<u>19.2</u>	<u>19.5</u>
Total professional fees	11.4	16.7	15.7	13.3	19.9	77.1	79.5

Source: BAA.

155. Given the detailed nature of some of the analysis undertaken by BAA's consultants, we recognized that agreement between the airlines and BAA on this expenditure was unlikely. However, we continued to recognize the need for consultation as one of the CAA's key criteria for including the expenditure in the RAB.
156. The SACC told us that it had not seen any reports produced by BAA's professional consultants, despite having requested copies in order to evaluate BAA's airport development proposals. The SACC said that, in spite of having spent over £50 million on consultants by 31 March 2008, BAA had informed Stansted users that no reports existed and that the optioneering process had taken place through work-shops.
157. We recognized that this expenditure is likely to be more dependent on a detailed ex-post review by the regulator, and we commissioned ASA to carry out an audit of BAA's spend on professional fees.
158. ASA noted that BAA's Framework Contract and other consultant procurement processes were transparent and were in line with best practice.
159. We considered each area of professional fees separately.

#### *Design and civil engineering*

160. These professional fees relate to all land use, design and architectural drawings and supporting documentation for the on-airport components of the SG2 scheme up to and including the planning application. They also cover all the necessary design work for the optioneering and consultation process. BAA indicated that these costs had increased due to a new requirement to provide a detailed Design and Access Statement as part of the planning application. BAA also advised ASA that most of the expenditure in this cost category had been incurred and that there was unlikely to be much further expenditure.
161. Given the difficulties of assessing the complexities of the drawings themselves, ASA found it difficult to provide us with a firm view on whether the expenditure to date had been unnecessarily high. Overall, ASA concluded that it felt the expenditure had been generally acceptable.

#### *Surface access*

162. These costs cover the detailed modelling, design of options and the consultation process for the key surface access improvements required for SG2. The total costs incurred to 31 March 2009 are forecast to be £32 million (in 2007/08 prices), representing over 40 per cent of the total external consultancy costs.

163. The nominal costs as at 31 March 2008 included the design of options for the M11 widening scheme ([§]); and the development of options and design for the upgrading of the West Anglian rail line and the design for a second tunnel bore for the airport branch line and a fourth platform at the airport station ([§]). This work is supported by detailed modelling of airport surface access demand for passengers and employees by mode and by time of day ([§]).
164. In the case of the M11 widening scheme, ASA noted that only about 16 per cent of users of this road development would be airport users. However, so far, BAA has paid the full costs of this work. [§] BAA also noted that the ATWP identified the M11 as a primary growth factor for the airport and referred to advice it had received from counsel which suggested that BAA should try to get as much certainty on the road widening scheme as possible by the time of the planning inquiry. [§]
165. In the case of the rail improvements, ASA noted that the majority of the consultancy expenditure had involved an assessment of the options for the development of the West Anglia main line (between London Liverpool Street and Cambridge). In the absence of any government proposals at the time, BAA sought to provide a scheme for the smallest capacity increase to meet its requirements. However, the costs of this consultancy work were not shared with Network Rail. ASA learnt that Network Rail now preferred a much larger scheme, in line with Transport for London and local authority requirements. Whilst BAA might not have been able to envisage this change in circumstances, ASA noted that, as a result, BAA's consultancy expenditure in this area was also now largely unnecessary.
166. BAA commented that it did not understand ASA's view that much of BAA's consultancy work would be invalid. BAA submitted that its studies had helped provide the technical basis for the 'Long Term Road and Rail Capacity in the East of England' announced by the Secretary of State, which was of key significance to the planning inquiry. In addition, BAA said that it was not yet known precisely what schemes would be implemented.
167. In the case of the surface access passenger and employee modelling, BAA remains the prime user of this analysis rather than the implementing agencies (ie the DfT, the Highways Agency or Network Rail). ASA recognized that future surface access demand was an important issue, but was concerned that this model might be too detailed for its primary purpose, which was, given the uncertainty in forecasts, to establish agreements with the key agencies for the funding of the surface access improvements when needed. In ASA's view, some of BAA's expenditure on modelling might not have been necessary.
168. BAA responded that:
- Mandatory aspects of major projects process for the Transport Assessment and Environmental Statement require robust modelling of airport surface access demand. At each key stage of the project the Department for Transport and Highways Agency have reviewed the performance of [BAA's] models and have signed these off as fit for purpose. In providing model 'sign-off' the Government's experts and advisers took into consideration the requirements of the scheme identification, appraisal and consultation stages of strategy development and, most recently for the purpose of preparing the G2 transport assessment.

### *Environmental and economic impact studies*

169. The professional fees in this area have included the preparation of all the necessary supporting documentation for the Environmental Impact Assessment, which was submitted with the planning application. The most significant component within this work was [redacted], covering construction impacts, contamination, sustainability appraisal, energy and waste management, the use of natural resources (energy and water) and project management. Further work by other consultants included a wide range of environmental assessment and impact studies, including air noise, health, ecology, cultural heritage, etc.
170. Given the diversity of this work, ASA noted that it was difficult to draw any firm conclusions about the validity of this level of expenditure. Overall, ASA suggested that the individual components would appear to be of an appropriate order of magnitude.

### *Legal, planning, financial and other*

171. BAA's other professional costs (£10.8 million to 31 March 2008) [redacted] and PR (costing £2.1 million).
172. ASA asked BAA to provide some supporting documentation for these costs but BAA was not able to do so, although BAA did offer to provide a list of tasks undertaken by its legal team. ASA recognized that the output from these advisers would be difficult to define precisely, as a significant part of the costs relate to oral comments and legal opinions.

### *ASA's conclusions*

173. ASA concluded:

We accept that BAA's external consultancy expenditure is designed to maximise their likelihood of obtaining Planning Consent for the G2 scheme and has been broadly based on their previous requirements at earlier Public Inquiries (eg T5). Our view is that, in certain topic areas, particularly for surface access requirements (which represents some 45% of external consultancy costs to date), the work undertaken has either been superseded by later studies or has been too detailed for its primary purpose which is to seek agreement with the relevant agencies for the funding of surface access improvements, as and when required by airport traffic demand. We are also concerned that these costs have not been shared with the agencies involved, or that sufficient safeguards are in place for any potential recovery of such costs.

### *CC recommendations*

174. We recognized that determining what proportion of BAA's SG2 professional fees should be included in the RAB is a matter of judgement.
175. We noted:
- (a) BAA did not consult effectively with its airline customers in advance of the expenditure;

- (b) BAA had not shared any significant outputs from the expenditure with its airline customers;
  - (c) there is evidence to suggest that BAA incurred too much cost too soon and, as a result, has incurred cost unnecessarily (eg surface access costs); and
  - (d) a higher proportion of BAA's consultancy costs might have been shared with other parties, eg Network Rail or the DfT.
176. We were not convinced that BAA would have incurred the same level of costs if it were a commercial operator rather than a regulated airport, and if it were bearing the cost itself. We also noted the lack of detailed board level appraisal and approval of BAA's SG2 costs, which suggested to us that there was an insufficient level of internal appraisal of this expenditure.
177. For these reasons, we did not believe that it would be reasonable to allow all of BAA's SG2 professional fees into the opening Q5 RAB. However, we recognized that determining the amount which should be allowed and the amount which should be excluded was a difficult matter of judgement.
178. Due to our particular concerns about BAA's professional fees related to surface access costs, we concluded that 50 per cent of the fees relating to surface access (£16 million, in 2007/08 prices) should be excluded from the RAB. In addition, due to our general concerns about BAA's lack of consultation and questionable efficiency in all areas of professional fees, we concluded that a further 25 per cent of the remaining total cost of professional fees should be excluded from the RAB (£16 million, in 2007/08 prices).
179. Therefore, we recommend that, in total, £32 million (in 2007/08 prices) of BAA's expenditure on SG2 professional fees should be excluded from the RAB, equivalent to approximately 40 per cent of the costs incurred. We recommend that the remaining cost of professional fees (£47 million, in 2007/08 prices) should be included in the opening Q5 RAB.

### *Project costs*

180. BAA's SG2 project costs relate to an internal BAA team preparing the planning applications and orders for SG2, as well as managing and coordinating its external consultants. The team is also responsible for managing and implementing the blight schemes, and other project support and administrative functions. The costs include staff, office accommodation costs, printing and publication costs, and computing costs.
181. ASA did not make a detailed assessment of these costs, but pointed out that significant design work had been undertaken for the public inquiry.
182. We noted that the airlines had seen little detailed evidence to support these costs. In addition, BAA provided us with very limited benchmarking data on its pre-spend planning costs (which include the project costs). We found the evidence it did provide to be inconclusive, given the difference in the scale and nature of the projects, though we accepted that benchmarking this type of project is difficult.

## CC recommendation

183. We recognized that, for many of these internal project costs, it was difficult for BAA to consult effectively. We also recognized that it was very difficult for the regulator to review these costs in detail.
184. We accepted that some considerable expenditure should be allowed, but we were not convinced that all BAA's project cost expenditure had necessarily been efficiently incurred.
185. As with the professional fees, we noted that:
- (a) BAA did not consult with airlines in advance of the expenditure; and
  - (b) it was not clear that BAA had incurred expenditure as efficiently as possible, and it might have done too much too soon.
186. Again, we were not convinced that BAA would have incurred the same level of costs if it were a commercial enterprise rather than a regulated entity which is able to pass on the costs it incurs to its customers. We also noted the lack of detailed board-level appraisal and approval of BAA's SG2 project costs, which suggested to us that there was an insufficient level of internal appraisal of this expenditure.
187. For these reasons, we did not believe that it would be reasonable to allow all of BAA's SG2 project costs into the opening Q5 RAB. Again, we recognized that determining the amount which should be allowed and the amount which should be excluded was a difficult matter of judgement.
188. We recommend that 50 per cent of BAA's expenditure on SG2 project costs should be included in the opening Q5 RAB (amounting to £6 million in 2007/08 prices) and 50 per cent should be excluded.

## Conclusions on SG2

189. For the reasons given above, we recommend that the majority of BAA's SG2 costs are included in the RAB, but that approximately 40 per cent of its SG2 professional fees and 50 per cent of its SG2 project costs should be excluded.
190. Table 11 summarizes our recommendations to the CAA for the treatment of BAA's SG2 Q4 capex with regard to its inclusion in opening Q5 RAB.

TABLE 11 CC recommendation for SG2 in Q4

	Total actual		CC recommendation	
	Out-turn prices	2007/08 prices	Out-turn prices	2007/08 prices
Blight	96.8	99.8	96.8	99.8
Land acquisition	2.1	2.0	2.1	2.0
Professional fees	77.1	79.5	46.3	47.7
Project costs	<u>11.3</u>	<u>11.7</u>	<u>5.7</u>	<u>5.9</u>
Total	187.3	193.0	150.8	155.4

Source: BAA, CC calculations.

## **Removing the return on capex underspend**

191. If the capex is overstated in each year, then the price cap (calculated as a return on the RAB) will also be overstated. To the extent that Stansted has priced up to the cap, then it may be appropriate to exclude the return made on the inflated RAB, either by reducing the RAB or by making deductions from income in Q5.
192. The price cap set at the start of Q4 was calculated using a percentage return on the forecast RAB. Thus, if the RAB is reduced, we should reduce the price cap. However, during most of Q4, BAA did not price up to the cap (the K-factor reflects this difference).
193. We considered the effect of 'clawing back' the return on the underspend on capex. We noted the following points:
- (a) In the first four years of the quinquennium, BAA did not make a return on the capex which we now propose to exclude from the RAB: the return on this capex underspend was lower in each year than the difference between BAA's allowable yield and its average yield (ie the amount it under-recovered), even before we consider the K-factor.
  - (b) In 2007/08, BAA priced up to the cap and may have included some of the rolled forward K-factor, and in 2008/09 it continued to do the same. In 2007/08 and 2008/09, the rolled forward K-factor (even adjusted for the reduced return) was higher than our estimate of the return on the capex underspend.
  - (c) Our calculations indicated that the return on the capex underspend has been more than offset by the K-factor.
194. As we do not recommend that the K-factor is rolled over into the next quinquennium (see Section 5 of the main report), we recommend that no adjustment is made to claw back the return on underspent capex.

## **CC recommendation for the inclusion of Q4 capex in the RAB**

195. We recommend that:
- (a) £32 million of BAA's SG2 professional costs and £6 million of BAA's SG2 project costs should be excluded from the RAB; and
  - (b) all other actual Q4 capex should be included in the RAB.
196. Table 12 shows BAA's allowable Q4 capex on the basis of these recommendations.

TABLE 12 Recommended Q4 capex to include in the RAB

Categories	2003/04	2004/05	2005/06	2006/07	2007/08	2008/9
						<i>Out-turn, £ million</i>
Capex included in determination (SG1)	18.3	18.3	22.7	59.0	60.5	-
New capex (SG1)	0.7	4.9	5.3	12.6	16.3	83.0
New capex (SG2)	-	23.8	27.4	35.2	27.4	37.1
Total proposed capex (out-turn prices)	19.0	47.0	55.5	106.8	104.1	120.1
						<i>2007/08 prices, £ million</i>
Total proposed capex (2007/08 prices)	21.7	52.1	59.9	111.2	104.1	114.6

Source: BAA, CC calculations.

197. Table 13 shows the value of the Stansted Q5 opening RAB on the basis of these recommendations.

TABLE 13 Proposed roll forward of Q4 RAB (CC)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/9 (projected)
Opening basic RAB value	863.6	873.5	857.2	896.5	1,005.9	1,102.1
Capital expenditure	19.0	47.0	55.5	106.8	104.1	120.1
Proceeds from disposals	0.0	-59.4	0.0	-0.1	0.0	0.0
Depreciation charge	-31.7	-31.8	-36.4	040.5	-45.8	-41.7
RPI adjustment	22.6	27.9	20.2	43.2	37.9	52.9
Closing basic RAB	873.5	857.2	896.5	1,005.9	1,102.1	1,233.4
Profiling adjustment (cumulative)	12.5	19.3	31.2	43.2	51.4	56.7
Pension adjustment	-	-	-	-	-	-17.6
Closing RAB value	886.0	876.5	927.7	1,049.1	1,153.5	1,272.5

Source: CC adjustment to CAA and BAA data.

Note: Assumed RPI of 4.8 per cent for 2008/09.

198. We recommend that the value of the opening Q5 RAB is £1.273 billion (in 2008/09 prices), which corresponds to £1.214 billion (in 2007/08 prices).

199. This amount is approximately £35 million lower than the value of the opening Q5 RAB proposed by BAA (£1.249 billion, in 2007/08 prices). The difference is due to our recommendation to exclude some SG2 capex (accounting for a decrease of £37 million), BAA's actual capex in 2007/08 and 2008/09 being lower than it forecast prior to the CAA's reference to us (accounting for a decrease of £9 million), and a pension adjustment (accounting for a decrease of £17 million) but, against these factors, an increase in the RPI adjustment, due principally to using a higher rate of RPI in the last two years of the quinquennium than forecast by BAA (accounting for an increase of £28 million).