H8 method statement and business plan guidance

CAP 3083

Published by the Civil Aviation Authority 2025

Civil Aviation Authority
Aviation House
Beehive Ring Road
Crawley
West Sussex
RH6 0YR

First published March 2025

Enquiries regarding the content of this publication should be addressed to: Robert.Toal@caa.co.uk

The latest version of this document is available in electronic format at: www.caa.co.uk/CAP3083

Contents

Chapter 1
Introduction and summary

Introduction

1.1 In November 2024, we published and consulted on our draft H8 method statement and business planning guidance (“the Draft Method Statement and Business Plan Guidance”). We received a number of responses to this consultation in December 2024, with further responses on cost of capital issues in January 2025.

1.2 In developing this document, we have considered responses to the Draft Method Statement and Business Plan Guidance consultation, and discussions between HAL and airlines as part of Round 1 of Constructive Engagement.[1] We have also taken into account the recent announcements by Government on the development of a third runway at Heathrow airport, and calls by some airlines and other stakeholders for a more fundamental review of the regulatory framework in place for HAL.[2]

1.3 This document sets out:

- an update on the H8 process (chapter 2);
- the framework for a new incentive on HAL to provide high-quality business plan information (chapter 3);
- the H8 method statement, which sets out our approach to setting price controls for H8 (chapters 4 to 6); and
- updated business planning guidance for HAL as it develops its H8 plan (appendix A), further guidance on areas to consider at initial proposals on cost of capital (appendix B), and cost and revenue data templates (appendix C).

1.4 We provide a summary for each of these chapters below.

1.5 Alongside this document, we are also publishing a letter to stakeholders on capacity expansion at Heathrow and the February 2025 airline submission calling for a fundamental review of the way in which Heathrow Airport is

1 Round 1 of Constructive Engagement took place between October and December 2024.

2 Heathrow Reimagined: A Better Hub for Britain, https://www.heathrow-reimagined.com/

regulated. The letter explains our present thinking on how we will take forward both the work on the H8 price review and work on capacity expansion.

1.6 As set out in the letter, we are publishing this final method statement on the assumption that large investment programmes related to the significant expansion of the airport should be considered in the round as part of our wider work on capacity expansion, to make sure there is a coherent regulatory package for both terminal and runway expansion.

1.7 Given the large investment programme needed for significant terminal and runway expansion and the need to consider the appropriate treatment of these costs, it is unlikely to be appropriate for these to be part of a business as usual price review for the H8 period. Our wider work on capacity expansion will provide a more flexible approach and timetable to allow us both to support the Government's work on these matters and explore the scope for different regulatory approaches to the regulation of these large capital expenditure programmes, consistent with our statutory duties.

1.8 Nonetheless, we will consider any further representations that HAL, airlines and or other stakeholders make on these matters and will retain an appropriate degree of flexibility such that issues can be dealt with in a way that is most appropriate and consistent with protecting the interests of consumers.

1.9 We will also need to consider any representations HAL or other stakeholders make on early costs, and will consult on the most appropriate treatment of such costs.

1.10 Therefore, our assumption in this final method statement is that the focus of the H8 work will remain the operation of the two runway airport, with work on significant capacity expansion carried out in a coordinated way but as part of a separate work programme. Nonetheless, as we have explained above we will retain an appropriate degree of flexibility and continue to discuss these matters with HAL, airlines and other stakeholders.

Overall context and update on H8 process

1.11 In the Draft Method Statement and Business Plan Guidance, we said that, for H8, we would be developing an approach consistent with Heathrow being a two runway airport with a relatively stable outlook for traffic forecasts.

1.12 Since we published the Draft Method Statement and Business Plan Guidance, there have been a number of significant developments which are relevant to our work to set a price control for Heathrow airport.

1.13 During the first round of Constructive Engagement, the likely scale, timing and cost of HAL's plans for terminal development was shared with stakeholders. These plans are still being developed, but we note that they will have significant implications for capital expenditure, capacity and levels of service at the airport in the long-term.

1.14 As set out above, the Government has also announced its strong backing for capacity expansion at Heathrow and airlines and other stakeholders have called for a review of the regulatory framework for Heathrow. HAL has also suggested changes to the regulatory framework will be needed to support capacity expansion.

1.15 We are developing our plans for this programme of work on capacity expansion, and we will share these plans with stakeholders in due course. It is also important that we protect consumers who will continue to use a two runway airport, as any significant increase in airport capacity will take time to plan and deliver. Therefore, alongside our work on capacity expansion and reviewing the regulatory framework, we intend to complete the H8 price review broadly as set out in the Draft Method Statement and Business Plan Guidance. This will include consideration of whether incentives for efficiency, including in relation to H8 capital expenditure and capital expenditure governance, can be further improved in the context of the investment programmes necessary for the efficient operation of the airport.

1.16 As set out below, we have updated the priorities for the H8 review to provide a clearer focus on issues that are key for furthering the interests of consumers:

i. **Progress the H8 review in a way that is effectively coordinated with the development of the regulatory framework for capacity expansion and a third runway at Heathrow**.

ii. **Allow for efficient investment that will deliver benefits for consumers, by providing effective oversight and scrutiny of HAL's H8 capex plans**.

iii. **Incentivise HAL to deliver a high standard of service quality and environmental performance throughout the H8 period**. HAL should be incentivised to further those objectives that are valued by consumers, now and for the longer-term, which will include improving operational resilience, supporting growth and technological change, and contributing to the transition to net zero.

iv. **Ensure current and future consumers and airlines face airport charges that are no higher than necessary**, including through incentivising efficiency, ensuring that any growth in HAL's RAB is sustainable and developing the regulatory framework in a way that is consistent with HAL continuing to access cost effective financing.

1.17 Our work on resilience will encompass issues relating to the closure of Heathrow airport on 21 March 2025 and any associated issues, to the extent that they are best dealt with as part of the price control review process.

1.18 In the Draft Method Statement and Business Plan Guidance, we said that we would keep the H8 timetable under review and provide a further timetable update in this method statement. We also received responses from stakeholders that the H8 timetable was looking challenging.

1.19 We have developed a revised timetable for H8 that we consider provides more flexibility and, therefore, a higher degree of confidence in meeting key milestones. This includes more time for development of our initial proposals and final proposals documents, with an outline approach to setting a holding cap for 2027 charges. More detail on the updated timetable is provided in chapter 2.

Business Plan Incentive

1.20 In our Draft Method Statement and Business Plan Guidance, we consulted on a new business plan incentive mechanism for H8. The incentive aims to encourage HAL to submit a complete, high-quality business plan, supported by appropriate evidence and by third party assurance.

1.21 We have considered feedback received in response to the Draft Method Statement and Business Plan Guidance, and we are proceeding with the implementation of a business plan incentive for H8.

1.22 Further details are set out in chapter 3, including our responses to points raised by stakeholders in areas such as assessment criteria and categorisation of the plan, and the structure and calibration of the incentive.

1.23 We have updated the business plan guidance in response to feedback received to the Draft Method Statement and Business Plan Guidance, to provide further clarity to HAL on our expectations for its business plan.

1.24 In our initial proposals, we will consult on our overall assessment of HAL's business plan and whether HAL should receive a reward, no adjustment or a penalty, and the level of any reward or penalty.

Method statement for H8

1.25 The method statement (chapters 4 to 6) sets out our approach to the H8 price control review. We intend to focus on incentivising HAL to act in a way consistent with furthering the interests of consumers, operating the airport efficiently and meeting the needs of its airline customers.

1.26 Our approach for H8 has been informed by:

- regulatory precedent from the H7 price control and the CMA's Final Determinations of the appeals brought by HAL and airlines;
- the findings from the 2024 lessons learnt review of our approach to price regulation (the "2024 Review");
- the views of stakeholders in response to the 2024 Review;
- stakeholder views in response to the Draft Method Statement and Business Plan Guidance;
- recent Government support on the development of a third runway at Heathrow; and
- airline and other stakeholder submissions around reform to the regulatory framework.

1.27 For the H8 review, we remain of the view that it will be appropriate to retain a broadly similar approach to the regulatory framework to H7. New mechanisms introduced in the H7 price control, such as capex incentives and traffic risk-sharing ("TRS"), have been in place for only a short period, so we cannot yet fully assess whether they have delivered the intended outcomes. Nevertheless, we have identified areas where our approach can reasonably be improved to deliver greater benefits to consumers. We will consider whether there are further steps we can take to improve incentives for efficiency and capital governance arrangements and take steps to ensure that our H8 work programmes are sufficiently flexible to take account of developments in the planned capacity expansion at Heathrow.

1.28 We summarise below key aspects of our approach to the H8 review.

a) Consumer research: We expect HAL to carry out its own consumer research and engage with consumers, local community groups and other stakeholders. We expect HAL's business plan to provide a clear "line of sight" as to how consumer priorities have been taken into account and will conduct our own independent review of how this has been done. We are also exploring how consumer research can be used to support our initial and final proposals.

b) Traffic forecasts: We have commissioned external advisors to develop an independent forecast for H8. We also expect HAL and airlines to work together to try and reach a joint view on a reasonable range of forecasts. We introduced a TRS mechanism in H7 and we expect to retain a TRS for H8 given its beneficial impact on managing risk and reducing the cost of capital.

c) Service quality: Changes to the regulatory arrangements should focus on consumer priorities and priority areas such as operational and asset resilience; we have amended the business plan guidance to reflect this. HAL has raised the issue of whether the framework for the regulation of service quality should be adjusted to provide better incentives for joint working between the airport, its airline customers and other stakeholders on service quality. Where HAL can reach agreement with stakeholders on these matters, we will consider appropriate changes to the framework for service quality.

d) Operating expenditure and revenues: To support the identification of efficient levels of operating expenditure ("opex") and revenues, we are working with consultants to develop an independent assessment, and will work with them to assess the information provided by HAL in its business plan, including where practicable the use of benchmarking and targeted bottom-up analysis.

e) Capital expenditure: For capital expenditure ("capex"), our initial focus is to understand the likely size of the efficient capex envelope for H8, and the key uncertainties around this envelope. Once the size of the H8 capex envelope is established, we will assess the efficiency of costs to be included in the H8 capex baseline using a combination of "top-down" and "bottom-up" analysis, including benchmarking and technical deep-dives. Capex to support capacity expansion will be dealt with separately as explained above. The H7 capital expenditure incentive and governance arrangements have been introduced relatively recently, but if there is evidence that these arrangements can be improved, we will take steps to further develop these arrangements and incentives.

f) Cost incentives: For opex and revenues, we expect to retain the current broad approach to incentives. For capex, as noted above we intend to build on the approach to capex incentives introduced in H7 and consider evolutionary improvements to these incentive arrangements, including in response to stakeholder feedback and evidence.

g) Environmental sustainability: We remain of the view that environmental sustainability is a priority area for H8 and we will ensure the price control provides for efficient and necessary expenditure to reasonably support the transition to net zero. HAL should set out clearly its plans to meet its environmental obligations and we have updated our business plan guidance to support HAL in developing its plans in this area.

h) The boundary of the "single till": We will consider arguments put forward by HAL and remain open to working with stakeholders to develop the regulatory framework to improve the incentives on HAL to invest in landside property, or dispose of it to a third party developer, where this can be demonstrated to be in the interests of consumers.

i) Use of the RAB: We note airline criticisms of the RAB-based framework. We have set out in more detail in chapters 4 and 6 why we consider the RAB-based framework remains appropriate for H8, but as noted above we will consider whether we can further sharpen the incentives for capital efficiency. As explained in those chapters, we are open to considering alternative regulatory approaches for the longer-term and in the context of expansion. On indexation, our current intention is to use CPI as the primary measure of inflation for H8, including for indexing the RAB.

j) Cost of capital: Stakeholders provided views on specific policy issues that they consider should be reflected in our estimate of the cost of capital. We will consider these in preparing our initial proposals where it is practical and reasonable to do so.

Business Plan Guidance

1.29 We have updated the business plan guidance to provide the necessary information for HAL to produce a business plan that appropriately supports the H8 price setting process.

1.30 The business plan should focus on the operation of the two runway airport, with significant capacity expansion of terminals and the third runway, which involves significant investment in the airport, to be dealt with separately. To the extent that HAL wants or needs to provide additional information on capacity expansion, it should do so separately and highlight this as additional information. HAL should separate out any impact of expansion on its H8 forecasts of costs, revenue, traffic and other building blocks.

1.31 The focus of the guidance is the overall scope of the business plan, the approach HAL should adopt to consumer engagement and the key building blocks associated with the price control.

1.32 Appendix A to this document sets out, by topic / building block:

- stakeholder views on the draft business plan guidance;
- a summary of key changes we made in each area in response to stakeholder views; and
- final business plan guidance.

1.33 The guidance is designed to specify a base level of information that HAL should provide as part of the H8 process. Nonetheless, HAL should provide further information to the extent that it considers that this would reasonably further the interests of consumers or that such information is reasonably required to fully understand its plans for H8 and beyond.

Next steps

1.34 The next key stage of the H8 review is the second round of Constructive Engagement, which takes place in March and April 2025 and will be focused on the building blocks and, to the extent possible, separation of the H8 and capacity expansion programmes. We will participate in those discussions, and continue to monitor the progress of Constructive Engagement, to ensure the process is achieving its objectives.

1.35 We also expect HAL to deliver its H8 business plan by July 2025, and we will assess that plan against the business plan incentive, and the guidance we have set out in this document.

1.36 Alongside these stages of the H8 process, we will continue to engage with stakeholders on capacity expansion and progress further our work programme to develop appropriate regulatory arrangements for new capacity.

1.37 We will also review the timetable for the next NERL price control review (the current review period is 2023 to 2027) to explore options for completing this important work in a reasonably timely way. This will include considering options to reduce the degree of overlap with key outputs for H8 and capacity expansion, to allow an appropriate degree of focus on air traffic issues. We will update stakeholders on potential changes as we develop our plans.

1.38 We remain open to stakeholders reaching out with views on, or requests to discuss, any of the issues set out in this document, either in relation to the H8 review, or wider developments.

Chapter 2

Update on the H8 process

Introduction

2.1 This chapter provides updates on the H8 process, specifically the timetable for the H8 review, and Constructive Engagement ("Constructive Engagement"). These are important issues which are of interest to stakeholders, and which will have an impact on the rest of the H8 process, including future rounds of Constructive Engagement, and HAL's preparation of its business plan.

2.2 These updates have been informed by recent developments, including Government statements on the development of a third runway at Heathrow airport, responses to the Draft Method Statement and Business Plan Guidance, and by our attendance at Round 1 of Constructive Engagement, which took place in November and December 2024.

2.3 We will continue to engage with stakeholders on any of these matters, including on the progress being made with Constructive Engagement and the interactions between work on H8 and the third runway and capacity expansion.

Timetable

Background

2.4 In the Draft Method Statement and Business Plan Guidance, we said that we are taking steps to meet the timetable set out in the 2024 Review[3] and that HAL will also have a key role in providing a high-quality business plan.

2.5 We said that we would keep the H8 timetable under review and provide a further timetable update in this Method Statement. We noted stakeholder requests to keep them updated and to consider suitable contingency arrangements if significant delays do occur.

Stakeholder views

2.6 HAL expressed concern about the delivery of the H8 timetable, including having sufficient time to submit its business plan following this Method Statement. It said

3 See CAA CAP3000, pages 16-17 (https://www.caa.co.uk/media/1chp0wbz/cap3000-setting-future-price-controls-lessons-learnt.pdf)

that we should set out any changes as early as possible in 2025 as well as providing early sight of any contingency plans.

2.7 Airlines expressed concerns about the overall timetable and the risk of any compression of the timetable on the time for meaningful engagement. Airlines were concerned that delays in the publication of H8 documents have negatively affected the Constructive Engagement process and will continue to do so.

2.8 They suggested keeping the H8 timetable under review and providing an update on feasibility in early 2025 and said the CAA should be prepared to intervene on the timetable in a timely way, to avoid the uncertainties that were experienced during the H7 process with late development and engagement on interim charging arrangements and price caps.

Update on our approach

2.9 We have reviewed the timetable for carrying out the H8 price review taking account of recent developments (including the Government's announcement on support for a third runway at Heathrow), stakeholder comments and the progress we have made on team resources.

2.10 Our current view is that the existing timetable for the H8 price review does not provide for sufficient time to develop our proposals in a way that we could be reasonably confident in protecting consumers and discharging our other statutory duties. In particular, the time to develop our initial proposals in December 2025 appears to be relatively tight in the context of:

- the need to consider issues raised during the first round of Constructive Engagement, including the boundary of the single-till and the capex programmes associated with the operation of a two runway airport, and airline concerns about the level of airport charges;
- the advantages of coordinating our work on H8 with the work we will now be undertaking on capacity expansion; and
- the need to bring in additional resources for us to support both the H8 and capacity expansion programme.

2.11 We have developed a revised timetable that we consider provides more flexibility and, therefore, a higher degree of confidence in meeting these milestones. Nevertheless, we will need to continue to keep the H8 timetable under review as we understand further the links between the H8 and capacity expansion programmes. This involves allowing additional time for Round 2 of Constructive Engagement and submission of HAL's business plan, and an additional three to five months for key CAA documents, as follows:

- CAA final method statement and business plan guidance in March 2025;

- multiple rounds of Constructive Engagement between HAL and airlines, including:
  - round 1 between October and December 2024 on high level issues of service quality and investment, which has been completed,
  - round 2 between January and April 2025 on more detailed building block issues, but excluding areas such as cost of capital and cost efficiency. HAL and airlines should also discuss issues around the separation of the H8 and capacity expansion programmes to the extent possible, which may require further engagement after round 2 has concluded,
  - round 3 between July and September 2025 on HAL's business plan submission, and
  - round 4 between April and May 2026 on the CAA's initial proposals;
- a single business plan submission from HAL by July 2025. This should follow the CAA's guidance and provide detail on forecast traffic, costs, investment and prices for the H8 period based on a two runway airport;
- initial proposals in March 2026. This would include draft licence modifications;
- CAA final proposals and statutory consultation on licence modifications in November 2026;
- CAA final decision and statutory notice on licence modifications in April 2027; and
- Licence modifications coming into effect in June 2027.

2.12 As a result of these changes, there may be advantages in setting a holding cap for 2027 (with revenues to be trued up or down on a net present value neutral basis over the five year price control period in our final proposals and final decisions). We would expect the 2027 holding cap to be based on our initial proposals.

2.13 We will continue to keep the H8 timetable under review as we understand further the links between the H8 and capacity expansion programmes. We will seek to update stakeholders on any emerging issues and further changes in a timely way.

Constructive Engagement

Background

2.14 In the Draft Method Statement and Business Plan Guidance, we summarised stakeholder feedback in response to our September 2024 letter which set out draft guidance on the Constructive Engagement process for H8, our views on the points raised by stakeholders and we set out targeted updates to our guidance on Constructive Engagement.

2.15 Since publishing the Draft Method Statement and Business Plan Guidance, HAL and airlines have completed Round 1 of Constructive Engagement.[4] The Independent Reporter ("IR") which was jointly appointed by HAL and airlines has delivered their report on Round 1, which is published with this document. Our update in this section has been informed by our attendance at Round 1 of Constructive Engagement, responses received to the November 2024 document, and the IR's report.

Stakeholder views

2.16 IAG and airlines in its group (Aer Lingus, BA and Iberia) were concerned about the H8 timescales, and how delays to those timescales might impact the Constructive Engagement process. They highlighted that Round 1 of Constructive Engagement had to take place in the absence of a final H8 Method Statement from the CAA, and that this was also a risk for Round 2 of Constructive Engagement.

2.17 HAL welcomed the objectives CAA set out for Round 1 of Constructive Engagement, and the CAA's support for the approach agreed for Round 1 by HAL and airlines (including around the provision of information during this round, which HAL noted would be high-level). HAL said a key part of the approach, which the CAA should explicitly support going forward, is the inclusion of airline presentations on key issues alongside HAL's presentations as part of Constructive Engagement, where airlines articulate their view of priorities for H8. HAL also said that both HAL and airlines should make relevant experts available as part of Constructive Engagement discussions.

2.18 It noted that the level of maturity of data and information for Round 2 is likely to vary by topic, reflecting the degree to which options have been developed in other governance forums and the maturity of solution definition. HAL said that the CAA guidelines for Round 2 should recognise that this variation is appropriate for this stage of plan development.

2.19 HAL agreed that the CAA should not take an active dispute resolution role in the Constructive Engagement discussions, but said that the CAA are an important

[4] There were some "wash-up" Constructive Engagement sessions in February 2025, after the formal end of Round 1 of Constructive Engagement in December 2024. These wash-up sessions focused on service quality, the passenger journey through the airport and consumer research.

observer in the process and can provide direction and/or ask and answer clarifying questions.

2.20 Finally, HAL said that the CAA should provide further guidance on Constructive Engagement for Rounds 3 and 4 and, in particular, on the role CAA intends to take as part of Round 4, which will be based on the CAA's initial proposals.

Summary of Round 1 of Constructive Engagement

2.21 Round 1 of Constructive Engagement took place between October and December 2024 (with follow up deep dive sessions in February 2025). Round 1 consisted of one scene-setting session and five substantive sessions on the following topics:

i. Strategy, capacity and traffic (11 November 2024);

ii. Customer (12 November 2024);

iii. Operational performance (3 December 2024);

iv. Capital choices (12 December 2024); and

v. Regulated asset base (RAB) and affordability (12 December 2024).

2.22 More information on the topics covered in session, as well as the conduct of the sessions,[5] is available in chapter 2 of the IR's report, which is published with this document. Overall, the IR concluded that the exchange of documents and information took place appropriately, with parties sharing pre-reading for each session according to the timescales agreed in advance (with some minor exceptions).

2.23 The IR's report also provided a summary of the areas of consensus and areas of difference that came up during the Constructive Engagement discussions, for each theme covered by the sessions above, which will be a useful input to prioritise areas of discussion for Round 2 of Constructive Engagement.

2.24 In terms of the quality of information provided by HAL and airlines during Round 1, the IR made a number of observations that we consider are relevant for the next stages of Constructive Engagement:

i. HAL provided information and its views on all of the topics identified by the CAA in its guidance, but, in some instances, the information provided was very high-level, which was to be expected at this stage of the process;

[5] For example location, attendance, minutes, exchange of documents and information etc.

ii. in terms of investment, the IR noted that information on the benefits was provided at a very high-level, and did not easily link with the information on costs. This was probably to be expected at this stage as the airport wanted to understand airlines' priorities on investment, but the IR noted that it would be useful for this information to be provided ahead of Round 2; and

iii. during the discussion, airlines provided some of their initial views on the main priorities for service quality and investment. However, they often did not provide very detailed views as they wanted more information in order to do so. As a result, HAL remains unclear on airline views on the relative weight between priority areas for H8.

Update on our approach

2.25 We consider that HAL and airlines made good progress on discussions during Round 1 of Constructive Engagement. We welcome that HAL and airlines have approached the process positively, providing materials in advance and a range of attendees for each session. We support the approach where presentations during Constructive Engagement are led by both HAL and airlines, as appropriate for the topic. We also agree that it is important for relevant subject matter experts from both HAL and airlines to attend Constructive Engagement sessions in the future.

2.26 The discussion during Round 1 has been helpful in providing early information on HAL's plans for capacity expansion and potential changes to the regulatory framework to support investment in commercial property. The discussion on these topics has highlighted that these are difficult issues requiring further discussion in Round 2 of Constructive Engagement.

2.27 HAL and airlines started Round 2 of Constructive Engagement in early March 2025. We have updated the timetables for Rounds 2, 3 and 4 of Constructive Engagement to reflect changes to the H8 timetable discussed earlier in this chapter. We consider that the draft guidance we previously issued on Constructive Engagement in September 2024 and, as updated in the Draft Method Statement and Business Plan Guidance, remains appropriate.

2.28 Based on Round 1 and other developments, we would make the following additional points for Round 2 of Constructive Engagement:

- As set out in chapter 1, we plan to carry out a parallel programme of work on capacity expansion alongside the H8 review. We would expect the discussion in Round 2 to focus on the H8 price control period, as separate engagement is likely to be required on capacity expansion and the third runway. HAL and airlines should also discuss issues around the separation of the H8 and capacity expansion programmes to the extent possible, which may require further engagement after round 2 has concluded.
- A key element of discussions during Round 2 of Constructive Engagement will relate to choices for the H8 period (for example around levels of service quality) and their implications for costs. Such discussions need to be supported by an appropriate level of information from HAL (recognising information will not be finalised or fully developed at this stage), to allow airlines to provide informed input where there are genuine choices to be made on the strategy for the H8 period and beyond.
- We expect airlines to continue to make sure technical experts attend relevant sessions, to support in providing input in a timely way to inform HAL's business plan. Where airlines require further information, this should be clearly set out and we expect HAL to respond to reasonable requests to meet these tight deadlines.
- For opex and revenues, we have, alongside our business plan guidance published a set of Excel-based data tables. These give HAL further clarity about the form, contents and granularity of information we expect to see in the H8 business plan and in reporting of information during the remainder of H7 and the H8 period. We encourage HAL to provide data at this level of granularity for Round 2 of Constructive Engagement, to the extent that this is available, and with appropriate confidence ranges around it.
- For capex, HAL should provide detail on the overall capex portfolio for H8, and all the capex programmes it envisages will make up this portfolio, for a two runway airport. We will consider if data tables are also appropriate for capex, following the Round 2 of Constructive Engagement, and we would share any such tables with HAL by April 2025 to inform HAL's business plan and therefore discussions in Round 3 of Constructive Engagement. We recognise that the separation of the H8 and expansion programmes will make this more complicated and may raise some issues around allocation of capex to be discussed and considered during the H8 review.

2.29 We recognise that there is a tight timetable for Round 2 of Constructive Engagement. All stakeholders will have a role in making sure the process is successful, and we will work with stakeholders to support this process and address issues arising.

Chapter 3
Business Plan Incentive

Introduction

3.1 In the Draft Method Statement and Business Plan Guidance, we set out for consultation a proposal to introduce a new business plan incentive mechanism for the H8 review.

3.2 The purpose of the business plan incentive is to incentivise HAL to provide a high-quality business plan, the quality of which we said we would evaluate on the basis of the following criteria:

- HAL's plan meets the requirements that we have set out in our business plan guidance, particularly on areas that are material and where high-quality information will be important for us to be able to properly develop our proposals for H8;
- the business plan is presented in a clear and coherent way, so that stakeholders can engage with the material presented;
- the way in which the business plan benefits consumers is clearly demonstrated;
- the plan is coherent and "joined up" across its separate sections;
- the plan is appropriately challenging in the targets it sets;
- there is evidence of third party assurance;
- HAL submits its plan on time;
- HAL responds to follow-up information requests in a timely way; and
- any additional information that HAL might submit to us late in the price control process is appropriate and HAL can justify why the further submission is necessary, appropriate and in the interests of consumers.

3.3 We proposed to evaluate HAL's plan using the following categorisation:

- Very high-quality plan: HAL's plan exceeds our expectations in terms of the quality of evidence and information it provides to support its plan. It is clear how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The plan is ambitious in the targets it sets for HAL.

- High-quality plan: HAL's plan meets the requirements set out in the business plan guidance. There is some evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The plan sets moderate targets for HAL.
- Low-quality plan: HAL's plan fails to meet a number of the requirements set out in the business plan guidance. There are significant failings and insufficient evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The targets set for HAL in the plan are not sufficiently stretching.

3.4 We said that:

- our assessment of HAL's business plan and information provided in response to information requests would be made in the round;
- in our initial proposals, we plan to consult on our overall assessment of HAL's plan and whether HAL should receive a reward, no adjustment or a penalty, and the level of any reward or penalty; and
- we would then consider further any representations and evidence on these matters before reaching our final decision.

3.5 In terms of risk and reward, we said it would be appropriate to set a high bar for HAL to earn a reward. For example, HAL would need to demonstrate that it meets our overall requirements of a high-quality business plan, as well as achieving "very high-quality" status in the areas of its business plan that we consider, having reviewed the plan, to be a high priority for furthering the interests of consumers. In contrast, if HAL were not to meet the requirements of a high-quality business plan and achieves "low-quality" status in priority areas, we would consider applying a penalty. Nonetheless, a full penalty would only be appropriate if HAL's business plan was assessed as low-quality across a significant number of areas of the plan and there was clear evidence of consumer detriment.

3.6 We proposed a symmetrical incentive with potential for bonuses and penalties equivalent to up to 20bps of return on regulatory equity ("RORE") in each year of H8, to be included in allowed revenue for the H8 price control period.

Stakeholder views

3.7 In their responses, HAL and airlines noted the importance of a high-quality business plan but they expressed concerns about how the CAA proposed to implement the business plan incentive.

Proposed assessment criteria and categorisation

3.8 HAL said it is not clear how the business plan would be assessed and categorised, nor what assessment criteria would be used. It also said the assessment criteria should be clear, objective and measurable, and it is unclear how the CAA intended to solve the issue of having no other business plans to compare against.

3.9 HAL also said that the CAA should provide detailed requirements and criteria well in advance of submission of the plan and that if these cannot be provided by early February, then either its business plan submission should be delayed, or the business plan incentive should be removed.

3.10 BA said the assessment criteria lacked detail and it was unclear what constitutes high, moderate and low quality. BA and the AOC/LACC recommended developing more explicit criteria and a transparent assessment methodology. BA proposed additional criteria that HAL should be required to meet:

- provide clearly evidenced costs, as well as demonstrating how proposals enable specific outcomes to benefit consumers; and
- demonstrate how the business plan has been developed through stakeholder engagement including Constructive Engagement. This point was also raised by the AOC/LACC, Aer Lingus, IAG, Iberia and Vueling.

3.11 These airlines said the proposed framework conflates quality and ambition requirements. They said that quality criteria should be considered as minimum requirements, with associated penalties for non-compliance and that ambition of the plan should be assessed separately and against its own criteria. BA said that demonstrating ambition, such as stretching efficiency targets that deliver clear consumer benefits and a genuine commitment to affordability, is much more challenging given that HAL's business plan cannot be compared with other company business plans. AOC/LACC said that greater consideration should be given to ambition in determining the quality of the plan.

3.12 BA suggested that we consider whether the criteria in NERL's capex engagement incentive (user focus, optioneering, responsiveness, mitigating/corrective actions) could be used in assessing HAL's business plan.

3.13 The AOC/LACC suggested that areas which required significant intervention in H7 should be priority areas for H8.

Structure and calibration of incentive

3.14 HAL agreed with implementing a symmetrical incentive, noting precedents from other regulated sectors.

3.15 Airlines (Aer Lingus, IAG, Iberia, Vueling, BA) and the AOC/LACC strongly disagreed with the incentive including a reward element, as we should not financially reward HAL for achieving regulatory expectations. BA and AOC/LACC referred to NERL's capex engagement incentive, where they said we previously supported a penalty-only incentive against the delivery of normal and expected activities.

3.16 Airlines said that penalties should be automatically triggered for a low-quality business plan. BA and the AOC/LACC proposed that, in order to avoid a penalty, all minimum requirements should be met, citing the minimum requirements approach of other regulators.

3.17 Airlines disagreed with the proposed level of the incentive, stating that it was too high and disproportionate, as the maximum reward is five times the amount payable to HAL in 2025 for service-related bonuses.

3.18 BA and the AOC/LACC also said that we should not undermine the intent of a potential penalty by providing compensation through cost of capital or other areas of the price control.

Update on our approach

3.19 We propose to implement a business plan incentive for H8, which we consider will be an important part of incentivising HAL to provide a high-quality business plan and responses to information requests.

3.20 We consider the criteria and categorisation in the Draft Method Statement and Business Plan Guidance provide clear and concise high-level guidance on our expectations, and are supported by the more detailed Business Plan Guidance set out later in this document. There would be potential difficulties with more detailed criteria and categorisation, including signalling an unduly mechanistic approach to the evaluation. While we note stakeholders' concerns about transparency, we intend to ensure that our approach and assessment are transparent, for instance by providing evidence and examples of high- and low-quality information. In addition, we will consult stakeholders on our assessment and the calibration of the incentive adjustment, within the broad framework established by this guidance.

3.21 While we have not included additional criteria, as we consider the current criteria cover the points raised by airlines, we have made clearer in the categorisation that we will consider consumer research and stakeholder engagement in our assessment of how consumers' needs have informed the plan. Also, our stated assessment criteria already require that the plan meets the requirements that we have set out in our business plan guidance (which requires clearly-evidenced forecasts of costs) and that the way in which the business plan benefits consumers is clearly demonstrated.

3.22 We have clarified the assessment criteria to note that any additional information that HAL might submit to us late in the price control process should be proportionate (in addition to being necessary, appropriate and in the interests of consumers, as previously specified).

3.23 In order to incentivise strong performance, we consider it appropriate to retain an 'ambition' dimension as part of our assessment. This reflects our present view that ambition is likely to focus on a small number of important areas, including service quality performance and cost efficiency, but also the advantages of not over complicating the specification of new incentive arrangements. Nonetheless, we will review the effectiveness of the incentive and whether to adopt the airlines' suggestions of separate 'ambition' and 'quality' dimensions at future price control reviews in the light of this review.

3.24 We remain of the view that it is appropriate to finalise priority areas during the H8 review, at an appropriate time, rather than specifying these up-front, to retain flexibility in our assessment. In particular, HAL's business plan may reveal particular challenges or issues for consumers and these should be given appropriate weighting in our final assessment.

3.25 A symmetrical approach to the business plan incentive is appropriate, with potential for rewards and penalties. The potential to earn a reward provides a stronger incentive to outperform baseline expectations than a "penalty only" regime. We consider a bonus for a very high-quality plan to be proportionate to benefits for consumers, as it would mean HAL has taken appropriate account of consumer priorities and views from stakeholders, HAL's proposals show ambition and are transparent, supporting a timelier price control review and a better outcome for consumers. We have set a high bar for HAL to earn a reward, which will require it to demonstrate that it has gone beyond normal regulatory expectations in priority areas in order to earn any bonus.

3.26 With regard to comparisons drawn by airline stakeholders to the NERL capex engagement incentive, we note that the incentive on NERL is a much more targeted incentive mechanism. The business plan incentive we are proposing for HAL is a much broader measure, reflecting all parts of HAL's planning and engagement: there is a more direct link between outperformance and additional consumer benefits, supporting the inclusion of a financial reward for outperformance of baseline expectations.

3.27 We note the concerns raised over the maximum level of the incentive and recognise that a degree of prudence is reasonable given that it is a new incentive and there are no direct comparators for HAL's business plan. We therefore propose to reduce the maximum penalty and bonus in a year from 20 bps to 10bps on RORE, which would be approximately £8 million per year, or around

£0.10 per passenger.[6] The actual assessment could lead to a penalty or reward within this range.

3.28 While we expect the package of H8 incentives to be consistent with the principle that has been endorsed by the CMA of a 'fair bet', we do not expect to make compensating adjustments in other areas of the price control (including the cost of capital) to take account of the introduction of the business plan incentive.

Our approach

3.29 We will introduce a business plan incentive and intend to apply penalties in areas where the business plan is assessed as low-quality using the criteria and categorisation we have set out. We would make our assessment in the round and explain our assessment to avoid applying disproportionate rewards or penalties, for example where there is a single area of the business plan that is high or low quality.

3.30 Nonetheless, we have reduced the materiality of the proposed incentive as discussed above.

3.31 In assessing the business plan incentive, we will apply the criteria set out below:

- HAL's plan meets the requirements that we have set out in our business plan guidance, particularly on areas that are material and where high-quality information will be important for us to be able properly to develop our proposals for H8;
- the business plan is presented in a clear and coherent way, so that stakeholders can engage with the material presented;
- the way in which the business plan benefits consumers is clearly demonstrated;
- the plan is coherent and joined up across its separate sections;
- the plan is appropriately challenging in the targets it sets;
- there is evidence of third party assurance;

[6] HAL reported a closing RAB in its 2023 regulatory accounts of £19.8 billion and, assuming a 60% gearing, 10bps of RORE would be equivalent to an adjustment to allowed revenues of approximately £8m in each year of H8. If this was evenly spread amongst each of the 79.2 million passengers who travelled through Heathrow in 2023 this would equate to £0.10 per passenger. The figures shown here are in 2023 prices and are illustrative only. Note also that this calculation uses the 2023 RAB as it is the latest RAB balance reported in regulatory accounts -the bonuses or penalties for H8 would be calculated using the forecast RAB values over the H8 period.

- HAL submits its plan on time;
- HAL responds to follow-up information requests in a timely way; and
- any additional information that HAL might submit to us late in the price control process is appropriate and HAL can justify why the further submission is necessary, proportionate, appropriate and in the interests of consumers.

3.32 We will use the categorisation set out below, which refers to the criteria above:

- Very high-quality plan**:** HAL's plan exceeds our expectations against the criteria. For example, it is clear how consumers' needs (as ascertained through consumer research and stakeholder engagement) have informed the development of the business plan and how they will be furthered by the implementation of the business plan, and the plan is ambitious in the targets it sets for HAL.
- High-quality plan: HAL's plan meets the requirements set out in the criteria. For example, there is some evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan, and the plan sets moderate targets for HAL.
- Low-quality plan: HAL's plan fails to meet a number of the requirements set out in the criteria. For example, there are significant failings and insufficient evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan, and the targets set for HAL in the plan are not sufficiently stretching.

3.33 We will set a high bar for HAL to earn a reward. For example, HAL would need to demonstrate that it meets our criteria of a high-quality business plan, as well as achieving "very high-quality" status in the areas of its business plan that we consider, having reviewed the plan, to be a high priority for furthering the interests of consumers. In contrast, if HAL were not to meet the requirements of a high-quality business plan and achieves "low-quality" status in priority areas, we would consider applying a penalty. Nonetheless, a full penalty would only be appropriate if HAL's business plan was assessed as low quality across a significant number of criteria or areas of the plan and there was consumer detriment.

Chapter 4

Method Statement: overarching issues

Introduction

4.1 This Method Statement sets out our approach to the H8 price control review. To further the interests of consumers, the price control sets a cap on the allowed level of revenue per passenger that HAL can collect from airport charges, as well as creating incentives on HAL to invest efficiently and provide a good level of service quality.

4.2 For the H8 review, we remain of the view that it will be appropriate to retain a similar approach to the regulatory framework to that of H7.

4.3 We have also considered the implications of the recent Government statements on the development of a third runway at Heathrow airport. We are of the view that a programme as large and strategically significant as the development of a third runway at Heathrow is best dealt with separately to the resetting of HAL's 'business as usual' price control. Given the large investment programme needed for both terminal and runway expansion and the need to consider the appropriate treatment of these costs, it is unlikely to be appropriate for these to be part of a business as usual price review for the H8 period. Therefore, the presumption is that matters relating to capacity expansion, including the significant expansion of terminal capacity will be dealt with in a new regulatory work programme on capacity expansion.

4.4 This will involve the need for careful analysis and close working with stakeholders to appropriately separate business as usual from capacity expansion capital expenditure. In this context, we note that the Government has an aspiration to decide on planning consent in 2029, which means substantial expenditure on construction activities might start in 2030 or 2031, which would be at the end of the H8 period. We expect to engage further with stakeholders on these matters and the wider capacity expansion programme in the coming months.

4.5 There are advantages to consumers of having new price control arrangements put in place in an orderly way for the operation of a two runway airport in the H8 period. The construction of new terminals and a new runway will take a number of years to complete and so the H8 period will involve HAL continuing to operate a two runway airport. It is important to consumers that there is an appropriate degree of focus on the regulatory arrangements that will support these operations.

4.6 We recognise the significant interactions between the H8 price control and the capacity expansion programmes and will take steps to ensure that we take a coordinated approach across these programmes. This approach will be designed to ensure consumers' interests are properly protected, including that there is no "double counting" of costs and that HAL is able to finance investment efficiently (with consumers benefitting from the price control being set on the basis of relatively low finance costs).

4.7 The Draft Method Statement and Business Plan Guidance identified areas where we consider that our approach could be improved from the H7 review, and said we would make changes where there is evidence of a better approach that can be reasonably introduced as part of this review. We are setting those changes out in this document.

4.8 In this chapter, we set out our views on the overall context and priorities for the H8 review. We then set out our proposed approach to the following overarching aspects of the price control review:

- scope of the price control and overall approach;
- consumer engagement; and
- environmental sustainability.

4.9 The following two chapters set out our approach on key components of setting the price control, including costs and cost incentives, traffic, service quality and financial issues. We also provide business planning guidance for HAL to support the production of its H8 business plan in Appendix A.

Overall context and priorities

Background

4.10 In the Draft Method Statement and Business Plan Guidance, we noted the unusual circumstances of the H7 review and said that we would not expect these to be repeated for H8. We said that, for H8, we would be developing an approach consistent with Heathrow being a two runway airport with a relatively stable outlook for traffic forecasts.

4.11 The issues we expected to be important in the context of H8 were:

- HAL's emerging plans to expand capacity within a two runway airport;
- the possibility that HAL might look to bring forward plans for a third runway while the H8 review is ongoing, and the need to consider these in the H8 context;
- the need to develop arrangements to ensure high-quality services, financial and operational resilience, and support the transition to net zero; and

- the need to manage likely upward pressure on airport charges, especially in the short term, due to the need to finance new investment, increases in the real costs of financing and potential increases in certain operational costs.

4.12 In this context, we identified three key priorities for the H8 price control review and sought stakeholder views on these priorities:

a) incentivising HAL to deliver a high standard of service quality and environmental performance in a timely way, including ensuring that HAL reasonably supports the transition to net zero;

b) allowing for efficient investment and providing incentives to increase capacity, improve the operational and financial resilience of the airport, meet environmental targets, support technological change and further other objectives that are valued by consumers, now and for the longer-term; and

c) ensuring current and future consumers and airlines face airport charges that are no higher than necessary, including through incentivising cost efficiency and ensuring that any growth in HAL's RAB is sustainable.

4.13 Since we published the Draft Method Statement and Business Plan Guidance, the UK Government announced its strong backing for capacity expansion at Heathrow airport, through a third runway. It asked HAL to provide proposals by this summer and said that it would then assess value for money in a new airports national policy statement ("ANPS"). As we have noted above and explain further below, we expect to consider plans for a third runway at Heathrow separately but will take a coordinated approach across these work programmes.

4.14 In the light of the recent UK Government announcements, and in response to feedback we received to the Draft Method Statement and Business Plan Guidance, we have updated the key priorities for the H8 price control review, which can be found at the end of this section.

Stakeholder views

4.15 Stakeholders set out their overall priorities for H8 and provided comments on the priorities we had set out in the Draft Method Statement and Business Plan Guidance. All of these responses were provided before the Government announcement on the development of a third runway at Heathrow.

4.16 A number of airlines (Aer Lingus, BA, IAG, Iberia and Virgin) considered that fundamental reforms are needed to how HAL is regulated, to improve consumer outcomes, particularly in relation to the high level of charges, affordability and resilience for UK consumers and the ability to sustainably grow HAL's position as a strong hub for the UK economy.

4.17 Virgin said that the RAB-based regulation model does not work for HAL and creates a perverse incentive for HAL to maximise capex spend and to increase the RAB. It says economic regulation of HAL should replicate competitive pressures to deliver a reduction in passenger charges.

4.18 On the priorities, airlines supported the approach but said that the priorities should be clarified and link more strongly with the CAA's primary duty to further the interests of consumers. They said this should mean putting more emphasis on affordability, the overall level of charges and HAL having a sustainable cost base, rather than "managing increases" in airport charges.

4.19 Airlines said protecting consumers and putting more emphasis on affordable levels of charges should come ahead of considerations about HAL's financeability, as this approach would better reflect our primary duty. Virgin said we had inappropriately conflated the needs of investors and consumers, and the AOC/LACC stated that "financial resilience" should not be a priority.

4.20 Airlines supported the references to the findings from the 2024 Review and identified other issues beyond the key priorities that need to be considered for H8, for example the approach to Other Regulated Charges.

4.21 HAL set out five key objectives that it considers the CAA should deliver on for H8 and address in its final method statement. These were:

- reforming the boundary of the single till to boost investment opportunities;
- seeking a collective approach to Measures, Targets and Incentives ("MTIs");
- targeted changes to capex governance arrangements;
- setting a clear direction on financeability; and
- improving the business plan incentive proposal set out in the Draft Method Statement and Business Plan Guidance.

4.22 HAL also says we should refer to "value for customer" as part of the priorities for H8.

Response to stakeholder views

4.23 A number of the comments made by airlines concern the overall approach we had set out to the H8 review in the Draft Method Statement and Business Plan Guidance. We address these comments below under the following headings:

a) overall regulation of HAL and the RAB-based model;

b) levels of charges and the underlying cost base at Heathrow; and

c) HAL's financeability.

4.24 We also explain below the approach we intend to take to the third runway and capacity expansion at Heathrow, bearing in mind the Government's recent announcement on these matters.

4.25 The issues that HAL set out in its response as key objectives for H8 all relate to important aspects of the price review. They are dealt with later in this document, as follows:

- on reforming the boundary of the single till, we explain in chapter 6 that we will consider arguments put forward by HAL, and remain open to working with stakeholders to potentially develop the regulatory framework in this area;
- on seeking a collective approach to MTIs, we have clarified in chapter 5 that we consider the current outcomes MTI scheme to be sufficiently flexible to allow a more “collective approach” to reflect the varying roles and influence that different stakeholders have on service quality;
- on targeted changes to capex governance arrangements, we explain in chapter 5 that we will work with stakeholders to consider these and identify any changes that need be made to the framework to ensure it is working as intended;
- on financeability, we explain our approach in chapter 6, emphasising that, as for H7, our overall approach will be to assess the issues in the round so that the price control is set at an efficient level and supports efficient financing, so that charges are no higher than necessary in the interests of consumers; and
- on the business plan incentive, we have responded to points raised by stakeholders in chapter 3 and have set out our approach to the H8 business plan incentive, including in areas such as assessment criteria and categorisation of the plan, and the structure and calibration of the incentive.

Overall regulation of HAL and the RAB-based model

4.26 While airlines made comments about the overall regulatory framework, in the context of our priorities we agree with many of the points made by airlines around the outcomes that our economic regulation of HAL should deliver, including:

- improving consumer outcomes and resilience at the airport; and
- delivering sustainable investment and overall and effective cost control that would feed through into airport charges and prices for consumers.

4.27 In addition to these matters, we understand airline concerns about the possible extent and efficiency of HAL’s capital spending, bearing in mind some of the indicative estimates of capex shared by HAL as part of the first round of the Constructive Engagement process. We also note that these were indicative estimates rather than a fully developed business plan (which would need to be supported by appropriate evidence and assurance).

4.28 There are also clear interactions with new capacity expansion programme. We have assumed in our approach to this method statement that significant expansion of new terminal capacity for the two runway airport should be considered as part of the wider capacity expansion programme. As part of this wider work on capacity expansion, we will consider issues around the most appropriate regulatory framework to deliver in the interests of consumers and ensure that airport charges remain at reasonable and sustainable levels.

4.29 Bearing all of the above in mind, we consider that the existing regulatory model, with suitable adaptions and improvements, can be used to reasonably protect consumers during the H8 period and in the context of a "business as usual" price control focusing on the operation of a two runway airport. Our work on capacity expansion may lead us to consider amendments to the existing regulatory model in future price controls.

Level of charges at Heathrow and the underlying cost base

4.30 We agree with the points raised by airlines around the need for HAL to have a sustainable cost base and, as set out in chapter 5, we intend to scrutinise HAL's cost and revenue forecasts for H8 carefully, with the intention of ensuring that only efficient costs are recovered through charges.

HAL's financeability

4.31 The Draft Method Statement and Business Plan Guidance discussed financial resilience and financeability in the context of a broader priority of allowing for efficient investment and efficient financing costs, which we continue to consider would be in the interests of consumers. Therefore, we do not agree with the interpretation put forward in some of the responses that the CAA has prioritised HAL's financeablity above other objectives or above our primary duty to further the interests of consumers. We are also clear that CAA12 does not require us to apply a specified hierarchy in the matters that we should consider in our work to further the interests of consumers.

4.32 We said in the Draft Method Statement and Business Plan Guidance that we expect to carry out financeability analysis for H8 that is similar to our approach to H7. Further discussion of feedback received on this issue is included in chapter 6 of this document.

Updated priorities for H8 price control review

4.33 In the light of stakeholder feedback to the Draft Method Statement and Business Plan Guidance, as well as the recent Government statements on the development of a third runway at Heathrow, we have updated our priorities for the H8 price control review. We consider that these updated priorities provide a clearer focus for the H8 review and also take account of wider developments in an appropriate way.

4.34 The updated H8 priorities are:

- **Progress the H8 review in a way that is effectively coordinated with the development of the regulatory framework for capacity expansion and a third runway at Heathrow**.
- **Allow for efficient investment that will deliver benefits for consumers, by providing effective oversight and scrutiny of HAL's H8 capex plans.**
- **Incentivise HAL to deliver a high standard of service quality and environmental performance throughout the H8 period**. HAL should be incentivised to further those objectives that are valued by consumers, now and for the longer-term, which will include improving operational resilience, supporting growth and technological change, and contributing to the transition to net zero.
- **Ensure current and future consumers and airlines face airport charges that are no higher than necessary**, including through incentivising efficiency, ensuring that any growth in HAL's RAB is sustainable and developing the regulatory framework in a way that is consistent with HAL continuing to access cost effective financing.

Scope and approach

Background

4.35 In the Draft Method Statement and Business Plan Guidance, we confirmed that we were not planning to carry out a market power determination as part of the H8 price control review. Nonetheless, we said we would consider proposals for focused changes that allow for a greater role of competitive forces, for instance in relation to the boundary of the single-till and airport charges, where there is a strong case that this is in the interests of consumers.

4.36 Consistent with established regulatory and CMA precedent, we proposed to use regulatory building blocks to determine an appropriate revenue requirement for HAL that enables us to set a five-year price control.

4.37 Alongside this approach, we said we would develop and improve the incentives for cost efficiency, quality of service, resilience, the delivery of environmental objectives and risk sharing to ensure that we further the interests of consumers and deliver our other statutory duties.

Stakeholder views

HAL

4.38 HAL acknowledged that the CAA would not conduct a market power assessment ahead of H8, but considered that regulatory impact assessments should be used in H8 to evaluate the benefits and costs of current regulation and to test assumptions about market power.

4.39 It said that the cost of delivering capital investment at Heathrow is determined by a number of factors, including service levels, provision of cargo facilities, operational complexity, and geographical location. In addition, HAL highlighted the large number of stakeholder interfaces it has to manage and the operational challenges which impact its business and capital investment. HAL said that the choices and operational priorities it has developed to reflect airline priorities and business models have benefited airlines and passengers, justifying the overall higher capital costs.

4.40 HAL also reiterated its commitment to long-term sustainable growth and expansion, including the option of a third runway. It said that it would be important for the H8 process to be able to accommodate potential developments related to the third runway (and its costs), if they took place within the H8 period. It said that costs associated with preparing and submitting any DCO application should be treated in the same way as other capex rather than revisiting previous category-based approaches used in Q6 and H7. It said it would welcome further engagement on a proposed approach.

Airline stakeholders

4.41 The AOC/LACC agreed with the CAA that the scope of H8 should be a two runway airport but thought that the CAA needs to have a longer-term strategy regarding the regulation of HAL that looks at proposed investment and overall affordability, and how H8 will facilitate this.

4.42 Virgin set out its views that the existing RAB-based regulation model is more suited to homogenous infrastructure or commoditised services, but not for HAL given the complexity of operations at Heathrow and the need to focus on customer experience. It also said that the RAB-based approach creates incentives for inefficient investment to inflate the size of the RAB (drawing on the Competition Commission's ("CC") BAA airports market investigation from 2009), as shown by the high level of charges at Heathrow, declining service standards and the focus on capacity rather than consumer outcomes. Virgin said these concerns were not addressed by the CAA in the Draft Method Statement and Business Plan Guidance.

4.43 Virgin also commented on the need to review other parts of the regulatory framework, including ex ante capex incentives, incentives on passenger forecasts and reliance on HAL to provide sufficient and timely data to facilitate the regulatory process.

4.44 As part of its comments on scope and approach, the AOC/LACC made a number of points around how financial and cost data should be presented in the business plan. These points are dealt with either in the later chapters of this method statement or in the final business plan guidance (Appendix A).

Update on our approach

4.45 We note HAL's point about impact assessments. We consider that the work we undertake to prepare and consult on our proposals reasonably considers likely impacts and is designed to ensure that our proposals are a proportionate way of furthering the interests of consumers. During the H7 price control review we used our statutory duties as a basis for assessing the regulatory framework for HAL and considering how this framework should be best developed. Our approach was broadly supported by the CMA in hearing the airport and airline appeals on the H7 price control and we intend to retain this approach for H8.

4.46 We also note the points HAL made on the factors that impact its capital investment. We will consider these points, and points raised by other stakeholders when assessing the elements of HAL's capital plan that relate to the operation of a two runway airport.

4.47 The position on capacity expansion has changed with the recent Government announcements on the third runway at Heathrow and we have explained above how we intend to deal with these matters. We will engage with HAL and other stakeholders further on these issues in the coming months.

Airline stakeholders

4.48 We agree with the point raised by Virgin and the AOC/LACC about the need for the CAA to be able to scrutinise HAL's longer-term investment plans effectively, when these span regulatory periods. We also note the points made on the RAB-based regulation model.

4.49 As we have explained above, we now plan to deal with capacity expansion and the related capital expenditure in a separate work programme. We will also consider whether a different or new approach is required to regulating capacity expansion given the likely size of the capital expenditure programmes, the longer-time horizons and particular risks associated with this activity. Nonetheless, we do not accept all the criticisms Virgin has made of incentive-based price controls that make use of a RAB to provide efficient funding. For instance, we note:

- that RAB-based regulation has advantages in terms of supporting efficient financing and can be supplemented with incentives for capital efficiency. We also note that at a high-level airports can have characteristics that have similarities to other businesses subject to price control, for example the operations of a water and waste water company are also highly complex and involve a wide range of customer facing activities; and

- that the relatively high charges and the service levels at Heathrow will be the result of a number of factors, including the operating environment, rather than necessarily indicating an issue with the underlying regulatory model. We also note that the approach that airlines at Heathrow have previously advocated will have contributed to the growth in HAL's RAB, both in terms of representations that airlines should not 'prepay' for upgrades in capacity and the conduct of airlines in favouring short-term price reductions over a reduction in HAL's RAB as part of the agreement on extending the H7 price control in 2019.

4.50 Nonetheless, in the context of capacity expansion, we will be considering the issues raised around the regulatory approach in the coming months. We also remain open to constructive suggestions as part of the H8 process as to how we can further improve incentives on HAL for efficiency and reasonable proposals to ensure that HAL's RAB remains at a sustainable level, as discussed further in the following chapters.

Consumer Engagement

Background

4.51 In the Draft Method Statement and Business Plan Guidance, we said that an in-depth understanding of consumers' views through research and engagement will be an important part of making sure that the price controls further the interests of consumers.

4.52 We stated that we intend to show how we have reflected consumer priorities in our proposals and decisions and that we expect HAL to:

- carry out its own research and engagement with consumers, local community groups and other stakeholders;
- demonstrate a clear "line of sight" as to how it has taken consumer priorities into account in the development of its business plan; and
- consult with us and stakeholders on its plans for new consumer research and engagement, to allow for appropriate input.

4.53 Furthermore, we said that airlines and other stakeholders may also have important insights into consumer priorities and that we will aim to consider this wider information. We stated that it will also be important for HAL and airlines to give full weight to consumer priorities during the Constructive Engagement process.

Stakeholder views

4.54 HAL said it will continue to conduct its own consumer research and analysis to provide insights into consumer priorities and to engage consumers on long term planning issues, and it will use a mix of direct, indirect and inferred consumer engagement tools.

4.55 It also encouraged the CAA to strengthen our own consumer research work and to set out our developing thoughts in this area. HAL suggested that we consider appointing a lead on consumer engagement and include the independent Heathrow Passenger Forum in Round 4 of Constructive Engagement. It also asked that we engage with HAL on the terms of reference if we choose to commission specific additional work.

4.56 BA said that HAL should consider airlines' consumer research and it should consult CAA and airlines on its future research and engagement plans. While BA agreed with the principle of demonstrating a clear link between consumer insights and future plans, it highlighted the importance of guaranteeing a stable, predictable and reliable passenger journey.

4.57 The AOC/LACC broadly supported our proposed approach to consumer engagement including recognising the importance of airline insight. It expressed concerns about the CAA relying solely on HAL's consumer insight and requested further details on the process for the CAA carrying out its own research. It also said that the outcomes of Round 1 of Constructive Engagement should help inform particular areas of focus for consumer research.

4.58 Heathrow Southern Railway supported the emphasis on understanding consumer priorities and consider the CAA's own research would be important in considering our primary statutory duty.

4.59 Virgin expressed its disappointment that our proposed approach to consumer engagement for H8 remains largely unchanged from previously. It said we should give much stronger recognition to the specific knowledge and expertise from airline input in this area.

Update on our approach

4.60 We remain of the view that an in depth understanding of consumers' views through research and engagement will be a crucial part of ensuring that the price controls further the interests of consumers.

4.61 We note HAL will carry out its own consumer research and analysis and we strongly encourage airlines and other stakeholders to provide supporting analysis and evidence. HAL and airlines should give full weight to consumer priorities during the Constructive Engagement process and HAL should seek to engage both CAA and airlines so as to provide full transparency in relation to its consumer research activities.

4.62 To support our work for H8, we are exploring how we provide a critical review of how HAL's consumer research has been used to develop its business plan and how consumer research can be used to support our initial and final proposals. We are considering appointing external advisors in this area and will update stakeholders in due course. However, we do not necessarily expect to carry out or primary research unless a significant gap is identified and we are best placed to lead research to address this gap.

Environmental sustainability

Background

4.63 In the Draft Method Statement and Business Plan Guidance we said that environmental sustainability is a priority area for H8 and that we will want to ensure that the price control provides for efficient and necessary expenditure to appropriately support HAL's transition to net zero.

4.64 We said that HAL should set out clearly its delivery plans for its environmental obligations and how it will reasonably support the transition to net zero in the H8 period and beyond. We said that we expect to see evidence that HAL has considered these issues as part of consumer engagement, Constructive Engagement and in its business plan.

4.65 We also said that we would review the incentives on HAL to improve environmental performance, including measures and targets it proposed to reduce emissions at the airport. As part of our initial proposals following the mid-term review of the H7 Outcome Based Regulation,[7] we are proposing to adopt HAL's existing carbon measure as the basis for a reputational incentive on HAL. HAL will be required to report information on greenhouse gas emissions: this will be a new measure under the MTI scheme.

Stakeholder views

4.66 Stakeholders agreed with our approach of making environmental sustainability a key priority for H8. Both HAL and airlines recognised the importance of cross sector working to achieve environmental obligations. HAL said that it is important to consider decarbonisation both on the ground and in the air. Airlines said that it is important that the sector to works together to achieve sustainability outcomes for example, by improving operations and resilience so that airport users can meet their net zero targets.

4.67 On environmental obligations:

[7] See CAP3073 Outcome Based Regulation Mid-Term Review – Initial Proposals. The OBR framework provides incentives on HAL to maintain and improve the quality of service that it provides to its passengers and airline customers.

- HAL suggested that our guidance could better reflect the key legislation or policy decisions on net zero which HAL will consider when it develops its plans;
- airlines asked for a clearer definition of environmental performance and targets; and
- the AOC/LACC suggested that HAL should clearly set out where it is complying with legal or regulatory objectives verses where it is seeking to push beyond these environmental obligations, either in terms of scale and / or delivery timescales.

4.68 On sustainability investment projects:

- HAL remains of the view that due to the importance of its sustainability projects to deliver decarbonisation, a more streamlined capex governance process is needed for net zero projects; and
- airlines said that sustainability projects should continue to be subject to the H8 capex incentive framework and governance arrangements, including appropriate delivery obligations and credible business cases to support each project.

Update on our approach

4.69 We remain of the view that environmental sustainability is a priority area for H8 and that we will want to ensure that the price control provides for efficient and necessary expenditure to support HAL’s existing environmental obligations (such as on noise, air quality and water quality) as well as its transition to net zero.

4.70 It will be important that HAL clearly sets out its delivery plans for its environmental obligations and for making appropriate progress with its transition to net zero in the H8 period. We have updated our business plan guidance to support HAL in developing its plans in this area (see Appendix A).

4.71 In December 2024, HAL held its first round of Constructive Engagement with airlines where it outlined its environmental goals which it said will support decarbonisation in line with wider sector targets, as well as its plans for a proposed carbon, energy and sustainability investment programme for H8. We welcome the progress that HAL is making with airlines in this area as part of Constructive Engagement and we recognise the importance of cross sector working to achieve net zero targets. We expect to see evidence that HAL has also considered these issues as part of consumer engagement and in developing its business plan.

4.72 As part of our assessment of HAL’s business plan, we will review the overarching environmental targets that HAL has considered when developing its plan. For example, we will engage with HAL and stakeholders to consider whether a target for the newly proposed carbon measure would be appropriate for H8. We intend to seek views from the CAA's sustainability panel to help advise us on these areas and to inform our assessment of HAL's business plan.

4.73 As part of our work on assessing costs, we will consider the investment and other costs that HAL has proposed to meet its environmental obligations and targets. A key focus of our review will be to ensure that HAL's proposals are reasonable and deliverable and that any capex is appropriately justified and efficient so that airport charges are not higher than necessary. We expect to see clear and robust business cases that explain how the proposed investment supports delivery of HAL's long term environmental targets in the most cost-efficient way over the long-term. This should include a clear description of how the programme will allow HAL to meet its environmental obligations in an optimal way. HAL should provide an appropriate "needs case" for the investment, and a thorough evaluation of the investment and the other options HAL has considered, to demonstrate that the programme provides value for money for consumers.

4.74 In terms of the specific projects within this programme, we expect HAL to continue working within the existing capex incentive framework and HAL-airline governance arrangements, including proposing appropriate Delivery Obligations ("DOs") for this investment. The framework is flexible, for example new projects can be developed during the price control period. It also allows HAL and airlines to work together to agree bespoke arrangements for different types of projects, provided HAL can demonstrate that the approach does not compromise the overarching criteria of investment being well evidenced and justified. If HAL considers that a bespoke approach to capex efficiency is important and justified for sustainability investments, for example in terms of how the G3 baseline is approved or how DOs are defined, and would like this to be reflected in the overall *ex ante* capex incentives framework, it can bring such proposals forward and we will carefully consider them.

Chapter 5

Method statement: costs and cost incentives, traffic and service quality

Introduction

5.1 This chapter sets out our broad approach to the H8 price review on cost assessment, cost incentives, traffic forecasts and service quality. We further the interests of consumers by setting a price cap that is based on efficient costs and a reasonable forecast of traffic for the H8 period. Our approach also creates incentives on HAL to invest efficiently and deliver a high standard of service quality.

5.2 It has the following structure:

a) traffic forecasts;

b) service quality and resilience;

c) costs and revenues; and

d) cost incentives (capex incentives, opex incentives and the boundary of the single till).

Traffic forecasts

Background

5.3 In the Draft Method Statement and Business Plan Guidance, we said that passenger number forecasts are a key building block for the price control as they are an input to the forecasts for operating costs, inform the relative benefits and costs from investment in expanding capacity, and are used in the determination of the allowed revenue per passenger. We confirmed that:

- we expect there to be advantages in commissioning an external independent traffic forecast for H8. Consequently, we would plan to commission work on external traffic forecasts in early 2025, in time to inform our initial proposals; and
- HAL and the airlines should work together during Constructive Engagement to reach a joint view on a reasonable range of forecasts. We understood that they would discuss traffic forecasts as part of Round 1 of Constructive Engagement starting in October 2024.

Stakeholder views

CAA independent forecast

5.4 In its response, HAL suggested that the CAA's work should be focused and tailored to specific capacity issues at Heathrow and that capacity inputs and assumptions should be agreed with HAL from the outset. HAL suggested that this would require upfront engagement with its own experts to ensure that the operating environment is properly understood.

5.5 Furthermore, HAL was of the view that forecast work undertaken by the CAA should reflect the emerging themes of Round 1 of Constructive Engagement and, in particular, the interaction between capacity, passenger traffic, and impact/choice on levels of service and resilience.

5.6 In the AOC/LACC response, the airline community welcomed that CAA would be undertaking its own, independent traffic forecasts for H8.

HAL/airline joint work on forecasts

5.7 HAL requested further details as to the CAA's proposed approach around the bringing together of the joint traffic forecasts and the corresponding timing of this including whether this would be undertaken after Constructive Engagement or within the final Business Plan. HAL also asked for clarification on how we would go about bringing together the views of airlines and HAL if their respective positions were found to be some way apart.

5.8 In the AOC/LACC response, the airline community reiterated the importance of reviewing past forecast compared to outturn performances. It noted that HAL and airlines should concentrate on reaching a view on a range while allowing a focus on the independent work being undertaken by the CAA.

5.9 Virgin pointed out that throughout the H7 process and subsequent appeal, HAL defended its passenger forecasts and modelling as robust despite the publicly announced monthly passenger volumes outstripping HAL's forecasts throughout the period.

Update on our approach

CAA independent forecast

5.10 We welcome the support provided by stakeholders for our proposed development of an external independent traffic forecast for H8.

5.11 Subsequent to the publication of the the Draft Method Statement and Business Plan Guidance, we have appointed consultants, Steer, to lead this work. The work, which commenced in January 2025, has several phases which include:

- the development of a broad approach to passenger forecasting;

- assessment of the traffic forecasts in HAL's business plan; and
- support for our development of initial and final proposals.

5.12 Steer will engage with HAL and the airlines in due course in relation to this work and we expect that this engagement will continue over the duration of the project. This will allow for the discussion of the relevant inputs and assumptions which should be taken into account in developing the independent traffic forecast.

HAL/airline joint work on forecasts

5.13 It will be important for HAL and airlines to seek to agree traffic forecasts as soon as practicable. However, we recognise also that the respective positions of HAL, airlines and our independent advisers may evolve over time as new information becomes available and, therefore, we do not consider that we are currently in a position to specify a timing for consensus to be reached.

5.14 In the event that agreement cannot ultimately be reached, we would expect HAL and airlines to submit their respective positions to us so that we can consider them as part of our overall assessment, together with the independent forecast.

Service quality and resilience

Background

5.15 Incentivising HAL to deliver a high standard of service quality and resilience is one of our main priorities for H8.

5.16 In the Draft Method Statement and Business Plan Guidance, we set out our expectation that, following the introduction of Outcome Based Regulation ("OBR") in H7, we would take a similar approach in H8 with the priorities for the price review reflected in the measures, targets and incentives ("MTI") and included in the Licence. We said that we will consider whether new outcomes or new measures should be introduced and whether to change the balance of incentives across the various measures. We also said it will be important to provide strong incentives on key consumer priorities and on HAL to maintain resilience during H8, and these considerations may require new or increased financial incentives.

Stakeholder views

5.17 HAL suggested a collective approach to MTI should be a priority to drive improved consumer outcomes linked to performance and resilience. It said the Method Statement should support HAL in bringing forward such proposals, in discussion with airlines. HAL said this would allow the MTI scheme to evolve and would introduce more collective accountability amongst all airport stakeholders, with HAL and other airport stakeholders working together to improve performance against key measures.

5.18 It said that KPIs could be set on non-HAL stakeholders where there is a clear and direct influence on HAL's service level targets. In support of this, HAL gave examples of security and baggage performance where control or influence is split between itself, airlines, other airport users and external factors.

5.19 HAL gave examples of aiports where such arrangements have been developed including:

- London Gatwick, which has Airline Service Standards in addition to the Core Service Standards delivered by the airport operator;
- Copenhagen, where the airport operator and users have a service level agreement where the airport is only required to pay rebates for service failures to airlines when the airlines have met their own key performance indicators, or else the rebates are paid to an investment pot for use elsewhere at the airport; and
- Groupe ADP, which has performance indicators for baseline service levels and excellence indicators which have bonuses. It also committed to developing a collaborative approach with stakeholders to address passenger experience issues.

5.20 BA, IAG and other IAG airlines agreed that the HAL should update the outcomes and MTI scheme based on evidence, consumer research and airline engagement. They said that financial incentives should be "penalty only" and focus on the incidence of significant service failures, such as for baggage and air traffic control delays.

5.21 BA said that the service quality measures and targets should reflect evidence of user issues, significant failures and areas of better performance, including basing measures on daily performance. It also supported more specific guidance on resilience.

5.22 The AOC/LACC said HAL should improve service standards and questioned whether financial incentives should be strengthened to improve baggage services. It said that the CAA should give specific consideration to baggage, flow and airfield performance, and supported the daily measurement of performance.

5.23 The Heathrow Strategic Planning Group said that operational resilience should be maintained with high-quality surface access. Heathrow Southern Railway supported a review of the CAA surface access policy.

Update on our approach

5.24 We agree with HAL that there should be work between an appropriate range of airport stakeholders (including the airport, airlines and groundhandlers) in order to help improve overall performance and deliver a better passenger experience. Nonetheless, we also recognise that the framework for economic regulation focuses on HAL and its obligations. We are also of the view that the current outcomes MTI scheme is sufficiently flexible to allow for a more "collective approach" to reflect the varying roles and influence that different stakeholders have on service quality. The structure of having financial incentives for measures very largely wholly within HAL's control and reputational incentives for measures where HAL has less control and influence and, where it can play a co-ordinating role across other airport stakeholders, should provide the flexibility to develop measures that address the varying degrees of influence that different stakeholders have. Where HAL is able to reach agreement with its airline and other partners that further changes are appropriate to the MTI arrangements to better incentivise overall performance, we are content to consider how best to adjust the regulatory framework to reflect these developments.

5.25 More specifically, in relation to HAL's comment about the measures of airline and ground handler performance at Gatwick airport, we note that these were jointly developed in a commercial process as part of a wider service performance package. HAL could engage with airlines to develop such proposals and KPIs and, if agreed by airlines, we would assess the consumer benefit of this and adapt the outcomes and MTI framework accordingly. The incentives in the MTI framework would need to remain focused on HAL as the regulated company, even if incentives were supplemented by wider arrangements and/or were triggered by performance across different stakeholders. We have amended the business plan guidance to reflect this.

5.26 We agree with airlines that HAL should update the outcomes and MTI framework taking into account evidence of consumer priorities from consumer research and airline engagement. We have amended the business plan guidance to reflect this. We also agree that the review of the framework should include consideration of baggage systems, air traffic control performance and security both in Constructive Engagement and in HAL's business plan.

5.27 We consider the following issues raised by airlines should form part of Constructive Engagement for H8:

a) amendments to the MTI scheme in response to evidence of significant failures;

b) the type and level of incentivisation on baggage performance measures and air traffic control; and

c) moving from monthly to daily performance measurement.

5.28 We note the comments from the Heathrow Strategic Planning Group and Heathrow Southern Railway on the contribution that surface access scheme improvements can make to operational resilience and wider modal shift. As we have stated before, our approach to assessing the benefits of projects will build on our existing surface access policy.

Cost and revenues assessment

Background

5.29 Forecasts for the efficient levels of costs and revenues are important components of the price control calculations.

5.30 In the Draft Method Statement and Business Plan Guidance, we said that for opex and commercial and other revenues we would work with consultants to develop an independent assessment of the likely level of these building blocks, including by assessing the information provided by HAL in its business plan. We said that, where practical, this would include:

- assessing the efficiency of opex and revenues at different levels of granularity;
- targeted bottom-up analysis;
- consideration of external benchmarking; and
- exploring how to make greater use of top-down international benchmarking.

5.31 For capex, we said that, in collaboration with our consultants, we would start by understanding the likely size of the efficient capex envelope and key uncertainties around HAL's H8 capex baseline under its Masterplan for capacity expansion in the two runway airport.

5.32 We said HAL should provide high-quality information with a sufficient level of granularity to support our work. For clarity, we provided further details on the form and content of cost and revenues information required in HAL's H8 business plan in the Draft Method Statement and Business Plan Guidance. We also said that that we would provide HAL with more detailed guidance and data templates where further guidance was needed.

5.33 In relation to surface access schemes we said that our broad policy remains that any schemes should provide value for money for consumers.

Stakeholder views

Opex and revenues assessment

5.34 Airlines (BA and the AOC/LACC) welcomed our intention to undertake independent benchmarking and said that bottom-up analysis should be the primary assessment tool for opex and revenues. They also said that bottom-up analysis should follow a targeted approach focusing on material opex and revenue items, and items where HAL is proposing substantial deviations from historical performance.

5.35 HAL said that a granular approach to benchmarking may not be appropriate, and a top-down approach could offer a better indication of efficiency. HAL offered to work with the CAA, our consultants and airlines on how to best leverage the work it has commissioned on top-down opex benchmarking.

Capex assessment

5.36 BA and the AOC/LACC encouraged the CAA to benchmark capex costs on a bottom-up basis, focusing on understanding key drivers of costs, suggesting that this could be done by project type. The AOC/LACC said that detailed cost information is available through the capital governance process and such information should form the basis for understanding the proposed capital envelope for H8. The AOC/LACC also said that the CAA’s assessment of HAL's masterplan should go beyond just the ‘masterplan’ element by considering the overall portfolio and underlying programmes.

5.37 In HAL’s view, the geographical location of Heathrow in London and associated higher construction and wage costs contribute to an overall cost premium, compared with other airports in the UK and Europe.

5.38 HAL also suggested that noise insulation expenditure is treated as capex for regulatory purposes rather than opex. It said that this would provide incentives around delivery of noise insulation projects and would allow costs to be spread over the period in which benefits materialise.

Data gathering

5.39 The AOC/LACC and BA identified several areas of opex and revenues where they considered that more granular data would enable more meaningful analysis, including breakdown of ‘people costs’, ‘maintenance’, ‘other opex’ and ‘property revenue’. They also noted that ‘commercial sensitivity’ should not preclude HAL from allowing CAA sight of the necessary data.

5.40 BA said that any proposed capital expenditure should include full information of options, prioritisation, expected outcomes, timescales, and benefits delivered against the proposed strategic objective. The AOC/LACC and BA said that a further breakdown of capex costs will be needed for the CAA to properly scrutinise key components of costs related to ‘leadership and logistics’, ‘risk’, and ‘programme costs’.

Surface access policy

5.41 HAL supported consideration of wider environmental benefits delivered by surface access schemes, which it said would shift the current balance away from purely supporting additional capacity.

5.42 Heathrow Southern Railway supported a review of the existing surface access policy, which was last updated in 2019. It noted that the policy needs to align with passenger needs, H8 priorities and the change in circumstances, including the net zero commitments.

Update on our approach

Opex and revenues assessment

5.43 The examination of HAL's business plan will continue to be a key component of our assessment of opex and revenues and there will be cost areas where the information in the business plan will form the starting point of our assessment.

5.44 Nonetheless, we will seek to broaden and deepen the evidence base we will draw upon in reaching our views on the efficient level of opex and revenues, by deploying a range of cost assessment tools. These will include:

- targeted bottom-up assessment of key components of material opex and revenues items. This will be supported by independent expert inputs and the use of external benchmarks where practicable;
- targeted external benchmarking of opex and revenue items where we can find robust industry and/or external benchmarks of comparable items; and
- top-down assessment of opex and revenues as overall cross checks. This may include overall opex and revenue per unit (for example, opex/commercial revenue per passenger; commercial revenue per utilised terminal area; staff costs per passenger). We will continue to work with our consultants and engage with HAL in exploring whether top-down econometric benchmarking approaches are also a credible additional cross check in H8.

5.45 We will rely on our own consultants' independent reports while taking into account studies submitted by HAL and other stakeholders. We will continue to engage with HAL and the airport community to ensure our independent assessment makes the best use of the information and approaches being developed by the Heathrow community ahead of the H8 business plan submission, including work on any top-down international opex benchmarking that HAL provides.

5.46 In relation to HAL's suggestion of treating noise insulation costs as capex rather than opex, HAL should address this as part of its business plan so that we can consider whether to accept HAL's proposal as part of our review. HAL will need to clearly demonstrate the benefits to consumers of any proposed changes to the treatment of these costs, and we intend to take a proportionate approach, making changes only where material benefits to consumers can be demonstrated and are well evidenced.

Capex assessment

5.47 At the price review, we will set an efficient capex baseline for H8 in the context of a two runway airport. As set out earlier, we are of the view that significant terminal expansion and the development of a third runway at Heathrow airport is best dealt with separately from the resetting of HAL's 'business as usual' price control. Nonetheless, we also recognise the interactions between the H8 price control and the capacity expansion programme, and will take steps to ensure that we take a coordinated approach across these programmes. This approach will be designed to ensure consumers interests are properly protected, including that there is no "double counting" of costs and that HAL is able to finance investment efficiently.

5.48 Our approach to set an efficient capex baseline will be complementary to the capex incentives framework and the capex governance arrangements in place between HAL and airlines, taking account of any changes we make to improve or strengthen these incentives. Our approach will broadly involve:

- conducting initial work prior to the business plan submission to understand the likely size and composition of the efficient capex envelope for H8 and the key uncertainties for the capex baseline. We will review information on projects that will carry over from H7 available through the capital governance process; the overall portfolio of programmes included in HAL's masterplan for capacity expansion in the two runway airport; and information that HAL has shared with stakeholders through the Constructive Engagement process;
- identifying the projects that will be included in the H8 capex baseline, including projects that are presently known but also an estimate of spending for likely projects that presently have a low level of maturity; and
- assessing the cost efficiency of projects included in the capex baseline for H8, using a combination of:

  (i) analysis of business plan data informed by top-down efficiency assessment;

  (ii) targeted external benchmarking with comparable projects (or components of projects);

  (iii) targeted independent technical deep dives of cost build-ups and business cases namely, but not limited to, material projects not suitable for benchmarking due to their unique characteristics; and

(iv) external benchmarking of indirect cost markups applied to direct project costs, related to 'risk', 'leadership and logistics', and other mark ups.

5.49 We consider that the mechanisms already in place offer an appropriate level of protection against cost increases in capex delivery outside of HAL's control. The capex envelope uncertainty mechanism allows HAL to apply to the CAA for an uplift to the overall capex envelope for H8, to account for a significant and unanticipated increase in capital expenditure. The *ex ante* capex incentives compare out-turn costs of an individual project against that project's revised capex baseline as developed by HAL and agreed with the airlines as projects move through the capex governance process during the price control period.

Data gathering

5.50 HAL should provide timely and high-quality business plan information to further the interest of consumers. The quality and completeness of HAL's business plan information is one of the elements that we will take into account in the new business plan incentive, as we explain in chapter 3.

5.51 To support HAL in providing high-quality information, with a level of detail that is sufficient and proportionate to allow for a robust and consistent assessment of costs and revenues, we have further developed our business plan guidance on data requirements for opex, revenues and capex as set out in Appendix A. For opex and revenues, we are also publishing data tables as part of our business plan guidance (in Appendix C). We will consider if data tables are also appropriate for capex, following the Round 2 of Constructive Engagement, and we would share any such tables with HAL by April 2025.

5.52 If it is appropriate we will also use our formal information gathering powers to gather important data and to provide assurance on the quality and accuracy of the data.

Surface access policy

5.53 It is likely that any major surface access schemes should be best assessed as part of our separate programme on capacity expansion. We intend to consult further on our approach to these matters in due course.

Cost incentives

Background

5.54 The Draft Method Statement and Business Plan Guidance explained that, for opex and revenues, we expect to retain the current broad approach to incentives, where we make a forecast, and HAL has the opportunity to outperform against the forecast, while bearing the risk of underperformance during the price control period. We will, however, consider alternative risk-sharing arrangements for specific costs and revenues where this furthers the interests of consumers.

5.55 We identified some specific areas where we want to consider further our approach to cost and revenue incentives and noted other areas where HAL may propose a change in approach in its business plan:

- adjustments to allowances where there are switches in major investments or cost items between opex and capex for or during the regulatory period;
- understanding and taking appropriate account of the link between investment and changes in opex and/or increases in non-regulated revenues and commercial revenues;
- the regulatory treatment of terminal drop-off charges, to make sure we are protecting consumers' interests;
- possible changes to single till boundaries for property and non-terminal car parks costs to incentivise investment. We said any changes might need to be timebound, so consumers benefit from growth in these revenues in the medium or longer-term; and
- ensuring that the estimates of single till revenue appropriately reflect developments such as recent changes to the arrangements for fast-track security charges.

5.56 We stated that we are also reviewing our approach to the regulation of Other Regulated Charges ("ORCs"). We said we would consider the approach to estimation and recovery of ORCs for H8, including whether the approach towards the recovery of the fixed costs adopted in H7 remains appropriate. We encouraged HAL to consider how it can better engage with airline and non-airline users on ORCs and improve the transparency of these charging arrangements.

5.57 On capex incentives, we explained that the *ex ante* capex efficiency framework has only been recently introduced and said that our focus would be on understanding how it is working in practice, before considering any fundamental changes. Any changes are most likely to focus on evolutionary improvements and in this context, we noted that HAL had raised issues around Delivery Obligations ("DOs" - that is the expected outputs of projects, including quality requirements and timing) that it says are unnecessarily slowing down investment. We said we expect HAL to engage with airlines on these matters and we will consider this in our work on how to best refine the capex incentives for H8.

Stakeholder views

Capex incentives

5.58 HAL supported the CAA's openness to consider evolutionary changes to capex incentives and governance. HAL said CAA should reform or remove DOs for smaller projects (less than £10 million) and for non-airline facing digital projects, which it said would allow for more effective delivery of benefits to consumers.

5.59 It said it is working with KPMG to identify lessons about the workings of the DOs under the new *ex ante* incentives framework and, while there are positive learnings in relation to project management and stakeholder engagement, it has identified a number of issues with the current approach. HAL said it will share the developing analysis from KPMG as part of the H8 process, in early 2025.

5.60 HAL also noted that technology projects are inherently more difficult to complete under the current DO approach, when compared to infrastructure projects, and suggested that a more flexible application of DOs could be beneficial, such as through a criteria-based assessment of projects to consider the suitability of implementing DOs in a more tailored way.

5.61 In addition, HAL considered that large and complex projects require a more programmatic and outcome-led view rather than a project-based and output-driven approach. This is due to the difficulty identifying and mitigating risks for such projects and establishing DOs. Applying the current approach to major projects could lead to delays and considerable increases in cost.

5.62 BA supported the continuation and tighter implementation of the *ex ante* capex efficiency incentives, and welcomed the CAA's guidance on such incentives (but thought it may need to collect additional information to enable a thorough assessment of the H7 framework's effectiveness). It said that a critical gap in the current guidance is the lack of a requirement for HAL to report on DOs that were considered but ultimately rejected.

5.63 The AOC/LACC suggested a review of realised benefits from investments compared to anticipated benefits to understand both the overall efficiencies of cost as well as the effectiveness of the capex governance arrangements, as this would not be captured in any review of DOs. It also said the CAA should consider the findings of the H7 Independent Reviews on Processes and Standards to identify and help inform any potential changes in the capex governance or incentive arrangements.

5.64 BA and AOC/LACC agreed with the CAA that sustainability projects should continue to be subject to the existing capex incentive framework and airline governance, including the use of DOs.

Single till boundary

5.65 HAL suggested that the inclusion of property within the single till has led to a lack of investment in property around the airport perimeter and central terminal area over the last twenty years. It said removing property and non-terminal car parking from the single till could open the door to significant investment in this area and deliver better outcomes for consumers, for example, improved access to facilities such as hotels, office and conference spaces, as well as improved parking areas, and investment to make these facilities more sustainable and reduce environmental impacts. It asked the CAA to set out an intention to remove these areas from the single till and for all stakeholders to work together on a specific work programme to assess how such a change could be implemented effectively.

5.66 It said several aspects of the single till framework were holding back investment:

- Heathrow and airlines' differing views on the risk-reward balance on property investment as opposed to other operational capex priorities;
- the longer payback period required for these investments compared to the length of the regulatory periods in place; and
- the comparatively low return when contrasting the regulatory WACC with that obtained in the real estate sector, which it said had been reinforced by elements of the CAA's and airlines' approach.

5.67 HAL said it is working with Frontier Economics to develop high-level regulatory options for moving commercial property and non-terminal car parking outside single till, which it would share with the CAA. Its response included an initial outline of some of these options. It said that the regulatory treatment of these matters should be set in advance and be generally applicable to avoid the need to negotiate agreements on each specific investment.

5.68 It disagreed with the suggestion in the Draft Method Statement and Business Plan Guidance that any changes to sharing of revenues from commercial property investments might need to be timebound (so that consumers benefit from revenue growth in the medium or long-term). HAL considers that such a potentially time-inconsistent approach could likely fundamentally undermine the incentive to invest.

5.69 BA noted that there are different approaches to the issue of under-performing assets but drew the CAA's attention to the need for single till regulation to deliver for consumers. It suggested the following:

- make HAL bear the risk of the non-aeronautical investments by including the expected return as an explicit assumption within the commercial revenue forecasts without the opportunity of a reset;

- reflect the limited risk exposure from those assets in the setting of the WACC by making an explicit adjustment; and
- questions with regards to the valuation, the approach to removal (for example, impairment), auditing the assets in question, and cost and asset allocation would all have to be addressed to avoid compromising single till regulation and protect against the risk of excessive charges, excess profits and perverse incentives.

Other Regulated Charges

5.70 HAL considers that the current ORC framework has misaligned incentives. In particular, the high electricity unit rate discourages users from switching to electricity, which is incompatible with net zero goals. HAL advocated for a "marginal cost" approach to ORCs, with all ORC fixed costs recovered through airport charges.

5.71 BA urged the CAA to deliver on its proposal to review the approach to estimation and recovery of ORCs for H8, including whether the approach towards the recovery of the fixed costs adopted in H7 remains appropriate. The AOC/LACC also welcomed the review of ORCs.

Terminal Drop-Off Charges (“TDOC”)

5.72 HAL argued that the TDOC has been in operation for a number of years and is now a mature commercial revenue product. Given this, it can be treated similarly to other commercial revenue streams and the risk sharing allowance can be removed. However, as the risk of regulatory changes in this area cannot be ruled out, HAL considered that the mechanism to adjust charges if drop-off charges can no longer be applied should be retained.

5.73 Heathrow Southern Railway advocated the use of revenues from TDOC to support surface access schemes at Heathrow. Similarly, Heathrow Strategic Planning Group said income from parking and TDOC should be hypothecated to improve active travel and public transport options.

Update on our approach

Capex incentives

5.74 We welcome the feedback we have received on the updated capex governance framework and how the new *ex ante* capex incentive has been working in practice, as well as the suggestions for improvement. This framework is still relatively new (it has only been fully in operation since March 2024) and we will work with stakeholders to consider these and other suggestions to identify any changes that need be made to the framework to ensure it is working as intended.

5.75 We will review the KPMG report as part of the H8 process together with evidence submitted by airlines. It may be that minor refinements to the framework can be discussed and, if appropriate, implemented through the existing capital governance processes. We will address any more fundamental policy questions concerning how the overall framework is operating as part of our initial proposals.

Single till boundary

5.76 We will consider further the arguments put forward by HAL that there may be situations where the operation of the single till does not provide a strong incentive for it to invest in landside property, and that addressing this could potentially result in better outcomes for consumers. We therefore remain open to working with stakeholders to assess whether we strengthen the incentives for HAL to invest in landside property or dispose of it to a third party developer, where this can be demonstrated to be in the interests of consumers.

5.77 Given the diversity of assets under consideration, the appropriate regulatory treatment may vary on a case-to-case basis or by different categories of investment. Nevertheless, it may be possible, as part of the H8 process to establish some baseline rules and/or agree a suitable procedure to govern these arrangements. This might include developing a mechanism for the CAA to make suitable adjustments to the RAB and/or the revenue assumptions relating to the assets in question. Where appropriate, we would also wish to ensure that any asset disposal is subject to effective competition to ensure the best value for the asset is obtained.

5.78 To help with our assessment of this matter, it would be helpful if HAL could submit practical case studies relating to landside assets, explaining its intentions or options with regard to such assets, how it would propose this be treated for regulatory purposes, and demonstrating how this would result in benefits for consumers.

Other Regulated Charges

5.79 As stated in the Draft Method Statement and Business Plan Guidance, we will be reviewing the approach towards the recovery of ORC fixed costs in future. Taking account of responses received, we expect to consider three main options for the recovery of ORC fixed costs during H8:

- all ORC fixed costs to be recovered from ORCs;
- non-airline ORC fixed costs to be recovered from ORCs, and airline ORC fixed costs to be recovered from airport charges (H7 approach); or
- all ORC fixed costs to be recovered from airport charges (as proposed by HAL).

Terminal Drop-Off Charges

5.80 TDOC charges were introduced for the first time at the start of H7, and there is now a number of years' experience with the operation of the scheme. We will, therefore, consider whether the TDOC revenue risk-sharing arrangements adopted for H7 remain appropriate for H8.

5.81 Investments in surface access schemes should be considered in their own right and whether they further the interests of consumers, rather than be dependent on the hypothecation of TDOC revenues.

Chapter 6
Financial issues

Introduction

6.1 This chapter sets out stakeholders' responses and our updated views on the financial issues sections of the Draft Method Statement and Business Plan Guidance. This chapter covers a range of issues, in particular how we treat the investment that HAL has already made in its regulated business (which we assess by calculating a regulatory asset base), the appropriate prospective return on this investment (the allowed cost of capital), how we intend to assess the future financeability of the regulated business and associated issues (such as the approach to estimating allowances for corporation tax and the approach to traffic risk sharing (TRS) arrangements).

6.2 In particular it covers:

- the RAB-based framework;
- indexation of the RAB;
- regulatory depreciation;
- financeability, target credit rating and gearing;
- allowances for corporation tax;
- TRS arrangements; and
- the cost of capital.

The RAB-based framework

Background

6.3 In the Draft Method Statement and Business Plan Guidance, we said that we would retain the RAB and the "building blocks" approach to setting the H8 price control for HAL. We noted that this provides regulatory consistency and reasonable stability for investors. This in turn would avoid any unnecessary increases in the costs of financing investment at Heathrow and should allow HAL to continue to access financing in a cost effective way.

Stakeholder views

6.4 In response, HAL supported the retention of the RAB and the "building blocks" approach.

6.5 A number of airlines raised a range of objections to the retention of this approach, suggesting that it had led to high airport charges and costs, and poor service quality and infrastructure, among other adverse outcomes. More detail is set out above in chapter 4.

6.6 Airlines emphasised that they considered HAL's RAB to be excessively large and argued for a substantial reduction in its value. For example, BA suggested that we should consider the disposal of non-core assets as a means of reducing the value of the RAB.

Update on our approach

6.7 While we agree with airlines that the RAB-based framework is subject to challenges associated with the incentives for efficient investment and value for money, we are also aware that the RAB reflects the level of historical investment in the regulated business. In order to ensure that HAL has continued access to funds for investment on cost effective terms, it is important that the existing RAB is valued and remunerated in an appropriate way, to allow HAL to recover investment already made in the business and efficiently incurred capex on maintaining and improving existing assets over the H8 period. This will help ensure HAL's cost of capital is no higher than necessary and so avoid undue upward pressure on airport charges.

6.8 We have explained in the Summary and chapter 4 the steps we are taking to review the regulatory framework for significant capacity expansion and the very large capital plans that will be associated with the development of the new runway and terminals.

6.9 We will also take steps to ensure that HAL's RAB remains at sustainable levels, including considering the best approach to regulatory depreciation, the indexation of the RAB and amending the single-till boundary (including in relation to asset disposals, the proceeds from which could be used to reduce the RAB) as discussed further below and in chapter 5.

Indexation of the RAB

Background

6.10 In the Draft Method Statement and Business Plan Guidance, we said that we expect to move from RPI- to CPI- or CPIH- indexation of the RAB for H8. We noted the Office for National Statistics' (ONS) use of CPIH and also that CPI is widely used, including in the regulation of NERL.[8] We also noted that the difference observed between CPI and CPIH in the past has typically been small.

6.11 We also said that we will consider whether wider changes to the indexation of HAL's RAB may be appropriate to support HAL's financeability and airline concerns about the size of HAL's RAB. For instance, our advisors FTI Consulting, recommended moving to a nominal cost of debt with corresponding changes to RAB indexation.

Stakeholder views

6.12 HAL said that it was important to ensure that any change to the indexation of the RAB was considered carefully and consistently with the calculation of the WACC.

6.13 On the choice of CPI or CPIH indexation of the RAB, HAL expressed a preference for CPIH inflation, noting that it is more consistent with the approach adopted in other sectors and more likely to align with the indices used for index-linked debt costs which would reduce the risk HAL faces.

6.14 BA noted that the use of RPI to index the RAB has led to significant increases in HAL's RAB. It proposed three options for addressing this:

- a nominal cost of debt;
- a cap and collar mechanism; and
- a sharing mechanism.

6.15 Virgin called for further analysis of CPIH and CPI, noting that the two are not equivalent and gaps between the two have at times been significant and long in duration.

Update on our approach

6.16 We have conducted further analysis of the relative merits of using either CPI or CPIH as the primary measure of inflation in setting the H8 price control and indexing the RAB.

6.17 While the choice is finely balanced, our current intention is to use CPI as the primary measure of inflation for H8 on the basis that there are a number of medium-term forecasts available for CPI from recognised sources,[9] but limited

8 The use of CPI in NERL regulation is referred to by the Eurocontrol principles as CPI is the harmonised index of consumer prices.

9 We have previously used forecasts from the Office for Budget Responsibility ("OBR") Economic and Fiscal Outlook reports. Medium-term CPI forecasts are also provided by Bank of England and HM Treasury.

forecasts are currently available for CPIH. We could consider this choice again for future price controls after RPI has transitioned to CPIH and medium-term forecasts for CPIH are more widely available.

6.18 We agree with BA that specifying a real cost of debt leaves open the possibility of a mismatch between forecast and outturn inflation.

6.19 We will examine the advantages and drawbacks of applying a nominal cost of debt in our initial proposals. If we conclude that such a mechanism is not appropriate, we will also consider whether a cap and collar mechanism or sharing mechanism could further the interest of consumers.

Regulatory depreciation

Background

6.20 We stated that we will consider how we balance the level of charges in the shorter term and the allowances for regulatory depreciation with a sustainable growth of the RAB.

Stakeholder views

6.21 HAL stated that it was open to a 30 year asset life assumption being considered for setting regulatory depreciation allowances.

6.22 BA stated that regulatory depreciation should be aligned to asset life to maintain intergenerational fairness. It also set out its view that accelerated depreciation does not necessarily support financeability unless the additional funding is used to reduce HAL's gearing.

Update on our approach

6.23 We will adopt an approach to regulatory depreciation that seeks to secure that any growth in HAL's RAB is sustainable, supports a reasonable level of airport charges in the short and longer term and is consistent with our approach to HAL's financeability.

Financeability, target credit rating and gearing

Background

6.24 In the Draft Method Statement and Business Plan Guidance, we said that we expect to carry out a financeability analysis for H8 that is similar to the analysis for H7. This includes adopting a notional financing structure and testing that the efficient notional company should continue to attract debt and equity financing for investment, even in reasonable downside scenarios.

6.25 The Draft Method Statement and Business Plan Guidance also said that we would use an updated version of the price control model ("PCM") that we used at H7.

Stakeholder views

6.26 Several airlines stated that the financeability duty should not be interpreted in such a way as to insulate HAL from risk. BA and the LACC/AOC said that the financeability duty should not be given undue priority.

6.27 Airlines also commented that the level of charges should be a key metric that we have regard to in setting the H8 price control. The LACC/AOC wanted more focus on the level of charges as a priority area.

6.28 HAL highlighted as one of five areas it considers a priority for the CAA that the CAA should provide a clear indication of the direction that financeability policy will take in H8. It said that this approach should recognise the importance of securing the right credit rating, cost of capital, the H7 "exit" point and the approach to inflation to ensure HAL is financeable.

6.29 Virgin commented that the price control model used in H7 was not transparent, noting that it includes several macros which make it more difficult to understand and use.

Update on our approach

6.30 Our duties under CAA12 are clear that our primary duty is to further the interests of consumers. Consumers will benefit from us taking an appropriate approach to the assessment of HAL's financeability, such that we can reasonably assume that the regulated business will continue to be able to access financing on cost effective terms. In discharging our primary duty, we must have regard to the matters set out in CAA12. These matters include the need to secure that HAL can finance its activities alongside (but not in preference to) the need to consider other matters such as the need to secure that consumers' reasonable demands are met and the need to promote economy and efficiency. As for H7, our overall approach will be to assess the issues in the round so that the price control is set at an efficient level so that charges are no higher than necessary, with this broad approach being designed to further the interests of consumers.

6.31 We recognise that lower airport charges and, where passed on to consumers, the resulting lower level of airline prices, can further consumers' interests. Bearing this in mind, the level of charges will continue to be an important metric in our assessment of the price control and we will continue to seek to ensure that airport charges are no higher than is necessary. But we do not consider that the "affordability" of charges for H8 is an appropriate benchmark for our assessment. While we used this term extensively during the H7 review, this was in the context of the aspiration set by the Secretary of State at that time for capacity expansion to be delivered at close to the then current level of charges in real terms. We also note that affordability is a term most commonly used for essential utilities, such as energy and water and is not directly relevant to the way we discharge our duties under CAA12.

6.32 We recognise the importance of the comments HAL makes on developing a clear approach to financeability to inform the price review. The Draft Method Statement and Business Plan Guidance established broad principles as noted above, which remain appropriate. We will set out a more detailed approach in initial proposals, which will address in detail our approach to issues such as credit ratings, the cost of capital and inflation.

6.33 We are currently in the process of preparing the price control model that will be used for setting the H8 price control. This model will be based on the H7 model and updated in the following respects:

(i) the model will be streamlined with unused elements removed; and

(ii) the layout of the model will be improved to more completely align with financial modelling best practice.

Corporation tax

Background

6.34 In the Draft Method Statement and Business Plan Guidance, we stated that we expect to take a similar approach to H7, where we applied an uplift to the cost of capital based on the headline rate of corporation tax. We also noted that we would want to check that this provides a reasonable estimate of tax costs for the efficient notional company.

Stakeholder views

6.35 Stakeholders did not comment on the Draft Method Statement and Business Plan Guidance in respect of tax.

Update on our approach

6.36 We will retain the same approach we described in the Draft Method Statement and Business Plan Guidance and so are proposing that the allowance for tax costs will be made by means of an uplift to the cost of capital, subject to checking this provides a reasonable assessment of tax costs.

Traffic risk sharing (TRS)

Background

6.37 We indicated in the Draft Method Statement and Business Plan Guidance that we expected to retain the TRS mechanism introduced in H7 for H8, given its beneficial impact on managing risk and reducing the cost of capital. We said we would review the design and calibration of this mechanism.

6.38 We suggested that, where there are links between the incentive package and the WACC, we will calibrate the impact of incentives on the WACC where it is reasonable and practicable to do so (for example, as we did in H7 by estimating the impact of the introduction of TRS mechanism on the cost of equity).

Stakeholder views

6.39 HAL stated that the balance of risk around smaller traffic variations will be different for H8 than it was for H7, with the risk of passenger numbers exceeding the forecast being much less than the risk of passenger numbers being lower. It indicated that this asymmetry may merit a different approach to the inner band of the TRS mechanism (that is, where there is less than a 10% difference between the forecast and outturn passenger volumes).

6.40 BA and the AOC/LACC suggested that there were multiple overlapping layers of protection against risk in the H7 package, namely: the asymmetric risk allowance, the TRS mechanism and the WACC. They stated that the effect of these mechanisms is to create greater upside potential than downside risk for HAL, and indicated their expectation that the CAA will undertake a fundamental recalibration of these risk-sharing mechanisms for H8.

6.41 CEPA, in a report for IATA, provided an analysis of the costs and benefits to HAL of bearing traffic risk on the assumption of a 10% traffic shock, and concluded that HAL is being overcompensated.

6.42 Virgin said that the TRS mechanism, where adjustments are spread over a 10-year period, provided HAL with a significant cash benefit from under-forecasting of demand in 2023, at the expense of consumers.

Update on our approach

6.43 We note HAL's comments on changing risk profiles but do not expect our traffic forecasts to exhibit systematic bias and we will calibrate the traffic forecast and TRS mechanism with the intention of balancing risks to the upside and downside.

6.44 The risk mechanisms do not provide multiple overlapping layers of protection, a view supported by the CMA in its Final Determinations on the H7 Appeals.[10]

---

[10] For example, we addressed airlines' points on multiple overlapping layers of protection in the H7 Final Proposals (CAP2365D) at paragraphs 11.23 to 11.30. The CMA also concluded that the shock factor did not duplicate of the cost of capital in providing compensation for traffic risk in Paragraph 9.283 of its H7 Final Determinations.

Nonetheless, we will consider the design and calibration of the TRS mechanism and traffic risks in our initial proposals and implement changes where it is reasonable and practicable to do so. However, we do not plan to reconsider the overall approach to traffic risks.

6.45 We will reflect on the worked example provided by CEPA and its implications for calibration of these mechanisms in our initial proposals. However, it will be necessary to consider a broader range of traffic risks, including the potential for considerably larger traffic shocks under future pandemic-like events.[11]

6.46 The Draft Method Statement and Business Plan Guidance set out later in this document states that HAL should provide evidence with its business plan to show that its proposals for calibrating the TRS mechanism provides a balanced set of risk protection and provides benefits to consumers.

6.47 We note Virgin's point concerning HAL's traffic outperformance in 2023. The economic impact of the TRS mechanism will be to return a significant proportion of the outperformance over the next 10 years through lower charges. This includes adjustments on a net present value basis designed to make sure that HAL does not make unearned gains and to protect the interests of consumers.

Cost of capital

Background

6.48 In the Draft Method Statement and Business Plan Guidance, we said that it will be appropriate to set a cost of capital consistent with HAL recovering the reasonable and efficient costs of financing investment.

6.49 We said that we will consider new precedent from other regulatory reviews, UKRN guidance, the comparators for beta estimation, new market evidence and further evidence from stakeholders.

6.50 We set out our intention to change the treatment of inflation in calculating the WACC, with the real WACC calculated by reference to CPI or CPIH rather than RPI as in previous price controls, to be consistent with our position of changing our approach to indexation of the RAB.

6.51 In addition, we commissioned FTI Consulting to provide an initial updated estimate of the WACC based on recent market information and to propose potential refinements to the approach we used in H7.

11 See, for example, Paragraph 11.10 of the H7 Final Proposals (CAP2365D).

6.52 Where there are links between the incentive package and the WACC, we said that we will explore and take decisions consistent with the interests of consumers.

Stakeholder views

HAL's response

6.53 HAL provided papers in support of its response by KPMG and Oxera . These papers highlighted certain key issues for consideration.

6.54 KPMG's report addressed asset beta. It set out an assessment of the risk of comparator airports relative to HAL. It concluded that HAL lies towards the top of the range for risk exposure compared with its peers. It further noted that, as the risk analysis already incorporates the TRS mechanism, no additional adjustments are required to amend the empirical estimates of comparator betas.

6.55 Oxera's report addressed the total market return ("TMR"). It proposed certain policy positions in respect of the TMR:

- the TMR estimate used for H7 should be updated to reflect developments in relation to the inflation series used to deflate historical nominal returns;
- the arithmetic average based on a one-year holding period should be used to estimate historical returns on an *ex post* basis;
- *ex ante* TMR estimates are more subjective than *ex post*, and no weight should be placed on these estimates;
- notwithstanding the above, the Barclays Equity Gilt Study[12] should not be used to estimate an *ex ante* TMR; and
- if an estimate of the ex ante TMR is made, a serial correlation adjustment should not be applied to this estimate; and
- it is not immediately clear what advantage the Fama-French approach to estimating the *ex ante* TMR confers over the Dimson, Marsh and Staunton (DMS) decompositional method.

6.56 Oxera also noted a higher TMR may be warranted to reflect higher gilt yields since 2022.

12 The Barclays Equity Gilt Study was used in previous price control reviews in other sectors (including PR19 and RIIO-2) to estimate the *ex ante* TMR. The study was not used to estimate the *ex ante* TMR in either the PR24 Final Determination or the RIIO-3 Sector-Specific Methodology Decision due to shortcomings that were highlighted in the data series. The use of the DMS series in favour of the Barclays Equity Gilt Study materially increased the lower bound of the PR24 TMR range.

6.57 On its cost of debt, HAL noted the following:

- HAL's actual debt costs have been efficiently incurred and should be passed through to consumers without adjustment. It considered that the cost of debt allowance should include both Class A and Class B debt;
- it plans to share a detailed spreadsheet that will allow the CAA to understand its actual cost of debt, including the impact of foreign currency debt and swaps;
- the proportion of new debt should be 25% as a holding estimate until more details become available, given HAL expects to incur significantly more capex during H8 compared to H7; and
- the cost of indexed linked debt should account for the fact that change clauses on corporate indexed linked bonds protect investors from changes to RPI in transitioning to CPIH.

Airlines' responses

6.58 Airlines expressed their support for a CEPA report commissioned for IATA in response to the FTI report.

6.59 CEPA stated that the "nascent" nature of H8 is not a reason to avoid discussing certain issues where there is likely to be disagreement. CEPA highlighted the following examples of issues that it expected would have been explicitly addressed:

- whether we intend to maintain the H7 relative risk beta adjustment of 0.10 and the 14bps liquidity cost adjustment to the cost of debt pertaining to cash balances accumulated during the pandemic period;
- the method for CPIH-RPI adjustment to the risk free rate given CAA's proposed move away from RPI indexation; and
- further guidance on the TRS mechanism, including how this would operate when airport capacity is a binding constraint on demand.

6.60 It requested that the CAA make the following commitments in relation to the cost of capital in the final method statement:

- a full assessment of relative risk for comparator airports;
- providing a workbook to the airlines covering HAL's cost of debt, including all relevant debt instruments and derivatives; and
- estimating an asset beta (and other revenue allowances) if all traffic risk was allocated to airlines.

6.61 CEPA also proposed various policy positions in respect of asset beta:

- incorporation of the latest post-pandemic data;
- updating the pandemic period end date to the 9th November 2020 and a corresponding update to the weight assigned to the pandemic period;
- a greater downwards adjustment to asset beta for HAL relative to comparator asset betas than was applied in H7;
- use of a local index to estimate the beta for Zurich Airport; and
- removal of the upwards adjustment to reflect the absence of capacity constraints at comparator airports.

6.62 In respect of the cost of debt, CEPA did not put forward specific policy proposals but noted that:

- the FTI report included an excessive debt premium in respect of the cost of new debt that has been driven by an unsuitable approach to inflation;
- the increase in the cost of embedded debt since the H7 Final Decision is excessive and similarly driven by an unsuitable approach to inflation;
- the pandemic-related liquidity costs included in the H7 cost of debt should be removed; and
- the CMA's decision to exclude an index-linked premium should be the starting point for H8.

Update on our approach

6.63 We note that all stakeholders have provided views on specific policy issues that they consider should be reflected in our estimate of the cost of capital.

6.64 We further note the expectations of stakeholders that certain policy issues in respect of the cost of capital should be addressed in the method statement specifically. In some cases, these have been presented as errors in FTI's analysis with stakeholders suggesting that these should be corrected in a reissued version.

6.65 The policy issues that have been raised are relevant to our analysis and we will consider these in preparing our initial proposals where it is practical and reasonable to do so. However, it is not appropriate for us to set out our position on these issues or to commission a further or updated FTI report at this stage. To do so would require considerable further analysis and this is better undertaken in our work to develop initial proposals.

6.66 Stakeholders have also requested clarification of the approach we intend to adopt for our initial proposals. On the specific commitments requested by CEPA:

- we will consider the relative risk of comparator airports as part of our broader assessment of the cost of capital. However, we cannot commit to definitively identifying what is driving differences between airport betas, given (among other things) constraints on the availability of data and the necessarily qualitative nature of this analysis;
- HAL is intending to provide information on its debt and derivative securities. We will review this information and consider whether to request further information on these matters and what information we should reasonably make available for wider comments as part of our consultation processes; and
- it may be useful to estimate, for illustrative purposes, the asset beta that would emerge if we were to assume that HAL bears no traffic risk, and we will consider this further in preparing our initial proposals.

6.67 To provide further guidance to stakeholders, we have set out a non-exhaustive list of issues that we will consider as part of our initial proposals in Appendix B.

6.68 We will also ensure that we update our approach to reflect the latest available market data as well as other information (such as the proportion of new debt) to the extent it is reasonable and practical to do so.