British Airways plc
Waterside
PO Box 365
Harmondsworth UB7 0GA

Stewart Carter
Civil Aviation Authority
Westferry Circus
Canary Wharf
London
E14 4HD

cc: economicregulation@caa.co.uk

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British Airways response to CAP3044
CAA Draft H8 Method Statement and Business Planning Guidance

Dear Stewart

Thank you for the opportunity to provide our response to the CAA's draft method statement for the H8 price control at Heathrow Airport (2027-2031) and business plan guidance to Heathrow Airport Limited (HAL).

Our response builds on our comments to the CAA's H7 lessons learned review (CAP2618) and takes into account the CAA's subsequent findings (CAP3000), as well as the guidance on CAA's Constructive Engagement guidance for H8 dated September 2024 and the ensuing response by the AOC/LACC.

We set out our response to the CAA's questions related to the draft method statement, business plan guidance and the proposed business plan incentive below. We will be providing a separate response to the specific questions on the cost of capital and the report by FTI, as well as the financial issues raised such as financeability and depreciation, by the deadline of 15 January 2025.

We welcome further engagement and are available for any questions on our response as the CAA develops its final method statement and business plan guidance for H8.

Yours sincerely,

Michael Petrides

Head of Economic Regulation
British Airways Plc

Non-confidential

1. Executive Summary

1.1. British Airways is fully engaged in H8, including the recently launched Constructive Engagement (CE) process. Our primary aim is to ensure that H8 yields an outcome in the interest of consumers at Heathrow and airlines using HAL's infrastructure. However, we continue to have fundamental concerns over the current economic regulation of HAL, HAL's very high level of charges, the affordability and resilience of key infrastructure for UK consumers and the ability to sustainably grow HAL's position as a strong hub for the UK economy. We believe that more fundamental reforms are needed to the regulatory system for UK airport infrastructure to improve consumer outcomes. Our comments to the CAA's draft method statement are made without prejudice to those reservations.

1.2. We also note the ambitious timelines set by the CAA for H8 and the continued delays over the past year in the H7 lessons learned exercise and issuing the draft method statement. These have meant that Round 1 of H8 CE has been launched without having the CAA's final approach in place which would have provided clarity to carry out the in-depth engagement required. Round 2 on the building blocks is also due to launch in January 2025 in the absence of a final method statement. We therefore welcome the CAA's intention of keeping the H8 timetable under review and look forward to an update in early 2025 on whether the timetable is feasible, as well as any contingencies needed.

1.3. We welcome the CAA's intention of providing clarity on its main priorities for the H8 price control review and we support the delivery of its findings from the H7 lessons learned exercise. While we agree with some of the priorities set out by the CAA, such as the need for HAL to provide a resilient service, to invest in an optimised infrastructure, efficient costs and environmental performance, these ought to be prioritised and further clarified.

1.4. The priorities for H8 should be sequenced in line with the CAA's hierarchy of statutory duties, with the primary duty being on protecting the consumer. We note the absence of any references to affordability to ensure consumers face airport charges that are efficient and reasonable. This goes beyond the CAA ensuring that charges are "no higher than necessary" and should focus on creating headroom in the aeronautical charge to accommodate investment. In order to do so the CAA ought to set out that it will:

i. Ensure that costs are efficient, including bottom-up opex and commercial revenue analyses, capex costs and the level of the WACC in line with the CAA's H7 lessons learned findings. The CAA ought to look at addressing the size of HAL's regulatory asset base (RAB), not merely its growth, given that it drives the majority of the cost. We have previously noted that HAL's RAB is by the far the largest among major European hubs (AENA, ADP and Amsterdam Schiphol), for instance more than double the size of Amsterdam Schiphol's RAB, driving around 90% of the level of charge.

ii. Recognise that investment projects will have to be prioritised over others to maintain an affordable capex plan delivering on resilience, capacity optimisation and enabling the sector to achieve cost reductions and its net zero targets. This is particularly relevant as HAL embarks on its long-term investment plan which, for H8, will include […] prioritising and seeking to deliver H7 roll-over projects.

1.5. The primary priority should not be overridden by secondary priorities and the CAA ought to clarify that financeability should not come at a higher cost than necessary. The CAA should set out that it will take into account market evidence and recognise that insulating HAL from all eventualities is inconsistent with the risk of a regulated business. Incentives should ensure a fair balance, avoid over-rewarding the licensee and avoid the risk of regulatory gaming.

1.6. While we recognise the CAA's intent behind exploring the option of a BP incentive (BPI), we strongly disagree with the proposal for awarding HAL with a bonus for producing a "high-quality" business plan (BP). It is entirely inappropriate to allow a regulated business to earn incremental income for producing what is effectively a normal activity expected of it in the context of its price control. This is particularly true given HAL's inadequate BP in H7 and the absence of comparator BPs against which HAL's BP can be assessed, which would risk arbitrary outcomes.

1.7. The incentive conflates quality with ambition, the proposed calibration is unclear and imbalanced, and the level of the bonus is entirely inappropriate. A "low-quality" scoring should trigger an automatic penalty – making it discretionary would lead to protracted discussions and would compromise the incentive's effectiveness. The proposed incentive is equally at odds with the CAA's own practice for a penalty-only incentive for NERL's capex engagement in RP3 and NR23.

1.8. We moreover propose some changes to the criteria for assessing the BP's quality, notably on the need for HAL's BP to clearly demonstrate how it has been developed through stakeholder engagement, including through Constructive Engagement.

1.9. We also make specific comments to the questions on the draft business plan guidance. These include the scope and presentation of financial data in the BP, how to reflect airline input in consumer engagement shaping the BP, our proposed cost categorisation, delivering on the CAA's lessons learned finding for bottom-up cost assessments, cost incentives, the inflation indexation on the RAB and treating potential underperforming assets.

2. Context

2.1. British Airways is fully engaged in H8, including the recently launched Constructive Engagement (CE) process. However, we feel it will be remiss, at this stage of the process, not to reiterate our fundamental concerns with the current economic regulation of HAL.

2.2. Passengers at Heathrow continue to receive poor value for money with poor consumer outcomes by having to pay among the highest airport charges in the world, without the equivalent level of world class service, quality or resilience. We appreciate that the CAA recognises the importance of HAL providing affordable and resilient services to consumers while striving to promote sustainable operations at the airport and growing Heathrow's importance as a global hub. We also note that the CAA has highlighted potential cost headwinds for H8, such as the significant increase in the cost of capital suggested by its consultant, and the important ramifications these could have for affordability and cost efficiency.

2.3. We believe that fundamental reforms are needed to the regulatory system for effectively regulating airport infrastructure in the UK, not the least the UK's only hub airport, to ensure it significantly improves consumer outcomes and delivers for the UK economy.

2.4. Whilst we continue to participate constructively in H8, this is without prejudice to our reservations about the suitability and appropriateness of the current regulatory model.

3. Timing of consultation and H8 timetable

3.1. We are concerned about the ambitious timelines the CAA has set for H8 following a series of delays to launching the lessons learned, publishing the lessons learned findings and publishing the draft method statement.

3.2. These delays have amounted to a total of more than a year and have in turn resulted in industry stakeholders being set with tight deadlines to respond to the CAA on important aspects of the price control in order to maintain an H8 start date of January 2027. It has also meant launching Round 1 of CE in November 2024 without having the final guidance on the CAA's approach to H8 in place. In CAP2618, the CAA was expecting the method statement to be finalised in December 2024 with CE beginning in early 2025.

3.3. Having the CAA's price control approach for H8 is essential to the CE process, as it enables airlines to carry out the in-depth engagement required, such as feeding back in an informed manner and understanding the trade-offs of the different priorities and options being presented. This will offer the best opportunity to reach consensus during CE without risking fundamental disagreements or reaching the end of the process without agreed outcomes.

3.4. In contrast, the current timing of the consultation means that Round 2 of CE on the price control's building blocks will begin in January 2025 without having the CAA's final method statement, which sets how the regulator would approach the very elements being discussed during that round.

3.5. We therefore welcome the CAA's intention of keeping the H8 timetable under review and look forward to an update in early 2025 on whether the timetable is feasible, as well as any contingencies needed.

4. CAA priorities for the H8 price control (Question 2.111)

4.1. We welcome the CAA's intention of providing clarity on its main priorities for the H8 price control review. We have consistently advocated for a clear framework for the price control with actionable objectives on how the CAA will deliver on its statutory duties and how to balance between its primary duty on protecting consumers and its secondary duty on HAL's financeability. We also support the CAA delivering on its findings from the H7 lessons learned exercise.

4.2. While we agree with some of the priorities set out by the CAA, such as the need for HAL to provide a resilient service, an optimised infrastructure, efficient costs and environmental performance, we note the need for these to be further clarified, complemented and prioritised. We are also cognisant of the needs for efficient, targeted investment where appropriate to enable those outcomes to be delivered.

4.3. However, while the CAA recognises the importance of "allowing for investment and providing incentives to increase airport capacity", there is no equivalent focus on maintaining a sustainable cost base that allows HAL to grow its position as a strong hub in the interest of the UK economy.

4.4. Firstly, **we note the absence of any references by the CAA to affordability** to ensure consumers face airport charges that are efficient and reasonable. While we agree with the CAA that charges should be "no higher than necessary"[1], this does not address the fact that charges at Heathrow are currently the highest in the world and that accommodating further investment would require **creating room in the aeronautical charge**. Addressing the high cost base at Heathrow and ensuring efficient charges should therefore be a primary policy driver for the H8 price control. In order to achieve this, it should be recognised that certain investment projects will have to be prioritised over others to maintain an affordable capex plan delivering on resilience, capacity optimisation and enabling the sector to achieve cost reductions and its net zero targets. This is particularly relevant as HAL embarks on its long-term investment plan which, for H8, will include [...] prioritising and seeking to deliver H7 roll-over projects.

4.5. Indeed, the explanatory notes to the Civil Aviation Act 2012 (CAA12) specify that economy, efficiency and securing all reasonable demands for airport services are expected to be met where **airport operators provide the services demanded by passengers at minimum cost**.[2] In the absence of legislative change or further guidance on the CAA12, we expect the legal framework to continue to be applied as intended by the legislator.

4.6. Secondly, we underscore the need for **sequencing the different priorities set out by the CAA** to align them with the hierarchy of its duties under the CAA12:

i. It should be clarified that **the primary priority is on consumer affordability**. This is to be achieved through ensuring efficient charges and costs, including bottom-

[1] Paragraph 2.12(c).
[2] See note 36(b).

up opex and commercial revenue analyses, efficient capex costs and the level of the WACC in line with the CAA's H7 lessons learned findings. We welcome the CAA's focus on ensuring that any growth in the regulatory asset base (RAB) is sustainable but ask that addressing the size of the RAB be added within this priority as it is driving around 90% of charge at Heathrow and is by far the largest among major European hubs. In fact, we note that demonstrating longer-term affordability is a requirement of HAL's Business Plan in the draft guidance (Table A.1). **The primary priority should not be overridden by the secondary priorities**.

ii. We agree with the CAA's focus on ensuring operational resilience at Heathrow through efficient investment and appropriate incentives. We highlight the need for financial incidence targets/penalties in areas of significant service failures such as the recurring HAL baggage systems failures, and suggest adding the need for improving system capacity, capability and processes. As stated above, it should be clarified that efficient investment should be prioritised and targeted where needed, recognising that certain capex projects will have to be prioritised over others to ensure an affordable and deliverable capex plan.

iii. For financial resilience, the CAA ought to recognise that this should not come at a higher cost than necessary, should take into account market evidence and acknowledge that insulating a firm from all eventualities is inconsistent with the risk of a regulated business. Incentives should ensure a fair balance, avoid over-rewarding the licensee and avoid the risk of regulatory gaming.

iv. Meeting HAL's environmental obligations should focus on enabling the sector to work together to achieve sustainability outcomes. This is to be achieved by enabling airport users to meet their net zero targets by reducing emissions and waste, such as through operational improvements and enhanced resilience. We agree with the CAA that sustainability projects should continue to be subject to the existing capex incentive framework and airline governance, including proposing appropriate Delivery Obligations and demonstrating credible business cases.

5. Business Plan incentive (Question 2.111)

5.1. We agree with the CAA's observation that HAL's H7 business plan (BP) lacked transparency and sufficient detail to enable stakeholders and the CAA to scrutinise the proposals properly. Given how fundamental this issue was in the H7 price control, we have previously advocated for a penalty-only BP incentive to ensure high-quality submissions by HAL and avoid the fundamental issues experienced in H7. We therefore recognise the CAA's intent behind exploring the option of a BP incentive (BPI).

<u>Proposed bonus and calibration</u>

5.2. However, we strongly disagree with the CAA's proposal for a BPI that would reward HAL with a bonus. The significant shortcomings in H7, including HAL's inadequate BP, offer little justification for allowing a regulated business to earn incremental income for producing what is normally expected of it in the context of its price control and meeting what would be fundamental requirements of its BP (see CAA's own statement for NR23 in paragraph 5.6 below). In addition, as noted by the CAA, there is no yardstick competition as in energy and water to enable meaningful a comparison of HAL's BP to another company in the sector, thereby risking arbitrary outcomes.

5.3. A significant weakness in the proposed framework is that it conflates quality and ambition metrics. These should be treated separately. Quality criteria should be considered as minimum requirements, with associated penalties for non-compliance. However, demonstrating ambition, such as whether HAL includes stretching efficiency targets that deliver clear consumer benefits and whether it shows genuine commitment to affordability is much more challenging given HAL's BP cannot be assessed comparatively against other company BPs.

5.4. Furthermore, the level of the bonus proposed is entirely inappropriate. While the CAA notes that the incentive would be "relatively modest" and would indicatively cost £0.20 per passenger, we note that such a bonus would effectively be five times the amount payable to HAL in the 2025 charges for service-related bonuses – which we also fundamentally disagree with.

5.5. In fact, the CAA's proposed calibration of the incentive is unclear, imbalanced and inappropriate and would risk setting dangerous precedent by creating perverse incentives. For instance, it is unclear whether and what areas HAL's BP would need to score either "Very high-quality" or "High-quality" to trigger a bonus. Similarly, the CAA alludes to no "full penalty" being payable despite HAL's BP being "Low-quality" in some areas (because it is not low-quality "across a significant number of areas of the plan"). It is unclear what the priorities areas are and whether/what weighting would be applied to them. A "low-quality" scoring should trigger an automatic penalty – making it discretionary would lead to protracted discussions and would compromise the incentive's effectiveness.

5.6. We also underscore the inconsistency that a bonus would create compared with the CAA's decision to apply a penalty-only incentive to NERL's capex engagement when producing its Service and Investment Plan (SIP) for the RP3 and NR23 periods – which we strongly support. We draw the CAA's attention to its own statements in the CAA's Initial Proposals for NR23:

> *"the incentive should remain "penalty only"* ***to avoid NERL earning incremental income for what should be a normal and expected activity***" [our emphasis added][3]

5.7. A penalty-only incentive is therefore the only appropriate means to incentivise HAL in producing a high-quality BP and avoid the shortcomings and behaviours exhibited in H7. A penalty-only framework for quality-related criteria is in line with the precedent set by both Ofgem's RIIO-3 BPI Stage A requirements and the CAA's own capex engagement incentive for NERL. We also ask that the CAA refrain from "compensating" HAL for any such penalties, for instance in the cost of capital, to avoid depriving the incentive of its intended effect.

5.8. Should the CAA consider that the incentive should still include a bonus, we would ask that the proposed BPI be removed.

Assessment criteria and description of "high-quality" BP

5.9. The assessment criteria currently lack sufficient detail to provide clarity on what constitutes high, moderate or low quality. Without this granularity, it will be challenging to ensure consistent and fair application of the incentive. We recommend developing more explicit criteria and a transparent assessment methodology.

5.10. To avoid a penalty, a BP must meet all specified requirements, not just a subset. These requirements should be expanded to include more rigorous obligations in relation to the CE process, similar to Ofgem's RIIO-3 approach. For instance, Ofgem's guidance states:

> *"The network company must include a summary, using the template provided, demonstrating how it used engagement with key stakeholders (eg connection customers, consumer groups, local communities) to inform the development of its business plan, and must provide evidence where this engagement has had tangible impacts on the contents of its business plan, including (where applicable) where decisions have been taken in a manner contrary to the stakeholder feedback."* [4]

5.11. HAL should be required to demonstrate how the results of CE have tangibly influenced its business plan, including clear explanations where decisions have been taken contrary to airline feedback.

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[3] CAP2394b, Appendix G, paragraph G24

[4] Ofgem (2024) RIIO-3 Business Plan Guidance. https://www.ofgem.gov.uk/sites/default/files/2024-07/RIIO-3_Business_Plan_Guidance.pdf

5.12. On the CAA's proposed assessment criteria for a high-quality plan, we therefore note that the following additions:

i. In addition to clearly demonstrating how the BP benefits consumers, the BP should demonstrate *how it has been developed through stakeholder engagement, including through Constructive Engagement*

ii. In setting a plan which his appropriately challenging in the targets its sets, *costs should be clearly evidenced*

iii. The way in which the BP benefits consumers is clearly demonstrated, *including how proposals enable specific outcomes.*

5.13. With reference to the CAA's proposed approach to categorising HAL's BP as "high-quality", we agree that it should set out how consumers' needs have been taken into account, but also *how stakeholders' input, including through the Constructive Engagement process, has been reflected*. Similarly, the plan should demonstrate how consumers' needs will be furthered by the implementation of the plan *through the delivery of specific outcomes*. The "Very High-Quality" may have to be removed as the incentive would have to be penalty-only.

5.14. We also ask the CAA to consider to what extent the criteria in NERL's capex engagement incentive can be transposed in the elements that HAL's BP has to demonstrate. These are:

1) User focus

2) Optioneering

3) Responsiveness

4) Mitigating/corrective actions.[5]

[5] See CAP2597b, Appendix D to CAA's NERL NR23 Final Decision.

6. Business Plan guidance (Question 4.31 and Appendices A to G)

6.1. We set out below our responses to the CAA’s questions on the BP guidance and the guidance itself. As mentioned above, we will be filing a subsequent response to the specific questions on the cost of capital and the report by FTI. While we provide some initial input below, our subsequent response will also cover the CAA’s questions on the financial issues raised, such as financeability and depreciation.

a. Scope

6.2. We have significant concerns about the current drafting of the guidance regarding price bases and the presentation of financial data in HAL's business plan. While we appreciate the CAA's intent to provide flexibility, we believe the current approach creates unnecessary ambiguity that will complicate the review process and potentially obscure important cost trends.

6.3. The guidance should mandate CPI as the standard price base rather than leaving this open to alternative approaches. While we understand that HAL may wish to present analyses using different indices to make specific points, these should be required as supplementary information rather than replacing the standard CPI-based analysis. This standardisation is essential for ensuring consistent analysis across different elements of the BP and enabling meaningful comparisons over time.

6.4. A particular concern is the lack of clarity around the treatment of real price effects and efficiency assumptions in the 'real' figures. The current guidance does not explicitly address whether these adjustments should be included in the real figures or presented separately. For the BP forecasts, we strongly recommend that the CAA requires HAL to explicitly separate:

i. Base cost projections

ii. Pure inflation effects using CPI

iii. Any real price effects

iv. Efficiency assumptions

v. Other adjustments.

6.5. This separation is crucial for understanding the true drivers of cost changes and ensuring appropriate scrutiny of HAL's assumptions. Without this clarity, there is a risk that important cost trends could be obscured by the mixing of different types of price effects.

6.6. The burden on both the CAA and the airline community will increase significantly if multiple price bases need to be reviewed and reconciled. This could lead to unnecessary complexity in the consultation process and potentially delay important regulatory decisions. Furthermore, it may create challenges in comparing HAL's proposals with other regulated entities and benchmarks.

6.7. We recommend that the CAA:

1) Revises the guidance to explicitly mandate CPI as the primary price base

2) Develops standard templates that clearly separate different types of price effects

3) Establishes clear procedures for presenting any supplementary analyses using alternative indices

4) Requires explicit documentation of all assumptions and adjustments.

6.8. This more prescriptive approach would improve transparency, reduce confusion, and enable more effective stakeholder engagement in the review process. It would also ensure that the CAA has the clear, consistent information it needs to make informed decisions about HAL's price control.

6.9. We would also recommend that the CAA creates a new simplified financial model that builds on the above principles. The current model is not fit-for-purpose and suffers from the use of macros and reduces transparency for relevant stakeholders.

6.10. With respect to scope, we recommend that the CAA requests information from HAL in a clear and transparent form that can be shared with stakeholders on any HAL evidence that is typically used in regulatory determinations. This should include detailed information on HAL's debt portfolio, including derivatives, and detailed reporting on proposed depreciation.

b. Consumer engagement

6.11. We are supportive of the principle of consumer engagement for HAL's BP. The CAA states that HAL's approach to consumer engagement should consider airlines' consumer research and insights, and that HAL should consult the CAA and airlines on its future research and engagement plans and reflect feedback in its BP. We agree with this principle and note that the success of H8 heavily depends on meaningful dialogue between the HAL, airlines and the CAA.

6.12. The proposed guidance states that HAL should demonstrate a clear link between its consumer insights and future plans under the range of scenarios being assessed, drawing on existing consumer insights, new intelligence and research to support these scenarios where possible. Whilst we agree with the principle, we note that is important that HAL's consumer engagement strategy reflects the key airline priority on guaranteeing a stable, predictable and reliable passenger journey in the consumer interest. This includes minimising disruption, delays and outages (such as the recurring baggage outages and flow rate restrictions), improving system capacity and improving PRM experience. Please note our responses to the service quality and resilience in paragraphs 6.19-6.21 .

6.13. While we agree with the approach set out by the CAA for how HAL should seek assurance that its BP reflects evidence gathered through consumer research and engagement, we are concerned by the lack of clarity about the requirements. It states that HAL should specify what assurance it has put in place for its own consumer research and engagement to support the development of its BP and the outcome of this assurance. take careful account of the challenge and other feedback it receives from this assurance exercise, and where its approach does not fully align with the outcome of the assurance, HAL should explain and justify its reasoning.

6.14. While we agree with the principle that HAL should take careful account of the challenge and other feedback it receives from this assurance exercise, we are concerned about the lack of clarity for circumstances where its approach does not fully align with the outcome of the assurance. We recommend that the CAA provides clear requirements for the level of explanation and justification which is required from HAL in circumstances where its approach does not fully align with the outcome of the assurance. This should also apply to any third party assurance received by the CAA itself.

6.15. We would also recommend that the CAA sets out the minimum information that should be shared with relevant stakeholders by HAL to inform the process. This reduces scope for framing of questions in a particular fashion and ensures that any engagement is based on accurate information.

c. Traffic

6.16. We note the CAA's statement in the H7 lessons learned findings that it will carry out an independent traffic forecast for H8 and we highlight the importance of HAL presenting its traffic scenarios in a way which allows the CAA's consultant to scrutinise them properly and critically evaluate them.

d. Environmental sustainability

6.17. As noted above, the guidance should set out that HAL's BP should demonstrate how it will enable the sector to work together to achieve sustainability outcomes. The guidance should specify that HAL should demonstrate how it has enabled airport users to meet their net zero targets by reducing emissions and waste, such as through operational improvements and enhanced resilience.

6.18. For sustainability investments, we agree with the CAA that, in line with the existing capex incentive framework and airline governance, these should demonstrate credible business cases and propose appropriate Delivery Obligations.

e. Service quality and resilience

6.19. We agree with the CAA that HAL should look at updating the broad outcomes used in H8 and should update the Measures, Targets and Incentives (MTI) scheme framework based on evidence, consumer research and airline customer engagement. Redesigning the service level incentive regime is crucial in promoting resilience at the airport. We underscore the importance of financial incentives (i.e. penalties) in incentivising performance, efficiency and resilience by HAL. Financial incidence targets are especially crucial in areas of significant service failures such as HAL's recurring baggage systems failures – which currently carry a reputational but not financial target while airlines continue to bear the entirety of the disruption cost and consumer impact – as well as ATC control delays which have grown significantly at the airport.

6.20. Indeed, the CAA should clarify that the targets proposed by HAL should seek to respond to evidence of user issues and significant service failures by HAL or its suppliers. Where such issues are identified, HAL should be proposing new financial incidence targets or modification of existing ones to inject and increase resilience in the system. The CAA should also clarify that the measurement of existing targets (such as security queues) may require modification to better reflect performance across relevant touchpoints of the passenger journey – for instance by requiring daily performance targets.

6.21. The guidance on resilience should highlight the importance of the BP demonstrating how the runway, airfield and terminal infrastructure will cope with, adapt and recover quickly from disruption and unplanned events. The BP should specifically show how it will reduce the likelihood of events, mitigate impact and increase recovery.

f. Cost categorisation

6.22. While we welcome the proposal for HAL to present a categorisation of costs and revenues, we disagree with the CAA's proposal that the current categorisation in HAL's regulatory accounts provides an appropriate basis for H8 BP data submission. The existing framework lacks sufficient granularity in several critical areas, which impedes meaningful analysis and benchmarking.

Opex

6.23. In relation to opex specifically, we make the following observations:

i. People costs: A fundamental concern is the presentation of staff costs. We strongly recommend breaking these down into four distinct categories: security, consultancy, operational, non-operational, and pensions. The current aggregated approach masks important trends and makes it impossible to benchmark effectively against comparable airports. This is particularly important given that staff costs represent one of the largest components of HAL's cost base.

ii. Other operating costs: The treatment of other operating costs is especially problematic. This category comprises nearly a quarter of total operating expenditure, yet it lacks any meaningful subdivision. This opacity is particularly concerning for services where there are single suppliers such as the NATS control tower contract. Without greater granularity, it is not possible to assess whether HAL is securing value for money in these single supplier arrangements.

iii. General expenses: The current 'General expenses' category requires substantial refinement. We need clear differentiation between costs that are largely outside management control and those that are discretionary. This distinction is crucial for understanding HAL's cost efficiency and assessing management performance. We recommend that the CAA requires HAL to provide a detailed breakdown of this category with clear justification for classification decisions.

iv. Areas of significant cost growth: The BP guidance should specifically require enhanced disclosure for any cost categories where HAL is proposing substantial increases. This additional scrutiny is essential for understanding the drivers of cost growth and ensuring that any increases are properly justified.

6.24. As an indicative list, we provide the following key cost categories which we would need the BP to set out:

People Costs	**Strategy Driven Costs**
• Terminal and Control Post Security – Headcount; Costs and opportunities with Next Generation Security • Consultancy costs	• IT • People requiring assistance (excl PRM – covered under ORCs)
Other Operating Costs	**Other**
• Control Tower / Airfield Management • Facilities Management (Terminals and Buildings) e.g. Cleaning • Maintenance e.g .Baggage	• Business Rates • Pension • Leadership & Logistics

Commercial revenues

6.25. In relation to commercial revenues, the treatment of property revenues requires further granularity. We recommend that property-related revenues are broken down by specific development projects. This granularity would enable proper assessment of investment returns, identify asset where performance is suboptimal and adopt appropriate remediation – see paragraphs 6.41-6.44. The current framework provides neither airlines nor the CAA with sufficient visibility to evaluate whether historical capital investments are delivering their projected returns. We also note our comments in paragraph 6.29 (6) below on the various commercial costs the BP should be setting out.

Capex

6.26. In relation to capex, we have the following concerns:

- The guidance does not require sufficient detail from HAL to allow CAA's independent advisors to effectively scrutinise the capex plan. We note that in both the iH7 and H7 reviews, the CAA's advisors commented on the lack of detail within HAL's proposals.

"However the [RBP] update and associated documents did not provide the sufficient level of detail for a meaningful review to be conducted. We are confident that additional information regarding the H7 Capital Programme exists, for example on the basis of other evidence provided to CPB, and that

further evidence and justification could have been provided to support HAL's RBP Update."[6] [Arcadis]

"As we have not had sight of the projects currently included within the capex estimates, it is not possible for us to assess the suitability of the portfolio or the appropriateness of cost estimates…. In particular, we believe there needs to be more scrutiny of the appropriateness of the overall capex envelope to ensure that it is set with reference not only to deliverability and affordability, but also with reference to the specific projects within the envelope."[7] [CEPA]

- The capital portfolio in H8 will be a combination of:

  - post-G3 H7 roll-over projects;
  - projects initiated in H7 as part of the H7 programmes, but still being scoped and developed;
  - and finally new initiatives for H8.

  These 3 groups will need to be prioritised against each other to form the H8 portfolio.

  It is essential that full information is provided by Heathrow for this process to be effective. This will require an updating and re-baselining of all existing H7 programmes, such that the pre-G3 projects and tranches can be assessed against new H8 scope initiatives, in terms of cost, outcomes, timescales and benefits.

- The expectation should be that any proposed capital expenditure is fully justified in terms of the potential options, expected outcomes, timescales and benefits that it will deliver against the proposed strategic objective. This should equally cover the impact on the consumer of not doing something, such that a full prioritisation and impact assessment can be carried out.

- The BP should be presented in a way that allows the CAA to understand and benchmark key cost drivers. This could be done by project type, noting variabilities, but also assessing the underlying cost drivers that make up the cost plan. This enable an understanding of: risk, programme costs, Leadership and Logistics and key components within the overall cost plans. This should consider and build on the current work being undertaken by G&T as part of the "H7 Independent Review to Process".

- The guidance does not propose how HAL justify its 'Leadership and Logistics' assumption, which is an area that has attracted little scrutiny from the CAA over successive price controls. The CAA should ensure that users receive sufficient

[6] Arcadis (2021) CAP2266B: HAL RBP Update: Capex plan Review. https://www.caa.co.uk/our-work/publications/documents/content/cap2266b/

[7] CEPA (2019) CAP1769A: CEPA review of Heathrow Airport Limited's (HAL's) initial business plan submission for the Heathrow interim H7 price control (iH7). https://www.caa.co.uk/our-work/publications/documents/content/cap1769a/

information to scrutinise the efficiency of HAL's Leadership and Logistics costs, the direct activity driving those costs within the capital plan, and examine that such costs appropriately reflect costs that ought to be capitalised (rather than treated as opex).

- We would also strongly recommend the CAA considers and builds upon, where necessary, the findings of the H7 Independent Review on Processes and Standards to identify any required changes in the governance or incentive approach.

Other Regulated Charges

6.27. In relation to Other Regulated Charges (ORCs), we urge 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[8]. Indeed, the CAA found in H7 that there would be significant advantages in distinguishing between airlines and non-airlines in determining ORCs and that there has been "no convincing evidence" that HAL is not capable of establishing charging arrangements consistent with the principles of transparency, cost pass through and user pays.[9]

g. Cost benchmarking & bottom-up approach

6.28. We welcome the CAA's intention to undertake more rigorous benchmarking of HAL's BP and would like to propose several specific areas where additional data requirements would enable more meaningful analysis and scrutiny.

6.29. The most critical area requiring enhanced benchmarking is operating expenditure, where we recommend a rigorous bottom-up approach focusing on key operational areas and areas where HAL has proposed or experienced large step-increases in costs. Broadening the evidence base to include bottom-up approaches is in line with the CAA's lessons learned findings in CAP3000.

1) Passenger Security: This requires particular attention given both its significant cost impact and the potential efficiencies that could be realised. We recommend detailed benchmarking of staff productivity metrics, processing rates, equipment costs and utilisation, training and recruitment costs, and management overhead ratios.

2) Security Control Posts: These costs should be analysed separately from passenger security given their distinct operational characteristics, different volume drivers and the fact that these are outsourced to an external supplier. This separation would enable more accurate benchmarking against comparable facilities at other airports and identify specific efficiency opportunities.

3) Facilities Management: A comprehensive breakdown of facilities management costs would enable comparison with both other airports and commercial property

[8] Paragraph 2.80 of the consultation.
[9] See CAP2524C, points 8.18-8.19.

operations, particularly focusing on maintenance costs per square meter, utilities efficiency, cleaning costs, and building management systems efficiency.

4) Staff costs: This should focus on comparative data on base wages by role, pension provisions, staff benefits, recruitment and training costs, and management salary benchmarks.

5) Key External Contracts: These include facilities management and maintenance. Special attention should be paid to contracts where limited competition exists, such as the control tower contract. We recommend requiring detailed cost breakdowns, service level specifications, historical cost trends, comparative data from other major airports, and evidence of market testing where possible.

6) For commercial revenues, we propose a targeted approach focusing on the following areas: retail revenue per passenger, property yields, car parking revenue per passenger, advertising revenue and performance metrics for specific revenue streams.

6.30. Where significant deviations exist from historical performance, HAL should be required to provide further supporting evidence, and the CAA should undertake greater scrutiny of HAL's proposals. We remain concerned with HAL using commercial sensitivity as a barrier to providing the CAA with necessary benchmarking data.

h. Other comments on cost guidance

6.31. We are concerned that there is an absence of any mention of ongoing efficiency improvements in the cost guidance, and multiple references to real price effects. The cost guidance, as currently drafted, builds in an expectation of cost increases whereas we expect there to be many opportunities to drive opex efficiency. HAL should be required to make an explicit assumption of ongoing efficiency, both for opex and commercial revenues. The CAA should also seek independent advice on an appropriate assumption of ongoing efficiency for both building blocks.

6.32. We also disagree strongly with the guidance on how the opex and commercial revenue forecasts should integrate with the capex building block. A significant oversight in the current guidance is its narrow focus on *planned* capital investment without adequately addressing investments made during H7 that will only begin generating returns or productivity improvements in H8. The H7 BP included £500m worth of capital investment that was intended to generate returns over a 10–15-year period, yet there is no current requirement in the draft method statement for HAL to demonstrate how the returns on these investments are captured in the H8 plan. Similarly, the airline community accepted the inclusion of the costs associated with resetting the organisation following Covid-19 ("Cost of Change") into the RAB, on the basis that this would deliver permanent efficiency savings. Despite this, there is no requirement for HAL to demonstrate that its BP includes these savings. This temporal disconnect needs to be addressed to ensure passengers are not paying twice for the same performance improvements.

i. RAB inflation indexation

6.33. One of the drivers of HAL's profitability over the past decade has been through indexation of the RAB to outturn RPI inflation. RPI was removed as an Official National Statistic in March 2013, due to not meeting international standards of representative inflation series. This is prior to the Q6 and H7 price controls. Other regulators have moved to CPI or CPIH linked controls, with Ofwat discussing the change from RPI in 2015.[10]

6.34. The CAA's proposed switch from indexing the RAB to CPI or CPIH instead of RPI is a positive development for customers and one that arguably ought to have been implemented as part of H7. We estimate that the size of HAL's RAB was about 6% larger in 2023 than it would have been if CAA switched to CPI indexation as part of H7. We have previously raised those issues in our response to the CAA's H7 lessons learned exercise.

6.35. While some of the impact of using RPI indexation will have been offset by using forecasts of RPI to deflate the nominal cost of debt, such forecasts have often underestimated outturn inflation. This has provided HAL with a windfall gain given the inconsistency between using inflation *expectations* for estimating the cost of debt and indexing the RAB to *outturn* inflation. For the Q6 price control, the CAA's decision assumed RPI inflation of 2.8% per annum.[11] This had underestimated outturn RPI inflation by 150bps over the past decade, equal to £2.2 billion in total, or £3.50 per passenger. Using CPI inflation would have still resulted in a windfall gain for HAL, but at around half the level. This effect has also been recognised by Ofwat, which demonstrated that differences between forecast and outturn inflation since 1997 has generally resulted in a net gain to companies.[12]

6.36. We propose different options for dealing with this inconsistency:

- Using a nominal cost of debt and not indexing the proportion of the RAB that is financed by debt, as being proposed by Ofgem and as being considered by CAA in its draft method statement

- A cap and collar mechanism could address the scope of inflation-driven returns, particularly in relation to the inflation indexation elements of the RAB.

- Introducing a risk-sharing mechanism that would allow customers to benefit from gains related to outturn inflation being higher than forecast.

j. Depreciation

6.37. The CAA is also considering the role of accelerated depreciation to reduce the size of the RAB in anticipation of future capital expenditure. This would increase charges

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[10] We note that Ofgem signalled their intention to change to a CPIH-linked control in December 2018 and the NI Utility Regulator has moved to a CPIH linked regime from GD23.
[11] Paragraph 6.60. https://www.caa.co.uk/publication/download/14642
[12] Page 18. https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Aligning-Risk-and-Return-Appendix-1.pdf

in the shorter-term by frontloading the recovery of the RAB, and in principle, make charges more affordable in the longer term.

6.38. However, there are key reasons why this is unlikely to be in the consumer interest. Firstly, the rate of depreciation ought to be aligned with the use of the assets that are in the RAB. For instance, the cost of an asset with a life of 20 years ought to be recovered over 20 years. This is to maintain intergenerational fairness and avoid current passengers paying for the services enjoyed by future customers or vice versa. Accelerating depreciation would imply that assets in the RAB have a shorter asset life than previously assumed. There is no clear engineering reason why this would be the case. It is not apparent that the asset lives of HAL's recent investments are materially shorter than historic investments. And if assets are underperforming such that they are being 'written-off' or impaired prematurely, it is not clear why passengers should bear this risk through accelerated depreciation.

6.39. Secondly, where depreciation is being accelerated to support HAL's financeability, such a change does not automatically improve HAL's financial resilience unless the funding is used to de-gear HAL. There is a material risk that accelerated depreciation simply delays the resolution of more difficult questions around HAL's financeability, and risks making HAL less financially resilient over time.

6.40. We will be providing further comments on depreciation in our subsequent response by 15 January 2025.

k. Size of RAB – potential underperforming assets

6.41. We welcome the CAA's focus on initiatives that may reasonably reduce the size of the RAB. The CAA notes the example of taking into account of the proceeds of sale of non-core assets within the price control review. We have previously highlighted to the CAA that we estimate HAL to have underperformed with investments worth up to £2.5 billion classified as "investment property" in the regulatory accounts[13]. During H7 we sought to understand the extent to which there were low yielding, relatively liquid assets that provided minimal benefit; our assessment in 2021 suggested that there could be as much as £100m+ per annum being subsidised by the consumer.

6.42. Airlines need to fully understand the extent to which 'revenue generating' assets drive value for the consumer, for instance the level of return being generated by those assets relative to HAL's WACC. The BP ought to allow this assessment to take place and propose solutions where inefficiencies are identified through an investment generating poorer returns (such as via relatively low non-aeronautical revenues) compared to passengers paying an overall cost of capital.

6.43. Currently, there is no follow up on whether those investments are delivering for the consumer, be it within the same or subsequent price controls, or whether they come at an excessive cost by failing to deliver expected returns. This differs materially from the energy and water regulatory regimes where the commitments related to

[13] Based on HAL's 2023 Regulatory Accounts.

capital projects are reflected in the setting of outcomes in subsequent price controls. For example, in the PR24 price control, Ofwat's setting of the performance commitment targets retained "memory" in relation to previously funded investments.[14]

> *"We also need to ensure that customers are not paying twice for performance improvements. For example, we need to avoid providing allowances now for improvements funded in the past or allowing companies to receive outperformance payments in the 2025-30 period for improvements funded in our efficient PR24 expenditure allowances. This is why our starting assumption is that companies will meet their PR19 PCLs, which we will only move away from if there is compelling evidence to support a different approach."*

6.44. With regards to potential solutions that could be examined, we note there are different approaches but draw the CAA's attention to the fact that these need to guarantee single till regulation which delivers in the interest of the consumer:

1) Make HAL bearing 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. HAL's regulatory accounts may have to separately track revenues associated with those investments.

2) Reflect the limited risk exposure from those assets in the setting of the WACC by making an explicit adjustment.

3) Divestment of the asset in question. However, we note that questions with regards to the valuation, the approach to removal (e.g. impairment), auditing the assets in question as well as cost and asset allocation will have to be addressed to avoid compromising single till regulation and protect against the risk of excessive charges, excess profits and perverse incentives. This will have to be the exception rather than the rule given the existence of more proportionate solutions as above.

6.45. […]

I. Cost incentives

6.46. We continue to support the continuation and tighter implementation of the CAA's ex ante capex efficiency incentives, which are critical in promoting efficiency in capital spending and delivering projects with firm and measurable objectives, as well as positive outputs for users and consumers.

6.47. We broadly welcome the CAA's guidance on capex efficiency incentives, though the CAA may need to collect additional information to enable a thorough assessment of the H7 framework's effectiveness.

6.48. The guidance provides a useful starting point in requiring HAL to report on projects that have gone through G3, their approved baseline spending, and subsequent

[14] https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Delivering-outcomes-for-customers-and-the-environment.pdf

performance against Delivery Obligations (DOs). However, this represents only the successful outcomes of the process. To properly evaluate the effectiveness of the framework, the CAA needs visibility of its operation throughout the project lifecycle.

6.49. Cost incentives information and data provided by Heathrow need to include the original baseline at G3 and then final baseline including any approved change control, before assessing the delivery of the DOs and any adjustments. This will highlight the scale and volume of change requests that have been approved. Similarly, visibility of risk estimation at G3 versus actual risk realised should be included to assess performance.

6.50. A critical gap in the current guidance is the lack of requirement for HAL to report on DOs that were considered but ultimately rejected. Understanding why certain DOs were deemed unsuitable or impractical would provide valuable insights into whether the current framework is working as intended. In particular, it would be useful for HAL to summarise the discussions it has had with airlines in the process of setting and agreeing the DOs, including elements rejected by Heathrow and also those that were rejected by the airline community. This information would help identify potential improvements for H8, particularly in terms of DO design and implementation.

m. General commentary on balance of risk and reward

6.51. More broadly, we have significant concerns about the overall balance of risk and reward in the regulatory framework, particularly regarding volume risk. The H7 settlement introduced multiple overlapping mechanisms that have created an asymmetric risk profile favouring HAL, which needs to be addressed for H8.

6.52. The current framework includes several layers of protection for HAL against volume risk:

- The traffic risk sharing (TRS) mechanism, while appearing balanced on paper, effectively provides HAL with disproportionate protection. The mechanism's banding structure, combined with the typical pattern of traffic shocks (sharp, short-term downside events versus gradual upside growth), means HAL receives greater downside protection in aggregate.

- The traffic shock adjustment in the passenger forecast represents an additional layer of protection that appears to duplicate protection provided elsewhere in the framework.

- The asymmetric risk revenue allowance is particularly problematic. Its calculation relies heavily on speculative CAA assumptions about the frequency and magnitude of future pandemic-level events. A more robust approach would be to rely on market estimates of this risk, given that pandemic risk affects all airports and should therefore be reflected in airport betas. The current approach creates an unnecessary duplication with what should already be captured in the asset beta.

- The asset beta itself includes compensation for volume risk, in excess of the actual risk faced by HAL given the protections introduced by the CAA.

6.53. The cumulative effect of these mechanisms has been to create greater upside potential than downside risk for HAL. This imbalance is neither justified by market conditions nor in passengers' interests. Our analysis suggests that HAL effectively receives multiple layers of compensation for the same risks, leading to overcompensation at consumers' expense.

6.54. For H8, we expect the CAA to undertake a fundamental recalibration of these risk-sharing mechanisms. However, we are concerned about the current process where HAL is expected to make initial proposals through its BP, with airlines and the CAA merely responding to HAL's position. This approach inherently disadvantages other stakeholders and risks embedding HAL's perspective as the starting point for discussions.

6.55. We will be providing further comments in our subsequent response by 15 January 2025.