

Draft H8 Method Statement and Business Planning Guidance (CAP3044)

Response from Heathrow Airport Ltd

Date: 13th December 2024

Prepared by: Heathrow Airport Limited

Status: Public

EXECUTIVE SUMMARY:

1. This document sets out Heathrow Airport Limited's (Heathrow) response to the CAA's (Civil Aviation Authority) consultation on the Draft H8 Method Statement and Business Plan Guidance.
2. The publication of CAP3044 represents an important milestone in the overall H8 price control process and the development and delivery of Heathrow's H8 business plan. The CAA's role in setting the right regulatory conditions and framework from the outset will help to enable a plan that will have wide ranging benefits not only for Heathrow's customers and consumers, but also for the UK economy. These benefits flow from the role the UK's only hub airport plays in creating economic growth by boosting connectivity, inward investment, tourism, billions of pounds of trade flows, employment and wider supply chain benefits.
3. Over the last few months, Heathrow has also been in discussions with our airline customers during the first phase of Constructive Engagement (CE) to understand their priorities and objectives for H8. Whilst those discussions will continue into 2025, a clear focus on resilience is a prevailing theme, which Heathrow will reflect and respond to as Heathrow develops the choices and options for H8.
4. As such, Heathrow welcomes some of the initial direction, guidance and opportunities that the method statement sets out – particularly on recognising the need for Net Zero to become a new and significant priority and demonstrating a proactiveness and openness to reviewing how the regulatory framework can best work to enable outcomes for consumers through various capital investment and operational improvements.
5. Heathrow also welcomes the CAA noting the likely upward pressure on charges within the H8 period. For the final methodology, the transparency on this could be enhanced by illustrating what the 2026 charge would have been using the H7 building blocks for 2026 together with the FTI initial H8 view of WACC. Such an approach would assist a collaborative approach for phase two of constructive engagement.
6. There are also several decisions and areas of information where Heathrow wants to work with CAA on and where more development would be beneficial to ensure the overall H8 process is effective. This includes clarity ahead of Heathrow developing its business plan on areas surrounding the business plan incentive and financeability and will both support the continued development of the options and choices that will inform Heathrow's business plan, as well as the delivery of a high-quality plan that matches the CAA's intention and ambition under the new Business Plan incentive proposal.
7. To maximise consumers benefits, Heathrow believes there are five key objectives for the CAA to deliver upon (outlined below). At present, the CAA method statement provides

an opening on each area, but by supporting these further in the final method statement, would allow Heathrow to come forward with specific proposals, in discussion with airlines and consumers, in order to deliver within H8:

- **Adjusting the regulatory framework to boost investment opportunities** - reform of the single till boundary to address the harm to consumers (i.e. drive a lower cost to consumer, deliver more facilities and create a better sense of place) arising from the lack of property investment in the central terminal area and the perimeter of Heathrow.
 - **Seeking a collective approach to Measures, Targets and Incentives (MTIs)** – drive improved consumer outcomes linked to performance and resilience, through an evolved and collective MTI regime.
 - **Evolving and targeting capex governance changes** – a framework to deliver benefits to consumer of small and digital/ technology focused capex projects, faster and more efficiently.
 - **Setting a clear direction on financeability fundamentals** – agreeing an approach that recognises the importance of securing the right credit rating, cost of capital, the H7 “exit” point, and approach to inflation to ensure Heathrow is financeable and can make the investments necessary for consumers.
 - **Improving the business plan incentive** – clear, objective and measurable assessment criteria to provide Heathrow with the framework to deliver on the CAA’s ambition for the BP incentive.
8. Heathrow remains concerned about the overall deliverability of the proposed H8 timetable. It is important to have an appropriate period between publication of the final methodology and submission of our Business Plan – in order to fully develop our plans with the information required by the regulator and to inform the choices outlined to airlines in Round Two of CE. Heathrow understands the CAA is undertaking additional work to assure themselves the timetable is deliverable. If this work leads to a proposed change, then the CAA could set out any changes as early as possible in 2025.
9. Heathrow is focused on ensuring the 2025 H8 business plan process is truly “Customer-led” – reflecting the views and priorities of our airlines, passengers, communities and wider commercial partners. By providing clarity and certainty on the above issues in its final method statement, the CAA will further enable Heathrow, and those stakeholders involved in the H8 process, to effectively deliver on this vision and give confidence in the future success of H8.

10. Heathrow's response is structured in a way that sets out in more detail the five key objectives for the CAA to deliver upon in its final method statement – and then takes each of the sections in the CAA's draft method statement in turn and sets out the responses to each. The final section is a summary of responses to the questions/ topics linked to the business plan guidance.

METHOD STATEMENT – KEY CONSUMER PRIORITIES:

Enhancing the regulatory framework to boost investment opportunities:

Rationale: There has been a lack of investment in property around the airport perimeter and central terminal area over the last twenty years. Investment in these areas would deliver significant benefits to consumers and cargo handlers in terms of cost, facilities and place) Heathrow considers that this lack of investment could arise via limitations of property being reflected within the single till. 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.

Outcome: The CAA setting out their intention to remove these areas from the single till and following on from this, all stakeholders working together via a specific work programme to assess how such a change could be implemented effectively.

11. Heathrow supports the CAA's openness to review the boundary of the single till regulatory framework outlined in the CAA's 'cost incentives' section, as well as referenced in the overall initial priorities and objectives section set out in CAP3044.
12. It is important that the right balance is struck between getting the contribution from commercial activities to the aviation till and preserving the right incentives for investment, so that benefits can be delivered to consumers. Heathrow considers that the current framework is not appropriately balanced for property and non-terminal car parks as demonstrated by the lack of investment that has taken place. Making appropriate changes could therefore deliver significant benefits to consumers such as lower costs, increased access to facilities that passengers and airlines want and need, and an improved sense of place (i.e. "look and feel")
13. The basis of the CAA's original implementation of the single till relates to the Competition Commission's 2002 report on economic regulation at Heathrow – however this report itself also outlined some of the limitations of the single till framework, including that it may inadvertently dampen investments in long-term "mixed" activities. Aligned to this suggestion, there is clear evidence of underinvestment in commercial property at Heathrow, with no perimeter development since 2005 and around half of the Central Terminal Area (CTA) mothballed for end of life.
14. Several aspects of the single till framework may hold back this investment. including:
 - Heathrow and airlines' differing views on the risk-reward balance on property investment vs other operational capex priorities;

- The longer payback period required for these investments compared to the length of the regulatory periods in place;
 - The comparatively low return when contrasting the regulatory Weighted Average Cost of Capital (WACC) with that obtained in the real estate sector. In addition, elements of the CAA's and airlines approach have reinforced this. For example, at H7 the CAA excluded all commercial investments that had a payback greater than five years.
15. Currently, this environment is detrimental to consumers. Boosting investments in these areas would deliver improved access to facilities such as hotels, office and conference spaces, as well as improved parking areas. Furthermore, a different regulatory set-up unlocking these investments could promote a faster transition to a making these facilities more sustainable and reducing their environmental impact, both a priority for consumers who travel through Heathrow and a necessity given the building standards by which they are measured.
16. Heathrow has worked with Frontier Economics and commissioned an initial review into the regulatory principles that underpin the single till framework, why a focused approach on moving commercial property and non-terminal car parks outside of the till still fits within these overall principles, and emerging options/ solutions that could be considered by Heathrow, the airlines and the CAA to evaluate. Heathrow is continuing to develop these options with Frontier and will share the work separately with the CAA during the rest of the H8 process. However, the below summarises some of the key findings.
17. The emerging analysis from Frontier suggests Heathrow has considerable potential for commercial property investment. Located in the west of London, one of the largest economic centres in the world, it is also one of the largest airports in the world in terms of passenger volumes and generally recognised as being the UK's 'best' airport in terms of service quality, and one of the top airports globally. All this suggests high demand for and profitability of commercial investments and commercial offerings at Heathrow. Nevertheless, and as outlined, there has been no major commercial property development at Heathrow for over 20 years. Not only has there been a lack of investment in new assets at Heathrow, the existing portfolio of assets has also been in decline, with many properties in need of renovation.
18. This is in stark contrast with the fact that over the past 10 years there has been significant investment in commercial property just outside the airport perimeter driven by private external developers, rather than Heathrow itself. This includes the development of new hotels and logistics hubs that are flourishing as they capitalise on the opportunities available in proximity to Heathrow. Further analysis from Frontier also demonstrated:

- *Commercial revenues vs competitors* – whilst pre-Covid Heathrow’s commercial revenues per passenger in 2018 were nearly twice the size of Schiphol’s (+89%), Schiphol generated more property revenue than Heathrow in 2018.
- *Opportunities* – Based on work from Frontier Economics and via data from Gerald Eve, rents for logistical properties in and around Heathrow were significantly above the UK average over the period 2017-2019, reaching around £15 per square foot compared to £7 per square foot for the broader UK market as a whole. This trend has only accelerated since 2020, with rents at Heathrow growing faster than in the rest of the UK, now reaching around £20 per square foot, compared to the average of £10. This strong price signal would drive a business like Heathrow with significant land holdings to expand its property portfolio to serve this high demand.

19. However, despite this potential, whilst Heathrow ranks number 1 in terms of total commercial revenue per passenger, based on a pre-pandemic benchmarking report produced by Pragma its performance in terms of property revenue is much lower than other airports where property is excluded from the regulatory till. The growth in property revenue also remained broadly flat over pre-Covid in the period 2010-2018, with an average annual growth rate of only 0.3%, whereas total commercial revenue per passenger increased by 2.1% per annum.

20. Taken together, Heathrow believes there is a strong case for commercial investment in non-terminal car parks and property to be removed from the single till. Heathrow considers that the next steps should be to review the appropriate mechanism to make this transition.

21. A key aspect of any change is that the framework should be set in advance so that the risk allocation and incentives are understood ex-ante. Moreover, they need to be generally applicable to avoid the need to negotiate agreements on each specific investment.

22. Heathrow notes that the CAA have suggested that “*any changes might need to be timebound, so consumers benefit from growth in these revenues in the medium or longer-term*”. Heathrow considers that such a potentially time-inconsistent approach could likely fundamentally undermine the incentive to invest, prolonging the current unsatisfactory position. Without certainty of consistency of treatment in the future investment will be unlikely to occur.

23. As part of the commissioned work from Frontier, Heathrow sought views on some high level options and the evaluation approach that could be taken into account, to support further CAA thinking that would have to take place. As outlined above, Heathrow will share this work as part of the H8 process as there are a wide range of options to explore,

but the options could range from a rolling incentive mechanism (RIM), which some other airports deploy and where an airport retains any revenue outperformance for future years, even if this moves into the next period - to a sharing agreement under which costs, revenue, and/or profits are shared between Heathrow and the single till. An initial element of these options has been shared during CE, and is included in the Annex to this response.

24. In addition, Frontier have outlined various ways and means in which the CAA could evaluate future proposals – including criteria such as consumer benefit, the ease of implementation, regulatory certainty, whether the proposal is “future proofed”, ownership and scalability.
25. Heathrow propose that if the CAA formally sets out in its final method statement that it is open to receiving proposals on removing commercial property from the single till, that this would act as the basis to begin a future work programme into how such proposals could be brought forward, and how the CAA would evaluate and review any proposals from Heathrow in the H8 business plan. This will ensure Heathrow presents solutions that meet the requirements of the regulator and the issues they consider to be important.

Seeking a collective approach to Measures, Targets and Incentives (MTIs):

Rationale: The importance of providing a resilient and stable operation for H8 is a key emerging priority from ongoing H8 constructive engagement. However, the level of influence and control between Heathrow and other airport users in delivering key elements of the complex airport eco-system, can vary from measure to measure.

Outcome: Using benchmarking/ examples from other airports and other regulated sectors as a starting point, the CAA could show an openness to evolving the MTI regime to introduce more collective accountability amongst all airport stakeholders - with the focus on improving the overall passenger experience and outcomes.

26. The ongoing process of constructive engagement (CE) between Heathrow and the airline community will play a key role in determining the size, scale and scope of service targets and incentives for H8.
27. The current emerging picture from the airlines identifies resilience and a reliable journey as key priorities from both an operational and commercial objective. As such, the service quality regime should seek to reflect and enable this where possible, whilst recognising that this is a collective responsibility on some key issues or areas (i.e. which could be delivered by KPIs on non-Heathrow stakeholders where there is a clear and direct impact/ influence on Heathrow's agreed service level targets).
28. Given this, there may be the case for a targeted review of MTIs on the basis of collective accountability to support the airport's overall deliverables for H8. This will ensure there is the right level of awareness and understanding amongst all about how each party plays a key role in delivering a reliable and resilient operational environment.
29. For example, in relation to Security (a wholly owned Heathrow product with a financial MTI included) the impact on performance varies between:
 - Heathrow control - Operational Delivery and Consistency on the day, internal Passenger Forecast (but is dependent on booking data), effectiveness of the Operational Plan
 - Wider communities control - Availability and Accuracy of the booking data; check in performance; on the day schedule changes; cargo Volumes; arrival Time (Transfers)
 - Outside combined control - Variance in Passenger Profiles; Weather; Transport Network disruption to Heathrow; Arrival time; Security incidents.
30. For other areas such as baggage, whereby there is a reputational rather than financial incentive at present, the picture is even more complex and challenging. Baggage performance has seen challenges, particularly at peak times where there is limited

capacity, where transfers in particular could be impacted by poor punctuality and delayed bag delivery times. Heathrow's analysis is that the three biggest categories for not loaded bags are:

- Failed at output: Bags have made it to the system output in time to be loaded but have not made the flight (can be aircraft hold size, handler resource challenges etc).
- Late arrival: Late inbound aircraft making the connection too tight for the bag to the outgoing aircraft.
- Late delivery: Inbound aircraft arrived in time however delays to unloading the aircraft by handler have meant transfer bags have missed.

31. As outlined above, baggage performance is not impacted by one single main issue or stakeholder – it is a complex and interconnected process that all airport stakeholders have a responsibility to make work. It is therefore important that any activity to improve baggage performance is not too narrowly focussed and considers the whole system.

32. The CAA should also look to examples in other regulated industries and in aviation, where this approach has been developed. Some other airports also have arrangements whereby these other players also need to meet certain service levels to help deliver the outcomes for customers. Whilst Heathrow will inevitably have different operating parameters to these airports, there will be lessons to learn - with the CAA having an important role in being open to this approach in the final method statement and potentially amending their current approach in H8 as a result.

33. At London Gatwick (LGW), commitments include a set of Core Service Standards (CSS), with service quality targets covering various aspects of its services to passengers and airlines, and provision for rebates to airlines if GAL misses these targets. In addition to the CSS, GAL has developed Airline Service Standards (ASS), which relate to key airline processes.¹ In 2016 these standards were extended to cover check-in queues, as previously they only covered the delivery of arrivals baggage.

34. Furthermore, in collaboration with airlines and ground handlers, GAL implemented a number of operational measures to address its performance in this area.² In addition, GAL worked closely with ground handlers, introducing direct financial incentives for good performance, assisting with ramp staff resources to help with turnarounds, and encouraging resource planning to improve their readiness for the summer peak.

¹CAA (2021), '[Licence granted to Gatwick Airport Limited under Civil Aviation Act 2012](#)', Appendix I: Core Service Standards, June, p42

²CAA (2024), '[Economic regulation of Gatwick Airport Limited: second consultation on extending the current commitments](#)', August, p35-36 paras 3.53-3.57.

-
35. At Copenhagen Airport, since 2008 the airport and its users must enter into a service-level agreement (SLA), including KPIs, the principles by which these are incorporated into charges, and provisions for resolving any disputes. The SLA was incorporated starting in the 2011-2015 regulatory period, requiring the airport to pay rebates to airlines if it did not meet the agreed level of service, if these KPIs were met by the airlines. If an airline failed to meet the pre-agreed KPIs, any rebates that would have been paid to that airline were instead transferred into an 'investment pool.' The funds in the investment pool could then be spent on any operational issue agreed between the airport and the airlines.
36. More recently, the service quality framework at the airport has been changed, including modifications in the compensation model and the frequency of measuring KPIs. As part of the revised scheme, if an airline fails to meet the pre-agreed KPIs on a weekly basis, and the airport fails to meet its performance targets, any rebates that would have been paid to that airline are instead transferred into an 'airline pool' distributed among airlines and their ground handlers.
37. A key element to this model is that there is a clear focus on collective outcomes first, with a financial incentive model to sit alongside. This is a key lesson to consider for H8 when the airport and airline work together and understand the key targets and service levels that delivered the level of resilience which has been agreed.
38. At Groupe ADP, improving the quality of service at the airports was a priority as part of the 2011-2015 Economic Regulation Agreement (ERA). Two categories of indicators with financial incentives were introduced - quality standard indicators, relating to service standards provided by all airports regarding their airline clients and passengers, and excellence indicators.
39. There are potential penalties for both types of indicators, but only the excellence indicators have potential bonuses (since the quality standard indicators relate to the fundamentals expected by users, so no outperformance is rewarded).³ In addition to these indicators, ADP committed to developing a collaborative approach with stakeholders to work on five key themes, relating to the main issues of passengers' airport experience: punctuality, hospitality, check-in, baggage delivery and assistance provided to disabled and mobility-impaired people. Whilst there is yet to be a new and agreed ERA post-Covid, historical discussions demonstrate an openness to a new approach.

³ AdP (2016), '[Economic regulation agreement between the Government and Aéroports de Paris 2016-2020](#)', p. 10.

40. Heathrow does not have a fixed view or solution on how this should work in practice – and acknowledges that other airports have different operating environments. However, there is precedence for the principle of such an approach – and with CE outlining the importance of resilience in H8, reviewing the potential opportunities collectively could have delivery knock-on benefits and successful outcomes.
41. In addition, any changes to H8 MTIs are also inevitably linked to the results of the CAA's OBR Mid-Term Review. As yet, this has not been provided and Heathrow would urge the CAA to publish so it can be fully utilised in CE and beyond to develop and evolve the service level regime for H8.

Evolving and targeting capex governance changes:

Rationale: The governance processes introduced in H7 remains in its relative infancy and continues to develop and mature; however, the CAA have acknowledged that there may be opportunities to improve the governance processes where there is clear consumer benefit. There is emerging evidence that the current regime is particularly onerous for smaller projects leading to delays and inefficiency, and that its application to digital initiatives leads to undue complexity and added delay.

Outcome: The CAA reviewing its approach and evolving Heathrow's capital governance framework to reform or remove delivery obligations (DOs) for smaller (<£10m) and non-airline facing digital projects. This would allow for faster, more effective and more efficient delivery of benefits to consumers.

42. On capex incentives and governance, Heathrow supports the CAA's openness to evolutionary changes to the processes – reflecting the need to balance their early implementation of the new framework and positive elements that sit within it, versus understanding practical examples of where there are challenges/ improvements to be made.

43. The new capex framework came into full effect from 1st March 2024 and the experience with the ex-ante incentives framework so far has already revealed important lessons about the workings of the Delivery Obligations (DO). Emerging analysis conducted with support from KPMG shows that there are positive learnings in relation to project management and stakeholder engagement improvements, but also opportunities to evolve the framework and to drive out current inefficiencies. Heathrow will share the developing analysis from KPMG as part of the H8 process, in early 2025.

44. Broadly, the experience with DOs to date shows a number of issues:

- Substantial direct and indirect costs associated to the implementation of DOs.
- Delays in project timelines, particularly in achieving Gateway 3 milestones.⁴
- Lack of flexibility in application, as a relatively standardised approach has emerged in practice, with equal weightings assigned to each obligation on outputs, quality and schedule.

⁴ The Heathrow Gateway Lifecycle is a process that reviews business cases at key points to guide investment decisions. The process includes a series of gateways, with G3 being a critical investment decision point where the Airline Community agree to the business case proceeding into implementation.

- Asymmetric incentives, as penalties are imposed for underperformance, but there are no equivalent rewards for overperformance such as early completion or delivery to a higher standard.
- The complexity of the framework has required changes to be made to Heathrow's systems which are still under development.

45. In addition, the review of ongoing technology projects in particular revealed that they are inherently more difficult to complete under the current DO approach, when compared to infrastructure projects. Technology projects are governed in the same way as infrastructure ones; however, there is not a "one size fits all" approach to capital delivery that can adequately encompass both types of projects. Technology projects use different milestones, have a different spend profile, do not necessarily have tangible assets and output definition making it more challenging to establish initial costs.

46. Moreover, technology driven business transformation is vision-led, where the route to delivering on the vision may need to be flexible as technology solutions develop and mature. This approach is also delivered via a programme of work where the initial tranche of projects guides the next tranche, likely through small projects where tests are carried out and then lessons learned.

47. These emerging findings suggest that a more flexible application of DOs could support better focus on incentives where they are needed, minimising the impacts of delay and the knock-on effects on the supply chain and benefits to the consumer.

48. This could be delivered through a criteria-based assessment of projects to consider the suitability of implementing DOs in a more tailored way. The criteria would incorporate a wider set of project characteristics, including for example:

- Impact on airline operations and direct impact on consumers.
- Expected timelines within governance gateways.
- Type e.g., commercial projects (where early delivery also brings early benefits) and technology projects (that tend to be more complex).
- Interfaces, e.g., if an integrated solution with multiple outputs is required to deliver all project benefits.

49. A further route for refinement could be to increase the current £1 million minimum threshold for DOs to focus efforts on projects where they can deliver the most value, thereby reducing resource strain on smaller projects – particularly given the anticipated increase in the number of projects subject to the framework.

50. Heathrow has established a different delivery mechanism for smaller projects (<£10m) to improve efficiency, but currently these projects are still subject to the overall DO

mechanism, which limits the improvements that can be achieved. Moving these projects outside of the overall DO mechanism would allow them to be delivered faster and more efficiently.

51. In addition to a more flexible approach to the DO framework to speed up delivery, the delivery of larger more complex projects requires specific considerations. The DO framework provides greater certainty, effectively driving a risk averse approach to capital delivery. However, for large and complex projects:

- It is highly unlikely that all risks will be identified and mitigated at G3, and therefore costs cannot be fixed at this point with confidence.
- It is also more complex to set a DO concerning outputs.

52. In these cases, the framework needs flexibility to adopt a more programmatic and outcome-led view rather than a project-based and output-driven approach. Potentially reducing the number of DOs could also be helpful to increase flexibility of delivery and stimulate innovation. Applying the current approach to this major project could lead to delays and considerable increases in cost.

53. Lessons learnt during this initial period underscore the importance of ongoing refinement and adaptation to ensure the framework continues to deliver value in the future. Heathrow will be developing this work and options ahead of the H8 business plan and looks forward to engaging with CAA and airlines as it distils findings from H7 experience and seeks to evolve the governance process within the H8 business plan.

Setting a clear direction on financeability fundamentals:

Rationale: Ensuring Heathrow's financeability is key enabler of delivering the CAA's primary duty towards consumers by enabling access to cost efficient funding that will unlock billions of investments in resilient growth for the benefit of our passengers and airline partners. Delivering resilient growth will require a step change in investment compared to H7 which Heathrow expects will need a return to a stable A- senior debt rating to be able to access efficient funding. This requires the financeability of the notional company to be calibrated correctly in line with precedent in other regulated sectors.

Outcome: The CAA should set out a clear approach to credit rating, cost of debt, H7 exit point, and financeability that is consistent with the approach in other regulatory sectors and CMA decisions. In particular, based on regulatory precedent, the CAA should target a BBB+ rating in the notional company (equivalent to A- senior debt rating in the actual structure).

54. Heathrow will provide more detail in this area in our response to the FTI report. Ahead of this response, Heathrow will set out a summary of the key issues to be addressed.

55. Credit Rating – Delivering resilient growth (as per the emerging theme from constructive engagement) will require a step change in investment compared to H7. This will not be deliverable unless Heathrow achieves an A- credit rating, allowing access to a wider pool of credit. In addition, a better credit rating will allow access to less costly debt reducing the cost of capital and leading to lower charges for consumers in the long run. Achieving A- This relies on the CAA adopting keeping a transparent, stable and predictable price review process, underpinned by solid evidence-based methodology. For H7, the CAA's approach differed in key aspects from that used in other regulated sectors and by the CMA, and therefore we consider that changes could be pursued for changes are required H8.

56. In particular, based on regulatory and CMA precedent, the notional company should target a credit rating of BBB+ (which is equivalent to A- rating on senior debt in the actual company) and finance-ability for H8 should be assessed by reference to the FFO/debt thresholds linked to the target rating.

57. Cost of Capital – Heathrow will respond to the FTI consulting report on the Cost of Capital for H8 separately, but would highlight a number of key elements for the CAA to consider:

- The proposed range for asset beta (0.44 to 0.61) is not consistent with the post-covid range of the comparator companies (0.55 to 0.70);

- The CAA's approach does not properly reflect the efficient cost of Heathrow's embedded debt; and
- The FTI approach to TMR does not take into account the most up-to-date data on historical inflation.

58. Inflation Indexation - Heathrow notes that the CAA expects to move from RPI to CPI or CPIH indexation of the RAB for H8. It is important that this transition applies a consistent approach between the RPI-CPI transition in the indexation of the RAB and the calculation of the WACC so that it is net present value neutral to Heathrow.

59. Cost of Debt - Adopting a nominal allowance for the cost of debt and thus removing indexation from the equivalent part of the RAB would reduce the level of RAB growth caused by indexation but would increase the WACC. This would mean higher aeronautical charges in the short term offset by lower charges in the future. This would change the balance between current and future users of the airport, potentially disproportionately benefitting future users of the airport at the expense of current users. This balance needs to be considered carefully.

Improving the business plan incentive:

Rationale: The H8 business plan incentive is a new proposal from the CAA. Although it exists in other sectors, these incentives benefit from being able to relatively assess against a range of submissions. Given the CAA will only have Heathrow to assess, it is vital that the requirements and criteria for assessing the business plan are set out clearly and well in advance of the submission of Heathrow's plan.

Outcome: Provide detailed requirements and criteria by which the business plan should be submitted well in advance of submission of the plan. If these cannot be provided by early February, then either the Business Plan submission should be delayed, or the business plan incentive removed.

53. Heathrow recognises that a high-quality business plan (BP) provides colleagues, customers and consumers with the confidence in both the robustness and delivery of the plan, and that incentives have worked in other regulated sectors. It is also recognised in other regulated sectors that incentives are both bonus and penalty based – not unequally weighted on either side.
54. Heathrow understands the aim of the CAA's proposals is to incentivise Heathrow's continuing commitment to that objective. At present, however, it is not clear how the plan would be assessed, nor what criteria would be used. Without such clarity, Heathrow does not consider that the proposal is appropriate.
55. To make this incentive effective Heathrow considers that more clarity is required on how the BP will be specifically "measured" and what criteria will be used to categorise aspects in the range from very high quality to low quality. The CAA state in CAP3044 that an important element is "*setting out final criteria for our assessment of the incentive and the approach to calibration*". Heathrow consider that to implement this incentive, the CAA needs to set out these criteria well in advance of the submission date of the plan – to ensure Heathrow has time to consider, reflect and implement.
56. In addition, it is unclear how the CAA intend to solve the issue of no other BPs to compare to. As outlined in CAP3044, Ofgem and Ofwat are able to provide a wider range of comparisons of BPs, whereas Heathrow is the only airport regulated where a BP is required as part of the formal regulatory process.
57. Alongside the above, the CAA suggest that information templates will be an important part of the CE process and the BP incentive process – but Heathrow is yet to see a CAA template and understand of what they would find acceptable if a joint airport-airline template is agreed, or what the process for approval/ sign off would be from the CAA.

METHOD STATEMENT – FURTHER HEATHROW RESPONSE:**Overall Context and Priorities:**

58. Whilst Heathrow acknowledges that the CAA will not run a market power assessment ahead of the H8 price control process, Heathrow maintains that lessons from other regulators mean that updated regulatory impact assessments and analysis provides stronger evidence to evaluate whether benefits of current regulation outweigh its costs, and critically whether the interests of consumers are being fully furthered. Assumptions around market power should be delivered via analysis and review.
59. Heathrow supports the CAA's initial analysis of the overall environment surrounding the H8 price control period – i.e. a traffic forecast, capital investment programme and operational expenditure level that are to be delivered against a backdrop of a two-runway airport.
60. Heathrow also welcomes the CAA considering the views represented in Heathrow's response to CAP2618⁵, and that there needs to be an openness and acknowledgment around the potential for expanding and/ or maximising two-runway capacity during H8 (or using H8 as a key element in the wider medium/ long term masterplan development at Heathrow).
61. In relation to the potential development of a Third Runway, Heathrow has consistently remained committed to long-term sustainable growth to reflect demand and continue to review our plans. The Airports National Policy Statement (ANPS) remains in full effect post legal challenges, providing policy support for our plans for a third runway and the related infrastructure required to support an expanded airport.
62. As such, and as Heathrow finalises its internal review and 'way forward' for the third runway, it is important that the H8 regulatory framework is able to acknowledge and accommodate any further developments related to costs if they take place within the H8 period - given the clear consumer interest that growth in new capacity delivers. It is therefore possible that an application for a Development Consent Order (DCO) for a third runway could occur in H8 and any final H8 methodology should accommodate such a possibility. Heathrow consider that any costs associated with a DCO submission could be treated in a similar manner to the rest of H8 capital expenditure and it is likely to be more applicable rather than revisiting previous Category-led costs witnessed under Q6 and H7 (as a bespoke process). This provides greater simplicity and alignment with proven

⁵ [Heathrow response to "Setting future price controls"](#), CAP2618, para 10.1, p33

existing processes. Heathrow would welcome further engagement on a proposed approach.

63. Heathrow believes the CAA is right to suggest that there will be *“the significant changes in circumstance since the H7 price control, the importance of HAL providing resilient services, meeting its environmental obligations and the challenges that the upward pressure on airport charges could create, both in the short and longer-term”*⁶. These priorities identified are the right ones and reflect the discussions held during constructive engagement.
64. As the UK’s hub airport, there are and have been a number of factors to consider when understanding and determining the impact on price. These include service levels, provision of cargo facilities, operational complexity and impact, and location.
65. Therefore, investment choices and operational priorities have been developed to reflect airline priorities and business models. For example, Heathrow has 124 pier served stands and over 90% of Heathrow movements use pier service stands. This is greater than many other leading hub airport competitors (such as Schiphol, Charles de Gaulle and Hong Kong). Whilst this has a higher capital cost overall, airlines and passengers overwhelmingly benefit in terms of operational ease, experience and comfort. Airlines also benefit from cargo operations in the aircraft’s belly hold, without any direct charge.
66. In addition to the large number of stakeholder interfaces with Heathrow, and the influence of these stakeholders in additional layers of capital governance, Heathrow’s operational environment present particular challenges. Delivering a complex Hub business model combining long-haul and short-haul operations across multiple terminals in a large estate, can drive costs. This includes other unique challenges, such as security requirements, logistics of working in the Central Terminal Area (CTA) and airside environments. The scale and high occupancy rates experienced at Heathrow result in these factors being above the norm.
67. Furthermore, the geographical location of Heathrow in London, and associated higher construction and wage costs, also distinguish Heathrow from other similar airports. Regional price differences, location factors, and intense competition for resources within the region contribute to the overall cost premium associated with capex delivery at Heathrow compared to other airports in the UK and Europe.

⁶ Draft H8 method statement and business planning guidance ([CAP3044](#)), para 1.4, p6

68. In CAP3044, the CAA set out three priorities for consideration in order to meet their consumer-led objectives⁷. Heathrow does not disagree with those listed and their contents but would suggest that the CAA do not take a hierarchical approach to the agreement of priorities for H8, but rather reflect the balance and interaction that exists between each. It is also important that the CAA consider the emerging views/ priorities from the current constructive engagement process taking place with the airline community.
69. For example, priority b) encompasses a wide range of elements that will deliver a successful H8 environment (e.g. efficient investment, financial resilience, environmental targets); however, this is dependent on a balanced service quality incentive process (priority a), and if costs are balanced to reflect the investment and delivery programme chosen. A focus purely and firstly on costs (priority c) may not lead to the right outcomes that have been agreed/ discussed by the airport and airline community at and through constructive engagement.
70. Moreover, Heathrow would suggest the inclusion of 'value for customer' is actively considered going forward as part of the CAA's prioritisation work, given the customer-led nature of our H8 business plan development.

Constructive Engagement:

71. Heathrow welcomes the CAA endorsing the approach and scope of the first Round of Constructive Engagement (CE) agreed between Heathrow and the airline community - in particular the endorsement of the topics and themes that have been focused on.
72. Heathrow also supports the CAA's objective for CE Round 1 is *"to identify airline customers' priorities on overarching issues such as service quality, investment and traffic forecasts, and seek to reach agreement on high level options to inform the business plan"*.
73. Heathrow has sought to deliver this by encouraging airline presentations on these issues alongside Heathrow's, pose questions to the airline community on identifying these priorities in our information packs (rather than present as 'decisions made') and sought wider airline subject matter expertise (SMEs) in attendance. Heathrow would welcome the CAA re-affirming these elements in the final method statement, as all parties continue into Round two – particularly on the need for both parties to provide relevant expertise into the discussions and topics at hand.
74. In addition, Heathrow supports the CAA's statement around the provision of information for this stage of CE and the CAA's role in the process. Given the stage of Heathrow

⁷ Ibid, para 2.12, p13

development and discussions with the airlines for H8 (priorities/ objectives rather than pre-defined options), Heathrow agrees that information is “*less likely to be detailed at this stage...it is appropriate that discussions are more focused on strategic choices...*”. Heathrow also agrees that the CAA should not take an active “policy” or dispute role in the discussions at this stage – but believe they are a vital observer in the process and can deliver direction or ask/ answer clarifying questions to all parties throughout.

75. Heathrow notes 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 already been developed in other governance forums and the maturity of solution definition. It is important that any new guidelines for Round 2 recognises that this variation is appropriate for this stage of plan development.

76. Heathrow considers that there is scope for further development of guidance for Rounds 3 and 4 of CE, and in particular on the role the CAA intend to take in leading CE during round 4, on the basis of their initial proposals.

77. Heathrow supports the ability to respond to Initial Proposals both in writing and bilaterally.

Scope of Price control and overall approach:

Consumer:

78. Heathrow will continue to conduct its own research and analysis to drive our choices and plans for H8, with the primary objectives of this research:

- to deliver insights into consumer priorities, preferences and valuations to inform our business plans;
- to provide consumers with the opportunity to engage with Heathrow on long term planning so they can provide inputs, feedback and views that can be reflected in our approach.

79. Heathrow utilise a mix of direct (airport trackers, insight community) indirect (web reviews, social media) and inferred (passenger volumes, operational metrics) consumer engagement tools to allow the airport to engage and understand consumer needs, across all journey touchpoints.

80. As such, Heathrow welcomes CAA being open to Heathrow’s suggestion in the CAP2618 response that the CAA should “*strengthen its own consumer research work and deliver on its own previous and correct analysis. during previous price control processes*”. Heathrow looks forward to the CAA setting out its developing thoughts in this area.

81. Heathrow would suggest the CAA consider not only appointing a dedicated “lead” on consumer engagement within their consumer & markets team, but also consider utilising the independent Heathrow Passenger Forum (HPF) formally within Round 4 of CE. Such an approach will allow for the CAA to meet the assertion in para 2.57 that “*airlines and other stakeholders may also have important insights into consumer priorities...*”

Traffic:

82. It is important to note that the H8 traffic forecast will sit within a different context than was the case in the build-up and development of Heathrow’s H7 Business Plan. Aviation demand has largely recovered from the pandemic, and the elements of any forecast for H8 will need to recognise available capacity and the need for resilient growth.

83. Heathrow would welcome further development of the CAA’s proposed approach around balancing Heathrow’s traffic forecasting, a potential “joint airline airport view on range” and the CAA’s independent forecasting.

- Joint Airport/ Airline Forecast Range: Is Heathrow expected to agree with the airlines, after CE on the range, or within the final BP submission itself? If the airlines and airport are unable to agree, does the CAA’s own work analyse Heathrow’s view as to the level of alignment? Heathrow will ensure our focus is on working with the airlines on such a range – however it would be useful to understand from the CAA at what point they consider this is required, and the process if Heathrow and the airlines do not agree.
- Independent CAA Forecast: It is important to note that any external work by CAA is focused and tailored to those specific capacity issues at Heathrow. This will ensure the relevance as well as complete transparency on methodologies and assumptions. Such a forecast would require upfront engagement with the experts at Heathrow on the terms of reference stage to ensure appropriate framing and that certain elements of Heathrow’s operating environment are not lost. Alongside this, Heathrow would request the CAA set out how these forecasts will reflect on any Heathrow and/ or joint airport/ airline forecast – to ensure consistency and simplicity in the process and avoid duplication.

84. In regard to Traffic Risk Sharing (TRS) for H8, Heathrow considers that the current approach for managing large variations in forecast greater than 10% remains appropriate. However, with the return to the airport operating at capacity, the balance of risk around smaller variations will be different for H8 than H7, with the risk of passenger numbers exceeding the forecast being much lower than the risk of them being lower. This asymmetry may merit a different approach to the inner band of the TRS. Heathrow will consider this area, and its interaction with risk, further in our response to the FTI paper.

Service:

85. Heathrow has set out its views on improving the MTI regime for H8, above.

Environmental Sustainability:

86. Heathrow supports the CAA's approach to net zero as a key priority for H8. As set out in Heathrow's response to CAP2618⁸, through Heathrow 2.0, Heathrow has a clear plan to decarbonise the airport and support sector-wide emission reductions. By 2030, our goal is that carbon emissions from flights falls by up to 15% from 2019 levels (our sustainably linked bond is a good demonstration of our financial commitment to delivery). Successful delivery of Heathrow's decarbonisation plans would mean that our residual emissions by 2050 would be well aligned to Government targets, and CAA support for achieving these goals is welcome.

87. As such, an approach by the CAA which adds significant weight to Heathrow's plans to decarbonise both on the ground and in the air – i.e. both our facilities and infrastructure, and also how Heathrow supports airline plans to decarbonise - is vital. Focusing on one above the other does not reflect the overall policy and financial environment that Heathrow operates in, as Heathrow continues to focus on meeting our environmental targets.

88. Heathrow looks forward to the CAA's conclusions on the proposed carbon measure as part of the OBR mid-term review.

89. The CAA suggests in its document that existing capex governance can be utilised for net zero projects. Whilst Heathrow acknowledges that this governance is still maturing, given the importance of projects to deliver decarbonisation, a more streamlined process for net zero projects could also be considered (particularly ones that are smaller and/ or have a digital/ technology element, as outlined in Heathrow response above related to capex governance).

90. Alongside the focus on Net Zero, sustainability extends to issues that Heathrow has a duty and responsibility to ensure are an integral part of our decision making – such as waste management and noise mitigation. Noise mitigation in particular is key to retaining community support and avoiding additional restriction on capacity as has been seen at some other European airports such as Schiphol and Brussels.

91. To provide greater certainty and clarity to local communities on aircraft noise – Heathrow suggests that the CAA could consider an approach whereby noise insulation expenditure is treated as capex for regulatory purposes rather than opex. This would improve the

⁸ [Heathrow response to "Setting future price controls"](#), CAP2618, para 11.1, p4

incentives around delivery of noise insulation, ensure that airlines only paid for work that was done, and allow the cost of the insulation to be spread over the period in which benefits are developed rather than being front loaded.

92. Further benefits from changing the cost categorisation of noise activities to capital expenditure include:

- Long-term alignment: Heathrow's commitment to residential insulation (26,000 homes), ventilation of 14 schools, protection of 3 care homes, and addressing vortex risks in around 6,000 properties requires dependable long-term investment.
- Potential to adapt the size of the scheme to reflect the benefits delivered: If research shows investment brings significant benefits, a wider boundary for insulation could be justified. Treating this expenditure as capital allows changes to be managed through existing governance rather than through license conditions
- Global benchmarking: Other airports, such as Paris CDG and Frankfurt, effectively make a direct link between noise charges and noise mitigation spending. Paris has an air noise tax on airlines based on a "polluter pays" principle—with higher fees for noisier aircraft and those operating during inconvenient hours. Alternatively, Frankfurt as well as having noise-based charges, also includes a specific passenger and cargo charge for the purpose of funding a package of noise management measures. These models demonstrate a successful integration of noise management costs and encourage best practices.

93. Heathrow looks forward to working with the CAA and other stakeholders on building out this potential option in H8.

Cost and commercial revenues:

94. Heathrow looks forward to the CAA setting out greater detail on its approach and delivery plan for the additional consultancy work outlined by the CAA, in particular:

- International cost benchmarking – the CAA acknowledge that “there are likely to be significant challenges, and it will take time to develop”. Heathrow look forward to working with the CAA with their approach.
- Masterplan – key thought needs to be given to areas of focus taking into account that some elements of the 2R capital investment programme have been part of governance processes with airlines, and it is important not to create duplication or undermine existing processes.

95. On surface access policy changes, Heathrow would welcome an openness to consider how surface access schemes deliver wider environmental benefit in a two-runway world

– to reflect the environment that the CAA has set out for H8 overall. This would shift the balance away from purely supporting additional capacity (as is currently the case).

96. In relation to ORCs, Heathrow would suggest that the current framework drives misaligned incentives, with Heathrow seeing excessive barriers to progress with delivery of key benefits to consumers - in particular a high electricity unit rate for ORCs disincentivises organisations operating at Heathrow to transition to electricity, a process which underpins our net zero goals. The CAA should be open to a marginal cost approach with all fixed costs recovered via airport charge, and one which gives more consideration to non-airline stakeholders, as this would provide the right incentives on issues such as the transition to net zero.

Cost incentives:

97. As set out above, Heathrow considers that there is a significant opportunity in changing the treatment of expenditure to provide noise insulation and vortex protection so that it is treated as capex for regulatory purposes. In addition, there are some wider economy trends that may lead to the balance between capital and operating costs changing in the future.

98. Of these, perhaps the most important is the move to cloud computing and remotely hosted technology. This will result in a switch in the balance between capital and operating costs as more and more new technology is delivered by opex solutions rather than capital. This is likely to have an impact on the extent to which frontier operating cost efficiency improves. As spend to save scheme switch from capex to opex, the impact of capital substitution will reduce, resulting in the opex efficiency potential moving closer to total factor productivity rather than being greater.

99. On Terminal Drop Off Charge (TDOC), Heathrow's view is that the TDOC has been in operation for a number of years and is now a mature commercial revenue product in its own right. Given this, Heathrow consider that it is appropriate for H8 to treat it in a similarly to other commercial revenue streams and to remove the risk sharing allowance. However, airport and other parking charges remain a potential area where further discussion is required, and the risk of regulatory changes in this area cannot be ruled out. Heathrow therefore consider that it continues to be appropriate to retain an adjustment mechanism to adjust charges if drop off charges can no longer be applied.

100. Heathrow would also note that accounting standards for regulated companies are planned to change shortly. For example, revenue reporting requirements will need to recognise the impact of regulatory correction mechanisms. It is important that these changes can be managed in a way that does not accidentally lead to unintended consequences in regulatory mechanisms such as TRS. Heathrow proposes that the CAA work with us to ensure that any consequential changes to Regulatory accounts can be

established so that the change in accounting standards does not lead to unintended consequences in the application of regulatory mechanisms.

Financial Issues and RAB:

101. Heathrow supports the CAA statement in CAP3044 on the need for a stable and predictable regulatory framework and reiterates the views in the airport's response to CAP2618 that the recovery of efficiently incurred expenditure through regulatory depreciation should be upheld, and that the deliverability of CAA's primary duty to consumers relies on companies funding licensed activities through efficient cost recovery. Any deviation from this principle risks unfinanceable outcomes and is extremely harmful to consumers.
102. Heathrow also supports the CAA retaining the RAB and the "building blocks" approach to setting the H8 price control for Heathrow.
103. On the size and scale of the RAB, it is important to note that the RAB primarily reflects investment that Heathrow has been agreed with the airlines and efficiently incurred, but that has yet to be recovered in charges. Heathrow provides its airlines with unique facilities - with more premium passengers than any other airport, supported by the highest levels of pier service. Heathrow also has a higher proportion of wide body planes, and also handles a greater value of cargo. These facilities add significantly to the scale of investment required at Heathrow and deliver significant value to airlines and passengers.
104. In addition, in real terms the RAB has been reducing since 2014, and the RAB per passenger has been declining even faster. It is important that efficient investment in the airport is not unnecessarily constrained in a way that leads to detriments for consumers simply as a result of concerns about the level of the RAB.
105. Heathrow notes that CAA is seeking to review further initiatives that might reduce the size of the RAB but would caution against a risk of a simplistic approach to the "sale of non-core assets", as suggested. As an example, the airlines have suggested that £2.5bn of investment properties included in the fixed asset register (FAR) and raised questions about whether they are paying excessively for these assets. This concern is misplaced for a number of reasons.
106. Firstly, investment properties in the FAR are revalued every year, and the majority of the asset value reflects the impact of revaluations rather than expenditure. Airlines charges are based on the RAB that only reflects expenditure.
107. Secondly, sale of the assets would not lead to lower charges. For example sale of a staff car park, would require either provision of new car parks, or an increase in charges for its use to reflect the purchased value.

108. Moreover, Heathrow does not consider it owns any non-core assets. Most developmental land is either required for Heathrow's future masterplan requirements and or subject to potential plans for development.

109. A short-term disposal of these assets would lead to higher costs for future development, require significant re-provision of facilities, and add significantly to costs. As set out above, removing property from the single till could enable faster development of these sites and deliver much greater benefits to consumers.

Cost of capital:

110. Heathrow will provide a separate response on cost of capital as it relates to the FTI report and have outlined a number of points in our response/ priority above.

Timetable:

111. Since the revised H8 timetable was confirmed by the CAA, Heathrow has been and will continue to focus on delivering key elements of the process, towards a June 2025 Business Plan submission.

112. However, it is important to note that elements of the revised timetable itself has slipped further (i.e. November publication of the Draft Method Statement was revised and set for October). Given the already tight time constraints, and the interconnection between some further elements that the CAA will publish (OBR review, final method statement, further CE guidance) and Heathrow's business plan delivery, the need to consider the ability for the CAA to deliver the next stages of the process, is vital. This is made even more important given the CAA are proposing a financial incentive/ penalty on the delivery of the business plan – meaning access to information and direction, with enough time to be fully considered and incorporated by Heathrow for the business plan, helps ensure fairness in the ability to meet expectations and any further measures linked to this.

113. A key element of confidence in a price control process is also the right level and communication of any contingency plans and revised dates. As such, Heathrow would welcome the CAA sharing early sight of contingency plans with airlines and airports, well in advance, to allow us to comment and collectively agree a way forward.

BUSINESS PLAN GUIDANCE – HEATHROW RESPONSE:**Scope:**

114. As outlined above, Heathrow agrees and supports the need to deliver a high-quality business plan for H8. However given the link to the business plan guidance and a new business plan incentive proposal, there is at present a lack of criteria/ requirements as to how each element would be judged or measured.
115. Heathrow would also note the need to consider an openness to planning or other costs related to the third runway project, should Heathrow consider it appropriate to pursue during the H8 period.

Consumer:

116. Heathrow supports the CAA considering its own consumer research/ engagement process to support the H8 price control process overall – and would note the need to ensure that particularly at Round 4 of Constructive Engagement, the CAA are engaging with a range of different stakeholders to test Heathrow's business plan, and the CAA's initial proposals the reflect it. In addition, Heathrow would suggest community engagement is also important to ensure their views are captured and integrated.
117. In relation to specific areas for consumer research and engagement, Heathrow considers that the CAA should prioritise absorbing all evidence that is made available to them (including elements brought forward by Heathrow, ACI, IATA, other stakeholders), so they can form an independent view on what really matters to consumers. In the future, as all stakeholders move towards Initial Proposals stage, Heathrow expects there will likely be emerging areas where further evidence and testing will become necessary to validate CAA's view to ensure that they are consumer driven in their decision making. Should the CAA choose to commission specific work at any stage of the price review process, it will be important to engage Heathrow since the Terms of Reference stage, to ensure collaboration and feedback can be provided early on. In addition, Heathrow would suggest engagement with the Heathrow Passenger Forum (HPF) would be an important element to their overall approach to more consumer engagement.
118. As outlined above, the CAA could also consider defining clear internal resource and accountability in this area. The experience in the initial stages of H7 suggests that there is merit in establishing a CAA focal point with clear roles and responsibilities with respect to consumer engagement, helping ensure that consumers' voice is fully integrated into regulatory decision-making.

Traffic:

119. In regard to traffic forecasts, Heathrow would suggest that whilst the independent forecast itself should be run separately from Heathrow and the airlines, the right inputs and assumptions on capacity must be agreed from the outset. Any independent forecast should also ensure legal and commercial confidentiality elements are agreed from the outset.
120. Overall, it is also important that the forecast work undertaken by the CAA reflects the emerging themes of constructive engagement round one; and in particular the interaction between stated capacity, passenger traffic, and impact/ choice on levels of service and resilience.

Service Quality:

121. Heathrow agrees with overall approach outlined by the CAA, the need for Heathrow's business plan to outline how to maintain and improve operational resilience, as well as ensuring there is consideration for passenger and airline insights to support the development of the MTI scheme. As outlined above, Heathrow also notes the need to adequately benchmark and reflect emerging view on H8 priorities from constructive engagement (CE), as well as demonstrate a willingness and openness to evolving the overall MTI system to foster greater collaboration, and therefore consumer outcomes.

Environmental sustainability:

122. Heathrow agrees in principle with the new guidance set out in the new net zero H8 priority but would also suggest that a key component to the development of our plans and choices will be the need to reflect any legislative or policy decisions by the UK Government, as well as prevailing industry and global policy direction in this area (either adoption or mitigation).

Costs:

123. Heathrow agrees overall with the overall approach and components of the CAA's price control calculations, and the inclusion of these in Heathrow's business plan. In regards to the use of the Heathrow's regulatory accounts, Heathrow would only note the need to understand and reflect the differences between the Fixed Asset Register (FAR) – which is the financial record of Heathrow's assets in its statutory account and reflects prevailing accounting rules, against the Regulated Asset Base (RAB) – which ensures that efficient Heathrow expenditure is recovered either directly in charges or over time through depreciation.
124. On cost benchmarking, Heathrow's view is that a granular approach to benchmarking may not be appropriate. A top-down approach could offer a better indication of efficiency

and Heathrow would like to work with the CAA and airlines on how best to leverage what is currently in progress.

Cost

125. Heathrow broadly agrees that Heathrow should provide views on further developing learnings from H7 and shed light on the issues described in the capex session above, thus informing possible framework refinements.

Capital

126. Heathrow agrees with the CAA that “*a stable and predictable regulatory regime that supports ongoing investment*” is vital to provide an appropriate level and quality of service proposition. Broadly, a similar approach to H7 is agreeable and Heathrow is clear that the financial matters and the impact and interests in consumers, will be clear.

127. Heathrow will set out its view on the FTI report on the cost of capital but welcomes this as a first step to support further development of the business plan and cost of capital expectations likely in H8.

Financial Issues:

128. Heathrow agrees with the CAA approach to all financial, cost and revenue data being provided in nominal and real prices, with real values in 2024 prices.

129. On gearing, Heathrow agrees with the guidance specifying that 60% remains an appropriate level for the gearing of the notional company upon which the financeability assessment is based

130. On the impact of a change to a 30-year timeframe, Heathrow is open to discussing but would caution on the impact on minimum cashflow requirements to meet rating ratios and thresholds. In addition, the CAA would need to ensure the airline community were comfortable with the trade-offs and short- and long-term impact of the charge profiles as a result of a different approach to depreciation. In addition, this approach will need to be consistent with the approach and profile of any decisions related to modernising and expanding of Heathrow

ANNEX – HIGH LEVEL OPTIONS ON PROPERTY INVESTMENT AND THE BOUNDARY OF THE SINGLE TILL; SHARED DURING CONSTRUCTIVE ENGAGEMENT ROUND ONE – THEME FIVE:

OPTIONS ASSESSMENT – HIGH-LEVEL RAG:

Property outside of single till

	On-RAB	Sharing	Disposal to Self	Disposal to 3 rd Party
Consumer Amenity	All development owned and operated by Heathrow Airport Limited BUT regulatory barriers to development remain in place without significant reform to capital governance.	Development sponsored and operated by a Heathrow Group company. Removes regulatory barriers to development.	Development sponsored and operated by a Heathrow Group company. Removes regulatory barriers to development.	Development sponsored by third party, loss of control over operation and use. Contrary to Begg Report (2011) recommendations.
Till Impact	As per current capital governance, increase in charge in H8 and H9, significant reduction from H10.	Flat charges in H8. Stepped decreases in future periods based on sharing of revenues from new development, but no reduction in RAB.	Flat charges in H8. Stepped decreases in future periods based on land sales of previous periods (reducing RAB)	Flat charges in H8. Stepped decreases in future periods based on land sales of previous periods (reducing RAB)
Risk Allocation	Single till exposed to construction risk (net of ex ante) and revenue risk/reward.	Single till not exposed to construction risk. Choice to participate in revenue risk/reward.	Single till not exposed to construction or revenue risk.	Single till not exposed to construction or revenue risk.
Long-term Growth	Full control of land and its future uses retained by Heathrow Airport Limited.	Control of land leased to Heathrow Group Company, with potential for landlord breaks included.	Control of land permanently transferred to Heathrow Group company via disposal.	Control of land permanently transferred to third party via a sale. Historic evidence that land fragmentation disrupts airport development.