

Draft H8 method statement and business planning guidance

CAP 3044

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Chapter 1

Introduction and summary

Introduction

- 1.1 In August 2024, we published the lessons learnt from the review of the approach to setting price controls for Heathrow Airport Limited (“HAL”) and NATS (En Route) plc (“NERL”) (the “2024 Review”).¹ In this, we said that we would publish a draft method statement for H8 that would provide guidance for business planning. We also said that we would consult for four weeks and any detailed guidance and templates may need to be developed separately.
- 1.2 In this document, we set out for consultation:
- the draft method statement, which sets out our proposed approach to setting price controls for H8, taking account of the lessons learnt from the 2024 Review;
 - the outline of a potential new incentive on HAL to provide high-quality business plan information, in response to issues identified from the 2024 Review; and
 - draft business planning guidance for HAL as it develops its H8 plan.
- 1.3 We summarise each of these sections below and then provide further detail on the consultation and next steps.

Method statement for H8

- 1.4 In the draft method statement, we summarise our overall objectives in setting the H8 price control and discuss our approach to the key issues. We intend to focus on incentivising HAL to act in a way consistent with furthering the interests of consumers, operating and developing the airport efficiently and meeting the needs of its airline customers. We recognise 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.
- 1.5 We are improving and developing the arrangements for constructive engagement (“CE”) between HAL and airlines, broadly along the lines we set out in our letter in September 2024, and provide some additional detail on what we

¹ CAA, Setting future price controls – lessons learnt from the review of approach, CAP 3000, August 2024

expect from each round of stakeholder engagement and the role of the CAA, in response to the views from stakeholders.

- 1.6 Where it is reasonable and appropriate to do so, we will build on the approach established in the H7 price control. Many of the new mechanisms introduced for the H7 price control, such as capex incentives and traffic risk-sharing, have only been in place for a short time. Nevertheless, we have identified areas where we consider that our approach can be improved and we will make changes where there is evidence of a better approach that can be reasonably introduced as part of this review.
- 1.7 We recognise the importance of understanding consumer priorities, which should inform both HAL's business plan and our approach to setting its price control. We expect HAL to carry out its own research and engagement with consumers, local community groups and other stakeholders. We expect HAL's business plan to provide a clear "line of sight" as to how consumer priorities have been taken into account in the development of that business plan. We are considering our own approach to research, which could supplement research and engagement conducted by HAL.
- 1.8 On traffic forecasts, we expect to commission an external independent forecast for H8. We also expect HAL and airlines to work together to try and reach a joint view on a reasonable range of forecasts. We introduced a traffic risk-sharing ("TRS") mechanism in H7 and we expect to retain a TRS for H8 given its beneficial impact on managing risk and reducing the cost of capital.
- 1.9 For service quality, we will consider whether outcomes should be updated and/or new measures should be introduced in response to consumer priorities and priority areas such as operational and asset resilience. We will consider the balance of incentives around these performance measures and targets, to support strong incentives on consumer priorities and maintaining resilience.
- 1.10 Environmental sustainability is a priority area for H8 and we will ensure the price control provides for efficient and necessary expenditure to reasonably support the transition to net zero. HAL should set out clearly its delivery plans to meet its environmental obligations and we will review the incentives on HAL to improve environmental performance during the H8 period.
- 1.11 To support the identification of efficient levels of operating expenditure ("opex") and commercial revenue ("comrev"), we will work with consultants to develop an independent assessment, as well as to assess the information provided by HAL in its business plan, including where practicable the use of benchmarking and targeted bottom-up analysis. For capital expenditure ("capex"), our initial focus will be to understand the likely size of the efficient capex envelope and the key uncertainties given we understand that HAL is planning a programme of investment to increase capacity of the two-runway airport.

- 1.12 We are aiming to provide a balanced and flexible set of incentives so that HAL targets both an appropriate quality of service as well as an efficient level of costs for delivering that quality of service. For opex and comrev, we expect to retain the current broad approach to incentives, though we will consider alternative mechanisms and risk-sharing arrangements for specific costs and revenues where this furthers the interests of consumers. Capex incentives are vital to ensuring that stakeholders can have confidence that investment has been efficiently incurred and that the path of HAL's airport charges in the longer term is reasonable. We intend to build on the approach to capex incentives introduced in H7 and consider evolutionary improvements to these incentive arrangements.
- 1.13 Given the relatively large size of HAL's capex programme it will be vital that we retain an approach that allows for and promotes the efficient financing by HAL of these expenditures. Otherwise, airport charges would be higher than is necessary or appropriate. Bearing this in mind we will retain the regulatory asset base ("RAB") and the "building blocks" approach to set the H8 price control for HAL, as well as retaining a broadly similar approach to the assessment of HAL's financeability. This provides regulatory consistency and reasonable stability for investors (which in turn will avoid any unnecessary increases in the costs of financing investment), as well as smoothing the recovery of the costs of investment over time.
- 1.14 Our approach to indexing HAL's RAB will be adapted to reflect changes to national statistics, with the calculation of RPI being expected to change so it is calculated on the same basis as CPIH. We will consider whether HAL's RAB should be indexed on the basis of CPI or CPIH. Further, we will consider whether wider changes to the indexation of HAL's RAB may be appropriate to support HAL's financeability and airline concerns about the size of HAL's RAB. In considering these matters we will take account of the impact on airport charges in the shorter and longer term.
- 1.15 On cost of capital, we have commissioned FTI Consulting to provide an initial updated estimate of the weighted average cost of capital ("WACC") based on recent market information and to propose potential refinements to the method we used at H7. FTI found that the update for recent market data suggested a potential increase in the real WACC, mainly due to the lower expected inflation and change in approach to indexation (which led to higher real costs of embedded debt and market returns than during H7). FTI has also identified further possible changes to our calculation of the main WACC parameters, which we will consider further for H8. FTI's report has been published alongside this consultation document and we also welcome stakeholder comments on this report and the updated estimates of HAL's cost of capital.

- 1.16 We will continue to keep the H8 timetable under review in light of the progress we make over the remainder of this year and anticipate providing a further timetable update in early 2025 when we finalise the H8 method statement.

Business Plan Incentive

- 1.17 In our 2024 Review we said that we would consider whether it is appropriate to strengthen the incentives on licensees to provide timely and high-quality business plan information, to further the interest of consumers.
- 1.18 We are considering the introduction of a new business plan incentive (“BPI”) mechanism for H8. The incentive aims to encourage HAL to submit a complete, high-quality business plan, supported by appropriate evidence and by third-party assurance.
- 1.19 To support our work on these matters, we have reviewed experience of similar incentives applied in other sectors and considered options for financial and non-financial incentives. The option we prefer as being the most likely to be effective is to introduce a symmetrical financial incentive, on HAL. Recognising that this is new, we are proposing a relatively small and simple incentive based on our overall assessment of the quality of HAL’s business plan.
- 1.20 HAL would earn a small reward if it provides a high-quality business plan. If HAL’s business plan is not assessed to be high quality, then there would be no reward and/or a potential penalty. We invite stakeholders’ comments on the approach and calibration of the incentive.

Business Plan Guidance

- 1.21 We provide draft business plan guidance to assist HAL in producing an H8 business plan that appropriately supports the H8 price setting process.
- 1.22 The focus of the guidance is the overall scope of the business plan, the approach HAL should adopt to consumer engagement and the key building blocks associated with the price control. Chapter 4 provides an overview of each of the areas covered by the guidance with detailed questions for consultation and the more detailed business plan guidance is provided in Appendices A to G.
- 1.23 The guidance is designed to specify a base level of information that HAL should provide as part of the H8 process. Nonetheless, HAL should provide further information to the extent that it considers that this would reasonably further the interests of consumers or that such information is reasonably required to fully understand its plans for H8 and beyond.

Next steps

- 1.24 We are consulting and seeking views on all parts of this document, including the draft method statement, business plan incentive, business plan guidance and FTI report on cost of capital.
- 1.25 Responses to this consultation on the draft method statement, business plan incentive and business plan guidance should be clearly labelled as to which area they are responding to and sent to economicregulation@caa.co.uk by 17:00 on 6 December 2024. Responses in relation to the cost of capital, the FTI report and the specific questions identified in chapter 2 on the cost of capital should be sent to economicregulation@caa.co.uk by 17:00 on 3 January 2025.
- 1.26 We expect to publish the submissions we receive on our website as soon as practicable after the consultation period ends. Any material that is regarded as confidential should be clearly marked as such, with an explanation of why the information is confidential, and included in a separate annex. We have powers and duties with respect to the disclosure of information under Schedule 9 of the TA00, Section 59 of CAA12 and the Freedom of Information Act 2000 and it may be necessary to disclose information consistent with these requirements.
- 1.27 We will review responses to our consultation and publish our final method statement and business plan guidance in February 2025. We will also take account of the findings from round 1 of Constructive Engagement, which started in October 2024.
- 1.28 We will provide separate guidance on data templates and any other areas identified following stakeholder responses where further guidance is needed.
- 1.29 Any questions related to this decision document should be sent to Stewart Carter at stewart.carter@caa.co.uk.

Chapter 2

Method statement

Introduction

- 2.1 This draft method statement sets out our views on the broad approach to the next price review for Heathrow airport. To further the interests of consumers, the price control sets a cap on the allowed level of price cap revenue per passenger that HAL can collect from airport charges, as well as creating incentives on HAL to invest efficiently and provide a good level of service quality.
- 2.2 Our approach has been informed by:
- regulatory precedent from the recent CAA price control for HAL (“H7”) and the CMA’s determination on H7 appeals;
 - the findings from the review of our approach to setting the H7 and NR23 price controls (the “2024 Review”); and
 - the views of stakeholders expressed in response to the 2024 Review.
- 2.3 For many parts of the regulatory framework, we consider that it will be appropriate to retain a similar approach between H7 and H8. The delays and challenges associated with the H7 review means that new mechanisms introduced for the H7 price control, such as capex incentives and traffic risk-sharing, have only been in place for a short time. Nevertheless, we have identified areas where we consider that our approach can be improved, and we will make changes where there is evidence of a better approach that can be reasonably introduced as part of this review.
- 2.4 In this chapter, we first set out our views on the overall context and priorities for the H8 review, then update on our approach to the Constructive Engagement process between HAL and airlines. We then set out our proposed approach to each of the following key aspects of the price control review:
- a) scope of the price control and overall approach;
 - b) consumer engagement;
 - c) traffic forecasts and incentives;
 - d) service quality and resilience;
 - e) environmental sustainability;
 - f) cost and commercial revenue assessment;

- g) cost incentives;
- h) financial issues and HAL's RAB; and
- i) cost of capital.

2.5 Finally, we provide an update on the development of a more detailed timetable for the H8 review.

2.6 We welcome stakeholder views on any of the matters raised in this chapter and set out specific questions in relation to our initial work on the priorities for the price control and cost of capital towards the end of this chapter.

Overall context and priorities

2.7 In the 2024 Review, we noted the unusual circumstances of the H7 review, which we would not expect to be repeated this time. For H8, we are developing an approach consistent with Heathrow being a two-runway airport with a relatively stable outlook for traffic forecasts. We anticipate that this will likely be the case as we have seen traffic at Heathrow airport rebound to levels at or above those seen prior to the covid-19 pandemic and the airport's scope to serve more passengers is limited by the cap on the number of flights that may use the airport in any year.

2.8 Nonetheless, we understand that HAL is developing plans to expand capacity within a two-runway airport. HAL's business plan and, so, our approach to setting the price control, will need to take account of the timing of any future planning application process and longer-term capital investment to provide this expanded capacity.

2.9 If HAL were to bring forward plans for a third runway we will consider these separately from the H8 review. Our experience of HAL's proposals to develop a third runway and the associated infrastructure prior to the covid-19 pandemic was that any such plans take a significant time to develop and there are significant uncertainties associated with the planning process. In these circumstances there are advantages for consumers in focusing the H8 review on a two-runway airport, with the option of developing supplementary arrangements to deal with a proposed third runway if this were to become appropriate in the future.

2.10 In addition to dealing appropriately with plans for new capacity and investment, we will want to develop arrangements to ensure high-quality services, financial and operational resilience, and support the transition to net zero. All these

matters are consistent with our primary statutory duty to further the interests of consumers and our secondary duties.²

- 2.11 It appears likely that the need to finance new investment, increases in the real costs of financing and potential increases in certain operational costs will put upward pressure on airport charges, especially in the short term. We will need to carefully consider the incentives and arrangements we put in place to manage these cost pressures and how we determine what would be a reasonable level of charges that would encourage investment, while constraining HAL's substantial market power.
- 2.12 Bearing all of the above in mind, we have identified the following priorities that will help us to meet our overall objective of furthering the interests of consumers:
- a) incentivising HAL to deliver a high standard of service quality and environmental performance in a timely way, including ensuring that HAL reasonably supports the transition to net zero;
 - b) allowing for efficient investment and providing incentives to increase capacity, improve the operational and financial resilience of the airport, meet environmental targets, support technological change and further other objectives that are valued by consumers, now and for the longer-term; and
 - c) ensuring current and future consumers and airlines face airport charges that are no higher than necessary, including through incentivising cost efficiency and ensuring that any growth in HAL's RAB is sustainable.
- 2.13 We would welcome views on these three main priorities and whether it would be appropriate to prioritise between them during the H8 process, in order to further the interests of consumers and better support the carrying out of our statutory duties.
- 2.14 In addition to these main priorities, there will be other important areas, such as ensuring that the system of Other Regulated Charges works effectively and supports the interests of consumers.

Constructive Engagement

Introduction

- 2.15 Constructive Engagement ("CE") involves both high-level and more detailed discussions between HAL and its airline customers and has been a key part of H7 and preceding price control reviews. CE is intended to support HAL to develop its business plan and the CAA to set price controls. In particular, it can

² A summary of our duties in setting the H8 price control is set out at Appendix A.

help both HAL and the CAA take account of current and future customers' requirements and priorities in areas such as service quality, capacity, resilience and the allowances for efficient costs.

2.16 As set out in the 2024 Review, for H8 we consider that the process of CE should start earlier, and involve multiple rounds, to provide greater opportunities for:

- airlines and HAL to reach consensus on key aspects of the price control review;
- airlines to influence HAL's business plan; and
- airlines and HAL to discuss our Initial Proposals.

2.17 In September 2024, we published a letter setting out draft guidance on the CE process for H8 ("the September 2024 letter"), including our views on:

- the purpose, scope and timing of each round of CE;
- the governance arrangements and outputs; and
- the role of the CAA.

2.18 This letter consulted on the high-level CE timetable that we had set out in the 2024 Review, which included four rounds of engagement, with the first one starting in October 2024.

2.19 In this section we:

- summarise key points raised by stakeholders in response to the September 2024 letter. The responses are available on our website;
- set out our views on these key points raised by stakeholders; and
- set out targeted updates to our guidance on CE.

Responses to the September 2024 letter on Constructive Engagement

2.20 We invited views from stakeholders on the draft guidance, and to date we have received three responses, from HAL, AOC/LACC and A4A.

2.21 All stakeholders broadly supported the CE process set out in the 2024 Review and the September 2024 letter, including the proposals that the process starts earlier and takes place over multiple rounds.

2.22 HAL and airlines have been working together since the publication of the September 2024 letter to put these arrangements in place. At the time of publication the CAA has seen a draft of the CE protocol, co-chairs have been appointed for Round 1 (one each representing HAL and the airlines respectively), and an independent reporter has also been appointed.

Purpose, scope and timing of Constructive Engagement rounds

- 2.23 HAL said that the role of the early stages of CE should be to allow HAL and airlines to understand each other's respective priorities and explore key choices for the business plan. HAL also said that discussions in Round 1 should focus on the broad vision and ambitions for the future airport, and provide parties with a chance to share and feed in their understanding of consumer priorities for areas such as investment and service quality.
- 2.24 In their responses, HAL and AOC/LACC set out their respective views on what topics should be covered in Round 1 of CE, summarised below:
- HAL supported discussing consumer priorities in areas such as investment and service quality, HAL's views on 'key areas' of the business plan (capacity upgrades, decarbonisation, surface access and property) and airline views on key benefits that they expect the business plan should take into account;
 - AOC/LACC supported discussing issues that were left over from H7, operational resilience, high-level commercial revenue forecasts for H8, and airline and CAA views on H8 policy approaches. AOC/LACC said that the CAA should clarify its policy positions on key issues in advance of Round 1; and
 - both HAL and AOC/LACC supported discussion of H8 passenger forecasts, HAL's approach and the impact of the forecasts on the price control.
- 2.25 HAL noted that, given the planned focus of Round 2 on the cost building blocks, the engagement would be more effective if it took place after the CAA published its final method statement for H8, which we said in the 2024 Review would be published in February 2024.
- 2.26 AOC/LACC said that, in order to be effective, the CAA's final business planning guidance would need to be issued in advance of the start of Round 3 of CE.
- 2.27 For Round 4, AOC/LACC requested clarity on the approach to this round and any parallel engagement on the CAA's Initial Proposals document.

Governance, outputs and role of the CAA

- 2.28 One of the key areas of feedback to the September 2024 letter was around information sharing during CE, and minimum information requirements.
- 2.29 Airlines (AOC/LACC and A4A) said that the CAA should set out a process for information sharing during CE, as well as minimum requirements for information to be shared during each stage. AOC/LACC also said that the CAA should set out consequences to HAL of not complying with these processes.

- 2.30 For Round 2, AOC/LACC requested that the CAA issues information templates for HAL to fill in, in order to ensure minimum granularity of information provided for this round. AOC/LACC provided an example template alongside its consultation response.
- 2.31 HAL noted that given the earlier start of CE, in particular for Round 1, it expects its plans to be less mature than they were during CE in previous price controls, and that therefore the information requirements the CAA sets should reflect this.
- 2.32 AOC/LACC said that the CAA should define, for each stage of CE, “entry” and “exit” criteria, or outputs, which would act as gateways for proceeding to subsequent rounds.
- 2.33 All respondents generally supported the CAA’s proposals for the co-chairing of CE sessions, and the introduction of independent reporting.
- 2.34 HAL supported the CAA’s proposed role during CE being a more active one than in previous price controls, and specifically CAA attending all sessions during the CE process. Nonetheless, HAL also said that the CAA’s role should not be one of moderator or arbitrator between itself and airlines during the CE process.
- 2.35 A4A said that the CAA should assist the parties to CE in resolving their differences during the CE process, instead of waiting for the Initial and Final Proposals to resolve all differences between parties.

CAA views

Purpose, scope and timing of Constructive Engagement rounds

- 2.36 HAL and airlines have now set up CE sessions for Round 1 covering five key themes: strategy, capacity and traffic; consumer; operational performance; capital choices; and RAB. We consider these five main themes cover the scope set out in the September 2024 letter and HAL and airline responses.
- 2.37 Where HAL or airlines have more detailed issues that they consider should be covered during early rounds of CE, we encourage them to use Round 1 to jointly identify these issues and agree a plan for addressing those either during Round 1 or in later rounds.
- 2.38 In response to the point raised by AOC/LACC regarding the timing of the final business planning guidance, the method statement and business planning guidance we note that the current plan is to publish the final method statement part way through Round 2 of CE. HAL has suggested the final method statement is published in advance of Round 2, but this would mean delaying the start of round 2 of CE and potentially HAL’s business plan by one to two months, which would have adverse implications for the remainder of the price review timetable, so we do not propose to adopt this suggestion.

- 2.39 For Round 2, HAL and airlines should discuss ways to account for this timing, for example by scheduling a dedicated session to discuss any issues coming out of the CAA's final method statement towards the end of Round 2.
- 2.40 On the AOC/LACC request for clarity on Round 4 of CE and parallel engagement, we propose to:
- invite written responses to our Initial Proposals, by a specified deadline, which will be in addition to the CE discussions and Round 4 report;
 - be open to requests for bilateral engagement with stakeholders on parts of our Initial Proposals; and
 - consider the need for additional information on our approach as the price control review progresses.

Governance and outputs

- 2.41 In the September 2024 letter we set out, at a high level, the information and views we expected to be provided during each stage of CE by HAL and airlines. We have considered responses and provide additional guidance on this in the next section, including the use of templates for Round 2 of CE.
- 2.42 Our guidance and the CE protocol developed by HAL and airlines support the process for effective information sharing during CE. We would note that it is in HAL's interest to provide sufficient information during CE with the aim of reaching a consensus with airlines on as many elements of the business plan as possible. We will take this into account in our assessment of the business plan. We also consider information provision, more broadly, in the proposed business plan incentive discussed in chapter 3.
- 2.43 We will attend CE sessions and monitor the quality and timeliness of information provided. Should HAL or airlines³ not be meeting the requirements set out in the CAA's guidance, CE protocol or final business planning guidance, we reserve the right to issue further guidance and will take this into account in our assessment of HAL's business plan and development of our Initial Proposals.

Role of the CAA

- 2.44 The CE process is for HAL and airlines to identify areas where consensus can be reached and areas where the parties have different views, in order to inform our Initial and Final Proposals. We do not propose to take an active role in resolving disputes during CE, and any remaining areas of disagreement will be dealt with as part of our Initial and Final proposals.

³ In relation specifically to submitting views or questions in a timely manner.

- 2.45 For areas where airlines raise concerns around provision of information, we would expect airlines to discuss these issues with HAL to seek resolution. We expect HAL to try and respond constructively to airline requests and all parties to take pragmatic and reasonable steps to resolve differences.

Constructive Engagement guidance

Introduction

- 2.46 We consider that the draft guidance we previously issued remains appropriate, and the responses we received to the September 2024 letter did not raise any fundamental issues that have led us to change this draft high-level guidance.
- 2.47 We have explained our views on key issues raised by stakeholders in the previous section. In this section, we provide additional guidance, which should be read alongside the draft guidance included in the September 2024 letter.
- 2.48 We are also committed to monitoring the progress of CE and issuing further guidance as needed.

Purpose, scope and timing of Constructive Engagement rounds

- 2.49 The objective of Round 1 of CE 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. We consider the current themes proposed by HAL and airlines for Round 1 CE sessions address this overall objective. To provide clarity for stakeholders, we note that:
- we will be setting out our policy positions for H8 in our Initial Proposals and not as part of CE. HAL and airlines can draw on our views on key issues in the draft method statement in this document and the 2024 Review as part of CE; and
 - the CAA's proposal to develop an independent traffic forecast is not in scope for Round 1 of CE. The discussions between HAL and airlines during Round 1 regarding HAL's current traffic forecast and key choices around capacity should form an input to the independent traffic forecast that will be developed by the CAA.
- 2.50 On the topics to be covered during each Round of CE, we provide the following additional guidance:
- Round 1 – given the earlier start of CE, we understand that information available from HAL is likely to be less detailed at this stage. Therefore, it is appropriate that discussions are more focused on strategic choices rather than the detail of individual building blocks.

- Round 2 – we support the use of templates for Round 2 and encourage HAL and airlines to work together to agree these. AOC/LACC provided an example template alongside their response to the September 2024 letter, and we consider this could be a good starting point for discussion. We are also planning to develop templates for the business plan submission, and will make drafts of these available to HAL and airlines (when they are sufficiently developed) to inform the Round 2 discussions.
- Round 3 – as set out in the September 2024 letter, the final business planning guidance will constitute the information requirements for this round.
- Round 4 – as set out in the September 2024 letter, we will issue an Initial Proposals document with relevant supporting documents which will facilitate discussions during this round.

Governance and outputs

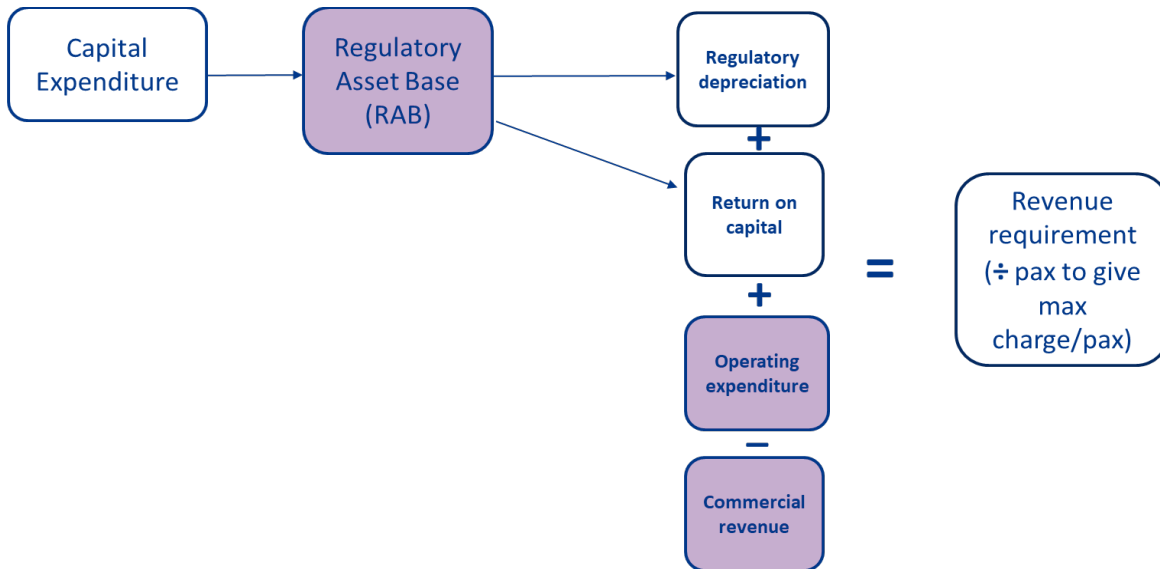
2.51 The outputs of each round of CE will be the reports produced by the independent reporter, as well as the notes of each session. These should be made available to the CAA and relevant stakeholders in a timely manner (no later than two weeks after the conclusion of the relevant round of CE, or within a timeframe to be agreed with the CAA).

Proposed approach to setting price controls

Scope of the price control and overall approach

2.52 As we explained in the 2024 Review, we are not planning to carry out a market power determination as part of the price review. Nonetheless, we will consider proposals for focused changes that allow for a greater role for competitive forces, for instance in relation to the boundary of the single-till and airport charges, where there is a strong case that this is in the interests of consumers.

2.53 Consistent with established regulatory and CMA precedent, we propose to use regulatory building blocks to determine an appropriate revenue requirement for HAL that enables us to set a five-year price control. This is summarised in Figure 2.1 below. This approach is well understood by investors and supports HAL's access to efficient financing, which is ultimately in the interests of consumers. Alongside this approach, we will develop and improve the incentives for cost efficiency, quality of service, resilience, the delivery of environmental objectives and risk sharing to ensure that we further the interests of consumers and deliver our other statutory duties. The price control, together with details on incentives (such as service quality, cost efficiency and risk sharing), will be reflected in modifications to HAL's economic licence.

Figure 2.1: Regulatory building blocks

Source: CAA

2.54 We aim to be proportionate and transparent in our approach. To do so, we will prioritise our work on areas that have the biggest positive impact for consumers.

Consumer engagement

2.55 An in depth understanding of consumers' views through research and engagement will be an important part of making sure that the price controls further the interests of consumers.

2.56 As set out in the 2024 Review, we expect HAL to carry out its own research and engagement with consumers, local community groups and other stakeholders. The consumer research should be designed to provide clear and reliable results, including using samples across different consumer types and including appropriate information and context to help participants make informed responses.

2.57 We expect to see a clear "line of sight" as to how HAL has taken consumer priorities into account in the development of its business plan. Airlines and other stakeholders may also have important insights into consumer priorities and we will consider any wider information that we receive on these matters as part of the price review process. It will also be important for HAL and airlines to give full weight to consumer priorities during the CE process discussed above.

2.58 We are considering how we can ensure that the research conducted fulfils our need to have a full understanding of consumer priorities and therefore we expect HAL to consult with us and stakeholders on its plans for new consumer research and engagement, to allow for appropriate input.

- 2.59 We will show how we have reflected consumer priorities in our proposals and decisions.

Traffic forecasts and incentives

- 2.60 Passenger number forecasts are a key building block for the price control as they are an input to the forecasts for operating costs, inform the relative benefits and costs from investment in expanding capacity, and determine the allowed revenue per passenger.
- 2.61 In the 2024 Review, we said that we expected there to be advantages in commissioning an external independent traffic forecast for H8. We also said that HAL and the airlines could work together during CE to reach a joint view on a reasonable range of forecasts.
- 2.62 We understand that HAL and airlines will discuss traffic forecasts as part of Round 1 of CE starting in October 2024. We plan to commission work on external traffic forecasts by early 2025, in time to inform our Initial Proposals.
- 2.63 In H7 we introduced a traffic risk-sharing (“TRS”) mechanism. We expect to retain a TRS for H8 given its beneficial impact on managing risk and reducing the cost of capital. However, we will review the design and calibration of the mechanism to make sure HAL has appropriate incentives to meet the needs of new and existing passengers, while continuing to provide benefits to consumers through lower financial risks and a lower cost of capital.

Service quality and resilience

- 2.64 As set out in the priorities above, we want to incentivise HAL to deliver a high standard of service quality and resilience. On operational resilience, HAL faces incentives on its performance on security queues, availability of stands and other assets, baggage services and airfield operations. We also expect HAL to be financially resilient and set out our views on this below in the section on financial issues.
- 2.65 In H7, we introduced Outcome Based Regulation (“OBR”), which included outcomes, measures, targets and incentives. We are looking to take a similar approach for H8 and expect the focus to be on making sure the right measures, targets and incentives are in place to support the main priorities for the price review discussed above. We want to retain the approach of specifying broad outcomes as a way of making more transparent the link between consumer priorities and the detail of the service quality measures and targets. Given the broad nature of the outcomes established in H7, we would not necessarily expect changes in these for the H8 review, but have an open mind if there is persuasive evidence that these can be improved.

- 2.66 We will consider whether outcomes should be updated or new measures should be introduced in response to consumer priorities and priority areas such as operational and asset resilience. This will take account of findings from the OBR Mid-Term Review, as well as proposals from HAL and airline stakeholders which should be informed by relevant consumer research insights where relevant.
- 2.67 We will consider the balance of incentives around these performance measures and targets, to support strong incentives on key consumer priorities. It will also be important to provide strong incentives on HAL to maintain resilience during the H8 period. This may require new or increased financial incentives for some existing and/or new measures.
- 2.68 In discussions during the 2024 Review, HAL and airlines raised points on the areas where they would expect greater focus for the service quality incentives. In the first instance, we expect these matters to be discussed as part of the CE process and we will then consider as appropriate in the price control review process.
- 2.69 We will also consider whether there are other improvements we can make to the framework, for instance simplifying arrangements if there are any measures and targets that are no longer needed or increasing the focus on verifying performance levels to ensure the appropriate delivery of consumer benefits.

Environmental sustainability

- 2.70 Environmental sustainability is a priority area for H8 and will want to ensure the price control provides for efficient and necessary expenditure to support HAL's transition to net zero.
- 2.71 HAL should set out clearly its delivery plans for its environmental obligations and how it will reasonably support the transition to net zero in the H8 period and beyond. We expect to see evidence that HAL has considered these issues as part of consumer engagement, CE and in its business plan.
- 2.72 We will review the incentives on HAL to improve environmental performance during the H8 period, including any measures and targets it has proposed to reduce emissions at the airport. We expect to introduce a carbon measure definition as part of the OBR Mid-Term Review and we will consider how this should be developed further for H8, including the target and incentive arrangements.
- 2.73 As part of our work on assessing costs, we will consider the investment and other costs that HAL has proposed in its business plan to meet its net zero obligations. We expect to see clear and robust business cases that explain how the proposed investment supports delivery of HAL's long term environmental targets. This should include a clear description of how the programme will allow HAL to meet its environmental obligations in an optimal way. HAL should provide

an appropriate “needs case” for the investment, and a thorough evaluation of the investment and the other options HAL has considered, to demonstrate that the programme provides value for money for consumers.

- 2.74 In terms of the specific projects within this programme, we expect HAL to continue working within the existing capex incentive framework and airline governance arrangements, including proposing appropriate Delivery Obligations for this investment. The framework offers flexibility for new projects to be developed during the price control period.

Cost and commercial revenue assessment

- 2.75 For opex and comrev, we will work with consultants to develop an independent assessment of the likely level of these costs and revenues and to assess the information provided by HAL in its business plan. Where practical, this will include widening the evidence base including further consideration of international benchmarking and targeted bottom-up analysis. For capex, our initial work will focus on understanding the likely size of the efficient capex envelope and the key uncertainties for the capex baseline.
- 2.76 To support the provision of high-quality information by HAL to support this process, we have developed our business planning guidance in this area in chapter 4, which includes additional requirements on the form and content of cost information that is required in HAL’s business plan, to allow for better and more consistent scrutiny of these costs. We are also consulting on introducing a new incentive for HAL to provide high-quality business plan information in chapter 3.
- 2.77 If it becomes necessary, we will use our formal information gathering powers where necessary, including to provide important data assurance.
- 2.78 We will also seek to broaden and deepen the evidence base in reaching our own views on the level of efficient opex and commercial revenues. We are investigating how we develop and use benchmarking information where practicable. In developing, and making greater use of, top-down international benchmarking, we recognise that there are likely to be significant challenges and it will take time to develop. We will also consider the efficiency of opex and commercial revenues at different levels of granularity using a range of different approaches. In so doing, our aim is to produce a reasonable overall estimate of efficient costs and revenues.
- 2.79 For capex, we expect to commission expert advice to assess the efficiency of HAL’s planned expenditure under its Masterplan for expansion of capacity in the two-runway airport. We will also need to consider whether the policy for surface access schemes remains appropriate for H8 and whether any proposed schemes provide value for money for consumers.

- 2.80 A number of stakeholders have raised issues around Other Regulated Charges (“ORCs”).⁴ We will consider the approach to estimation and recovery of ORCs for H8, including whether the approach towards the recovery of the fixed costs adopted in H7 remains appropriate.

Cost incentives

- 2.81 As set out above, we aim to provide a balanced set of incentives, so that HAL targets both an appropriate quality of service as well as an efficient level of costs for delivering that quality of service. We also want to make sure the approach is sufficiently flexible so that it reasonably supports net zero and provides appropriately resilient services to consumers and airlines.
- 2.82 For opex and comrev, we expect to retain the current broad approach to incentives, where HAL retains the risk for over and underspend. We will, however, consider alternative risk-sharing arrangements for specific costs where this furthers the interests of consumers.
- 2.83 We have identified some specific areas where we want to consider further our approach to cost and revenue incentives and are aware of other areas where HAL may propose a change in approach in its business plan:
- adjustments to allowances where there are switches in major investments or cost items between opex and capex during the regulatory period;
 - understanding and taking appropriate account of the link between investment and changes in opex and/or increases in non-regulated revenues and comrev;
 - the regulatory treatment of terminal drop off charges, to make sure we are protecting consumers’ interests;
 - HAL’s potential proposed changes to single till boundaries for property and non-terminal car parks costs to incentivise investment.⁵ Any changes might need to be timebound, so consumers benefit from growth in these revenues in the medium or longer-term; and
 - ensuring that the estimates of single till revenue appropriately reflect developments such as recent changes to the arrangements for fast-track security charges.

⁴ Other Regulated Charges (“ORCs”) are charges for specified services (such as utility services and IT) and facilities (such as baggage) that are collected separately from the airport charges (which are subject to the price control).

⁵ The single till approach involves combining aeronautical revenues and commercial revenues (from activities such as retail, parking and property rental) to determine the overall price cap.

- 2.84 As noted above, we are also reviewing our approach to the regulation of ORCs. We encourage HAL to consider how it can better engage with airline and non-airline users alike on the way it calculates ORCs and on its overall approach, and how it can increase the transparency of ORCs, to address concerns raised by stakeholders.
- 2.85 On capex incentives, HAL's capital efficiency incentives have only been recently introduced and our focus will be on understanding how they are working in practice. Any changes are most likely to focus on evolutionary improvements and in this context, we note that HAL has raised issues around Delivery Obligations (that is the expected outputs, including quality requirements and timing) that it says are causing some issues that unnecessarily slow down investment. We expect HAL to engage with airlines on these matters and we will consider in our work to refine the capex incentives.

Financial issues and the RAB

- 2.86 We are seeking to further the interests of consumers by providing a stable and predictable regulatory regime that supports ongoing investment as required to allow HAL to provide the airport operation services that consumers want. To achieve this, we propose to take a similar broad approach to financial issues as we took at H7, updated to take account of new market evidence, regulatory precedent and emerging issues.
- 2.87 There are a number of financial policy issues that have a material impact on both the level of the price cap and the incentives on HAL, including:
- the level of the allowed cost of capital (which is itself made up of a number of individual policy decisions on the components of the cost of capital) and is discussed in more detail in the section below;
 - the assumptions we make about the capital structure of the notional company and, consequently, the credit rating that it is able to sustain;
 - our approach to the calculation of an allowance for corporation tax;
 - our policy for remunerating capital investment through depreciation of the RAB; and
 - how the RAB is indexed to allow for inflation.
- 2.88 Each of these issues contribute directly to the level of airport charges. We recognise the importance of being mindful of the level and profile of charges over the price control period and beyond. In H7 we examined policy options for altering the profile of charges (and thereby the level of charge in any given year) and we expect to do the same in this price control.

- 2.89 As noted above, we will retain the RAB and the “building blocks” approach to setting the H8 price control for HAL. This provides regulatory consistency and reasonable stability for investors (which in turn will avoid any unnecessary increases in the costs of financing investment).
- 2.90 A number of airlines have expressed concerns about the size of HAL’s RAB. We note that HAL is proposing to expand the capacity of the two-runway airport, requiring further investment during the regulatory period. We will consider how we balance the level of charges in the shorter-term and the allowances for regulatory depreciation with a sustainable growth of the RAB. To the extent there are further initiatives that might reasonably reduce the size of the RAB, such as taking account of the proceeds of the sale of non-core assets, then we are open to considering these matters as part of the price control review.
- 2.91 Consistent with the approach adopted by other economic regulators, we expect to move from the RPI to CPI or CPIH indexation of the RAB for H8. While CPIH is ONS’s lead measure of the rate of inflation, we note that CPI is also widely used and would provide consistency with the approach we have adopted to setting price controls for NERL. We note that the difference between CPI and CPIH has been relatively small historically.
- 2.92 To the extent that we decide to take a different approach to indexation of the WACC or parts of the cost of debt, we will look to also reflect this different approach in the indexation of the RAB. We also note that, Ofgem is looking at setting a nominal cost of fixed rate debt and hence removing indexation from the equivalent part of the asset base.⁶ We will consider whether there is merit in adopting a similar approach for HAL.
- 2.93 When setting a price control, we use a financial model to assess the level of charges and the extent to which those charges will be sufficient to enable the notional company to access the capital it needs to finance its business. Assessing this ability to access capital is a central part of how we respond to our statutory duty to have regard to the need to secure that HAL is able to finance its provision of airport operation services.⁷ For H8, we are developing an updated version of the price control model. We will use this for our Initial Proposals and will expect HAL to provide inputs for this model as part of its business plan.
- 2.94 For the corporation tax allowance, we currently expect to take a similar approach to H7, where we applied an uplift to the cost of capital based on the headline rate

⁶ For example, see inflation option 1, which is Ofgem’s preferred option in Ofgem, RIIO-3 Sector Specific Methodology Decision – Finance Annex, July 2024, for the for the electricity and gas transmission and gas distribution sectors.

⁷ See clause 1.(3)(a) of the [Civil Aviation Act 2012](#). See also appendix [duties].

of corporation tax. However, we will want to check this provides a reasonable estimate of tax costs for the efficient notional company.

- 2.95 We expect to carry out financeability analysis for H8 that is similar to our approach to H7. This includes adopting a notional financing structure and testing that the efficient notional company should continue to attract debt and equity financing for investment, even in reasonable downside scenarios.

Cost of capital

- 2.96 Consistent with established regulatory practice, it will be appropriate to set an allowed weighted average cost of capital (“WACC”) consistent with HAL recovering the reasonable and efficient costs of financing investment.
- 2.97 In the 2024 Review, we said that the approach we adopted to calculate the cost of capital in H7 should provide a reasonable starting point for our H8 work. We also said that we will consider new precedent from other regulatory reviews, the UK Regulators Network (“UKRN”) guidance,⁸ the comparators for beta estimation, new market evidence and further evidence from stakeholders. We continue to consider this approach is appropriate.
- 2.98 As noted above, we are minded to change the treatment of inflation in calculating the WACC, with the real WACC calculated by reference to CPI or CPIH rather than RPI as in previous price controls, to be consistent with our position of changing indexation of the RAB.
- 2.99 We have also commissioned FTI Consulting to provide an initial updated estimate of the WACC based on recent market information and to propose potential refinements to the methodology we used in H7. FTI’s report is published alongside this document.⁹
- 2.100 FTI found that the update for market data (up to 31 July 2024) suggested a potential increase in the RPI-real WACC (from 3.16% to 4.56%).¹⁰ The increase is mainly the result of external factors – the planned alignment between RPI and CPIH from 2030, the lower level of forecast inflation for the H8 period, and changes in interest rates. Our proposed change to CPI/CPIH indexation and updates for more recent market data on betas also lead to some further, relatively small changes to the WACC estimates.

⁸ UKRN, UKRN guidance for regulators on the methodology for setting the cost of capital, March 2023

⁹ FTI Consulting, Cost of Capital Strategy for H8, November 2024

¹⁰ While we quote RPI-real figures here in order to provide a like-for-like comparison with the H7 WACC, our intention for H8 is to use a CPI-real WACC as described in this section.

- 2.101 On inflation, in November 2020 the UK government announced that RPI would be aligned with CPIH from 2030 (so within the H8 period).¹¹ This change increases the real RPI-deflated cost of both equity and debt. In addition to this the current expectations for inflation during H8 are substantially lower than during H7, which further increases the real RPI-deflated cost of debt.
- 2.102 On interest rates, the current environment of higher interest rates is expected to lead to an upwards trend in the cost of embedded debt going into H8.
- 2.103 The increase in the estimate of HAL's WACC driven by these changes (from about 3.2% to 4.6%) is relatively significant. As noted above in the section on financeability and the RAB, we will consider carefully how to balance shorter-term price levels with a sustainable growth in HAL's RAB, to both allow HAL to efficiently finance investment and to protect the interests of consumers.
- 2.104 FTI has also identified further possible changes to our calculation of the main WACC parameters, including the approach to estimating beta and further use of cross-checks. Nonetheless, the initial estimates made by FTI suggest that these changes may not have a significant impact on the overall WACC, based on current market information, though this will require further analysis during the H8 price control review.
- 2.105 We will consider the potential changes suggested by FTI, as well as considering further market data, evidence from stakeholders and emerging precedent during the course of H8. We welcome views from stakeholders on the changes proposed by FTI and other evidence that we should consider.
- 2.106 Where there are links between the incentive package and the WACC we will explore and take decisions consistent with the interests of consumers. We will calibrate the impact of incentives on the WACC where it is reasonable and practicable to do so (for example, as we did in H7 by estimating the impact of the introduction of TRS arrangements on the cost of equity).

Timetable

- 2.107 We are taking steps to meet the timetable set out in the 2024 Review.
- 2.108 HAL will also have a key role in providing a high-quality business plan.¹² We expect HAL to provide all of the information requested on time, with properly supported views, compelling evidence, including benchmarking, and appropriate

¹¹ HM Treasury, A consultation on the Reform to Retail Prices Index (RPI) Methodology, <https://www.gov.uk/government/consultations/a-consultation-on-the-reform-to-retail-prices-index-rpi-methodology>

¹² This being HAL's plan for investment in Heathrow airport and its view on the efficient costs, service quality framework and charges required for the five-year period, 2027-2031.

assurance. It is the quality of the supporting evidence and supporting narrative that will be key to ensuring the business plan is of a high quality.

- 2.109 Stakeholders have requested that we continue to review and update them on the timetable including any delays. They have also asked us to consider suitable contingency arrangements if significant delays do occur.
- 2.110 We continue to keep the H8 timetable under review in light of the progress we make over the remainder of this year and anticipate providing a further timetable update in early 2025 when we finalise the H8 method statement.

Questions for consultation

- 2.111 Stakeholders are invited to comment on any aspect of our consultation on this draft method statement and we would particularly welcome views on:
- the three main priorities for the H8 price control review set out in paragraph 2.12 above and whether it would be appropriate to prioritise between them during the H8 process, in order to further the interests of consumers and better support the carrying out of our statutory duties; and
 - the following questions on the cost of capital (noting the later response date in paragraph 1.25 for these questions):
 - What are your views on the approach set by FTI and the recommendations and findings on the cost of capital? Are there any other developments and recent precedent we should consider at this stage?
 - What are your views on the relative merits of adopting a nominal allowance for the cost of debt?
 - What are your views on use of CPI or CPIH as a basis for indexation of the RAB and for deflation of the cost of capital?

Chapter 3

Business plan incentive

Introduction

- 3.1 HAL's H7 business plan was developed in the difficult and uncertain circumstances of the suspension of its plans for capacity expansion and the impact of the covid-19 pandemic. Nevertheless, there were several elements of the business plan that did not comply with the requirements set out in our business plan guidance.
- 3.2 We issued business plan guidance several times during the H7 review to support HAL in developing its plan, including updated guidance in June 2020 which set out our "criteria for high-quality business plans".¹³ Our subsequent assessment demonstrated that HAL's business plan did not meet our expectations of a "high-quality" submission.¹⁴ We considered that, in a number of areas, HAL's plan lacked sufficient detail to enable the CAA and other stakeholders to scrutinise the proposals properly.¹⁵
- 3.3 In the 2024 Review we said that we would consider whether it is appropriate to strengthen the incentives on licensees to provide timely and high-quality business plan information for the H8 review. This conclusion was consistent with the recommendations of our advisory panel, which had said that we should consider applying stronger incentives for HAL to comply with its guidance, which has been done in other regulated sectors.
- 3.4 This chapter sets out for consultation a proposal to introduce a new business plan incentive ("BPI") mechanism for the H8 review. In this section we:
- consider business plan incentives in other sectors and the type of incentive that could be implemented for the H8 review;
 - set out for consultation our proposal for a new incentive mechanism including how we would assess HAL's business plan and calibrate the incentive; and
 - identify key questions for consultation.
- 3.5 The incentive aims to encourage HAL to submit a complete, high-quality business plan, supported by appropriate evidence and by third-party assurance. We consider that a high-quality business plan submission that is well-evidenced

¹³ The June 2020 Consultation See: appendix E, [CAP1940](#).

¹⁴ The April 2021 Consultation. See appendix E, [CAP2139A](#).

¹⁵ The April 2021 Consultation. See para 18, [CAP2139](#).

and is shown to be in the interest of consumers furthers the interest of consumers because it would:

- enable airlines appropriately to engage with and challenge HAL’s proposals for H8; and
- facilitate our conduct of the H8 review in a timely and proportionate manner, as a result of the high-quality information and airline engagement.

3.6 Also, as business plan information is an important input to our proposals for the H8 price control, a high-quality business plan means we are more likely to set proposals with strong and well calibrated incentives on HAL to deliver on consumer priorities.

Business plan incentives in other sectors

3.7 Incentives to encourage high-quality plans, promote ambition and “truth-telling” have been a feature of energy and water regulation in the UK for multiple price control reviews and these mechanisms continue to evolve.

3.8 In previous price control reviews, Ofgem and Ofwat have both offered early draft determinations for those companies whose plans were assessed to be high quality and close to the regulators’ final proposals.¹⁶ More recently, these regulators have moved away from offering procedural incentives and have focused on reputational and financial incentives. For example:

- Ofgem’s RIIO-3 BPI uses financial incentives to encourage high-quality and ambitious plans from energy network companies;¹⁷ and
- Ofwat’s PR24 quality and ambition incentive involves a penalty for company plans that are assessed to be inadequate quality or lacking ambition and a reward for high-quality company plans.¹⁸

3.9 It is useful to consider these incentives, but we recognise that parts of these approaches rely on being able to compare business plans between companies during a price control review process, which would not apply in the case of H8 and we need to consider carefully whether these arrangements could be adapted for the circumstances of Heathrow airport.

¹⁶ For example, see Ofwat’s PR19 Initial assessment of plans [PR19-initial-assessment-of-plans-Overview-of-company-categorisation-FINAL.pdf](#), and Ofgem’s RIIO-ED1 assessment of business plans and fast-tracking [Assessment of RIIO-ED1 business plans and fast-tracking](#).

¹⁷ [Ofgem RIIO-3 Business Plan Guidance](#)

¹⁸ [Ofwat PR24 Appendix 12 - Quality and ambition incentive](#)

Options for type of incentive

- 3.10 We have focussed on whether reputational or financial BPIs are appropriate for H8. The experience from Ofwat and Ofgem indicates these approaches may be more effective than procedural incentives. Moreover, with a single business plan from HAL and a targeted and proportionate approach to reviewing this plan, there would be limited benefits from a formal fast-tracking mechanism.
- 3.11 A reputational incentive is likely to only provide a relatively weak incentive on HAL to produce a high-quality plan. Reputational incentives can be effective when there is a clear reputational benefit for companies to outperform their peers during a price control review, but this would not be the case for H8.
- 3.12 Financial incentives would involve offering a reward and/or imposing a penalty where we have assessed HAL's plan against a set of assessment criteria. A financial incentive could provide a relatively strong incentive on HAL to submit a high-quality business plan even without comparator business plans. We set out for consultation a potential financial incentive in the following section.

Our draft proposal for a new incentive mechanism

Introduction

- 3.13 We are considering a new financial incentive on HAL to submit a high-quality business plan for H8.
- 3.14 As this is a new incentive for H8, we would propose to use a relatively modest financial incentive that is applied in a simple manner, based on an overall assessment of HAL's business plan. We would then look to learn from how well this works at H8 and consider whether this remains an appropriate approach for future price control reviews.

Approach to the assessment of HAL's business plan

- 3.15 The incentive would involve us in an overall assessment of whether HAL's business plan information represents a high-quality plan. Our draft guidance in chapter 4 below sets out our requirements for HAL's business plan and we consider that a high-quality plan is one where:
- HAL's plan meets the requirements that we have set out in our business plan guidance, particularly on areas that are material and where high-quality information will be important for us to be able to properly develop our proposals for H8;
 - the business plan is presented in a clear and coherent way, so that stakeholders can engage with the material presented;

- the way in which the business plan benefits consumers is clearly demonstrated;
- the plan is coherent and joined up across its separate sections;
- the plan is appropriately challenging in the targets it sets;
- there is evidence of third-party assurance;
- HAL submitted its plan on time;
- HAL has responded to follow-up information requests in a timely way; and
- any additional information that HAL might submit to us late in the price control process is appropriate and HAL can justify why the further submission is necessary, appropriate and in the interests of consumers.

3.16 We would evaluate HAL's plan on the basis of the criteria set out above. This evaluation would then allow us to categorise HAL's plan. Our indicative approach to this categorisation is set out in Table 2.1 below.

Table 2.1: Approach to categorising HAL's plan

Very high-quality plan	HAL's plan exceeds our expectations in terms of the quality of evidence and information it provides to support its plan. It is clear how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The plan is ambitious in the targets it sets for HAL.
High-quality plan	HAL's plan meets the requirements set out in the business plan guidance. There is some evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The plan sets moderate targets for HAL.
Low-quality plan	HAL's plan fails to meet a number of the requirements set out in the business plan guidance. There are significant failings and insufficient evidence of how consumers' needs have informed the development of the business plan and how they will be furthered by the implementation of the business plan. The targets set for HAL in the plan are not sufficiently stretching.

3.17 The assessment of HAL's business plan and information provided in response to information requests would be made in the round with evidence and we will provide examples of high and low-quality information. In our Initial Proposals, we

plan to consult on our overall assessment of HAL's plan and whether HAL should receive a reward, no adjustment or penalty as a result of the business plan incentive and the level of any reward or penalty to be applied. We would consider further any representations and evidence before reaching our Final Decision on these matters.

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

Calibration of financial incentive

- 3.19 We are proposing a symmetrical incentive mechanism, with potential for rewards and penalties, as we recognise that the potential to earn additional revenue can provide a stronger incentive to outperform than a penalty only regime. We propose that the size of the incentive is relatively modest for H8, as a new mechanism introduces the risk of unintended consequences.
- 3.20 To assess how to calibrate the incentive, we have reviewed the BPI mechanisms that Ofgem and Ofwat have introduced. Under the RIIO-3 regime, Ofgem's BPI exposes licensees to potential upsides and downsides equivalent to up to 60bps of return on regulatory equity (RORE).¹⁹ Ofwat's BPI for PR24 provides for direct bonuses or penalties of up to 30bps of RORE.²⁰ Ofgem and Ofwat have used RORE as it is a measure of the impact on the returns earned by shareholders in the notional company.
- 3.21 As a relatively modest incentive, we could allow for bonuses and penalties equivalent to 20bps of RORE in each year of H8. This would be included in allowed revenue for the H8 price control period. As an illustration, this would be approximately £16 million per year, or around £0.20 per passenger.²¹

¹⁹ See figure 3, Ofgem's [RIIO-3 Business Plan Guidance](#).

²⁰ See chapter 2.2, Ofwat's [Appendix-12-Business-plan-incentives-1.pdf](#). We note that Ofwat uses multiple types of rewards and penalties, for example adjustments to RORE as mentioned here, as well as applying different cost sharing rates.

²¹ This is calculated as follows: HAL reported a closing RAB in its 2023 regulatory accounts of £19.8 billion and, assuming a 60% gearing, 20bps of RORE would be equivalent to an adjustment to allowed revenues of

Implementation

3.22 We expect to make a final decision on whether to proceed in principle with this incentive in our Final Method statement due to be published in February 2025, and set out final criteria for our assessment of the incentive and the approach to calibration. As noted above, we would then consult on our assessment of HAL's business plan in our initial proposals. Any adjustments to HAL's H8 price control revenues stemming from the introduction of this incentive would be included in our H8 Final Decision and the subsequent licence modification. At that stage, airport and certain airline stakeholders would have rights of appeal to the CMA, including in relation to the business plan incentive.

Questions for consultation

- 3.23 Stakeholders are invited to comment on any aspect of our consultation on business plan incentives and we would particularly welcome views on:
- Do you agree we should introduce an incentive on HAL to comply with the business plan guidance?
 - What are your views on how we propose to implement this incentive mechanism for H8? This includes:
 - the description of the high-quality plan and which particular areas we should focus on where high-quality information will be important for us to be able to properly develop our proposals for H8;
 - how we assess the business plan and determine the financial incentive;
 - the size of the reward or penalty that should be attached to the BPI; and
 - any potential unintended consequences we should consider in how we set the incentive.

approximately £16m in each year of H8. If this was evenly spread amongst each of the 79.2 million passengers who travelled through Heathrow in 2023 this would equate to £0.20 per passenger. The figures shown here are in 2023 prices and are illustrative only. Note also that this calculation uses the 2023 RAB as it is the latest RAB balance reported in regulatory accounts. The bonuses or penalties for H8 would be calculated using the forecast RAB values over the H8 period.

Chapter 4

Business plan guidance

Introduction

- 4.1 This business plan guidance is intended to assist HAL in producing a business plan for the H8 period that appropriately supports our price control process, including providing a clear focus on HAL identifying and meeting the needs of consumers in an efficient and effective way. The plan should be robust and transparent and support both:
- the process of CE and HAL's engagement with wider stakeholders; and
 - the CAA's work in setting of an appropriate price control.
- 4.2 The focus of the guidance is the overall scope of the business plan, the approach HAL should adopt to consumer engagement and the key building blocks associated with the price control. This chapter provides an overview of each of the areas covered by the guidance, with the more detailed business plan guidance provided in Appendices A to G as follows:
- scope (Appendix A);
 - consumer engagement (Appendix B);
 - traffic (Appendix C);
 - service quality and resilience (Appendix D);
 - environmental sustainability (Appendix E);
 - costs and cost incentives (Appendix F); and
 - financial issues and WACC (Appendix G).
- 4.3 This chapter also identifies key consultation questions in relation to each of the above areas.
- 4.4 The guidance provided in this chapter and the associated appendices are designed to specify a base level of information that HAL should provide as part of the H8 process. Nonetheless, HAL should provide further information to the extent that it considers that this would reasonably further the interests of consumers or that such information is reasonably required to fully understand its plans for H8 and beyond.
- 4.5 HAL should also bear in mind the assessment criteria set out in chapter 3 above and seek to provide a business plan consistent with these criteria.

Overview

Scope

- 4.6 We expect HAL to provide a high-quality business plan. This means providing all of the information requested on time, with properly supported views, compelling evidence, including benchmarking, and appropriate assurance.
- 4.7 Appendix A provides more detailed draft business plan guidance on the area of 'Scope'. Table A.1 contains general guidance as to the form and content of the business plan overall as well as specific guidance in relation to the:
- scope of the plan and the importance of a clear and transparent narrative;
 - time-period which the business plan should cover;
 - level of detail which should be provided;
 - proposed price base and details as to the inflationary assumptions which should be used; and
 - form and level of assurance that should be provided with the business plan as a whole.
- 4.8 Our business plan guidance as set out in Appendix A is designed to help ensure that the information provided in the business plan is useful in informing us in setting a price control which is based on complete, well-evidenced and accurate information. Information provided in the way which is specified should also support the CE process and HAL's engagement with wider stakeholders on a range of matters as part of the overall process.

Consumer engagement

- 4.9 An in-depth understanding of consumers' views through research and engagement will be an important part of making sure that the price controls further the interests of consumers. As set out in the 2024 Review, we expect HAL to carry out its own research and engagement with consumers, local community groups and other stakeholders.
- 4.10 The consumer research should, as far as possible, be designed to provide clear and reliable results, including using samples across different consumer types and appropriate information and context to help participants make informed responses. We expect to see a clear line of sight as to how consumer priorities have been taken into account in the development of HAL's business plan.
- 4.11 Appendix B provides more detailed draft business plan guidance on the area of 'Consumer engagement'. This draft guidance is intended to result in the provision of underlying evidence as to consumer priorities as well as how this evidence has been used to formulate the business plan. Table B.1 provides

general guidance, as well as a description of the approach which HAL is expected to adopt in relation to consumer engagement. This includes our current views as to the assurance which HAL should seek in relation to its consumer engagement strategy.

Traffic

- 4.12 As highlighted in the 2024 Review, the process of setting passenger traffic forecasts was a contentious issue for the H7 review, and we are committed to improving this process for the H8 review.
- 4.13 In respect of HAL's traffic forecasts we expect:
- HAL and airlines to try and reach a joint view on a reasonable range of forecasts for the H8 period;
 - HAL to include traffic scenarios in its business plan and show how these are integrated with the wider plan; and
 - HAL to consider whether there is scope for improving TRS arrangements and to make proposals for updating the calibration of the existing TRS mechanism for H8.
- 4.14 We consider that the draft business plan guidance in Table C.1 in Appendix C on the area of 'Traffic', alongside engagement between HAL and airlines as part of the CE process, will support an improved process of setting passenger traffic forecasts for H8.

Service quality and resilience

- 4.15 HAL's business plan should set out its proposals to update the service quality Outcomes and the Measures, Targets and Incentives ("MTI") scheme framework. This should include any updates to the broad Outcomes used in H7 and updates to the specific measures, targets and incentives within the MTI scheme. These updates should be supported by evidence, including on the links between business plan proposals and consumer research and engagement undertaken by HAL and airlines.
- 4.16 Maintaining and improving operational resilience will continue to be important in H8, particularly as:
- passenger traffic at Heathrow airport has now returned to a level in excess of 80 million per year; and
 - HAL has plans to maximise the use of existing runway and terminal capacity.
- 4.17 In this light, HAL should set out how it will maintain and improve operational resilience as part of its business plan proposals and how this relates to service

quality outcomes and the MTI scheme. As part of its business plan, HAL should set out how any surface access improvements will contribute to resilience.

- 4.18 Appendix D provides more detail of our draft business plan guidance on the areas of 'Service quality and resilience'. Table D.1 contains both general guidance and specific guidance as to the development of outcomes and MTI for H8 and how operational resilience, including surface access, will be delivered and optimised during the period.

Environmental sustainability

- 4.19 Recognising that the transition to net zero is a priority area for the aviation sector, it is important that our regulatory framework reasonably supports HAL in its transition to net zero. As this is a new priority for the H8 review, we have developed business plan guidance which sets out the information and evidence that we expect from HAL's business plan to support our review of HAL's proposed environmental targets and its supporting investment in this area as part of the price control process.
- 4.20 Appendix E provides draft business plan guidance on the area of 'Environmental sustainability'. Table E.1 provides general guidance on what we expect to see from HAL's business plan in this area as well as specific guidance as to the provision of details on environmental outputs and targets, and environmental sustainability investment.

Cost and Cost incentives

- 4.21 Forecasts of costs (opex and capex) and commercial and other revenues are important components of the price control calculations. It is important that the business plan provides a breakdown of costs and commercial and other revenues at a level of detail which can be used to inform our understanding of these costs and revenues, including by allowing us to carry out benchmarking of these costs where appropriate. Providing details of costs and revenues at the prescribed level of detail should also support the CE process and HAL's engagement with wider stakeholders on these matters.
- 4.22 It will be important that the data submitted by HAL can be reconciled to information in its regulatory accounts. However, we also recognise that some definitions may need to sensibly evolve over time to reflect changes in the categories of costs which HAL incurs and revenue streams which it recovers.
- 4.23 The business plan should also provide HAL's views on the overall balance of incentives during H7, how the *ex ante* capex efficiency framework has been operating in H7 and any improvements which it thinks should be made for H8. This information should help us to facilitate the CAA's assessment of the effectiveness of capex efficiency incentives in H7, with a view to making improvements for H8.

- 4.24 Appendix F provides draft business plan guidance on the areas of 'Cost' and 'Cost incentives'. Table F.1 provides draft guidance in relation to cost and commercial revenues. This includes operating expenditure, commercial and other revenues, Other Regulated Charges and capital expenditure. Table F.2 provides business plan guidance in relation to cost incentives. It sets out guidance as to the overall balance of incentives as well as on capex incentives.

Financial issues and the Cost of Capital

- 4.25 It is important that we provide a stable and predictable regulatory regime that supports ongoing investment as required to allow HAL to provide an appropriate level and quality of airport operation services to support the interests of consumers.
- 4.26 In developing its business plan, HAL should consider whether to take the same approach to financing as was used to support the setting of the H7 price control or whether to update this to take account of new market evidence, regulatory precedent or emerging issues. As part of its business plan, HAL will need to demonstrate that it has carefully considered these matters and provided evidence to support its chosen approach and explained why the approach is in the interests of consumers.
- 4.27 Our business plan guidance also sets out the information that HAL needs to provide in its business plan to support our work to appropriately calibrate the price control.
- 4.28 For the price control model we will use for our Initial Proposals, we will expect HAL to provide inputs for this model as part of its business plan.
- 4.29 For cost of capital, we have provided guidance based on initial analysis by FTI Consulting, which we expect HAL to take into account as it develops its business plan.
- 4.30 In Appendix G, Table G.1 provides business plan guidance in relation to financial issues and Table G.2 provides guidance in relation to cost of capital.

Questions for Consultation

- 4.31 Stakeholders are invited to comment on any aspect of our consultation on business plan guidance and we would particularly welcome views on:
- **Scope:** Do you agree, as specified in the draft guidance, that all financial, cost and revenue data be provided in nominal and real prices, with real values in 2024 prices (or an alternative price base with clear justification)?
 - **Consumer engagement:** do you have any views as to potential focus areas both for consumer research and engagement and for the approach to seeking assurance that HAL's business plan reflects this evidence?

- **Traffic:** Do you agree that the factors identified in the draft business plan guidance are those which reflect the key issues that HAL should take account of in developing the H8 traffic forecast?
- **Environmental sustainability:** do you consider that the new guidance in this area is appropriate for HAL to develop its plans, and for airlines to engage on HAL's proposals in this area and what, if any, further guidance on environmental sustainability could be included?
- **Service quality:** Do you agree with the proposed approach to updating the existing Outcomes and the MTI framework following on from its introduction in H7, and that HAL's business plan should take into account both its own consumer research and engagement and their work to understand airlines' consumer engagement and insights?
- **Resilience:** Is the guidance for resilience covering operations and assets adequate to address the planned growth in H8 within the existing airport capacity?
- **Costs:** Do you agree that the categorisation of costs, revenues and capital expenditure in HAL's regulatory accounts provides an appropriate basis for the specification of data to be submitted in the H8 business plan? If not, please describe what alternative categorisations you think should be considered, and why.
- **Costs:** As part of the final business planning guidance, we intend to specify further data to facilitate additional benchmarking. Please provide any suggestions you have for what this may cover, focusing on those areas of costs and revenues having the biggest impact and most amenable to benchmarking analysis (including identification of potential data sources).
- **Cost incentives:** Do you agree that the guidance we have provided on capex efficiency incentives will result in a business plan submission by HAL which will facilitate the CAA's assessment of the effectiveness of capex efficiency incentives in H7, with a view to making improvements for H8? If not, what additional information should CAA request in order to facilitate this assessment?
- **Financial issues:** What are your views on the guidance specifying that 60% remains an appropriate level for the gearing of the notional company upon which the financeability assessment is based?
- **Financial issues:** What are your views on the guidance requiring HAL to assess the impact of regulatory depreciation by analysing the profile of the RAB over a 30 year period?

- **Financial issue:** What are your views on whether HAL should use the credit metrics referred to in the guidance when assessing the credit rating that the notional company might be able to obtain under its proposed business plan?

APPENDIX A

Draft business plan guidance – scope

Scope

Table A.1: Draft business plan Guidance on Scope

Scope
<p>General Guidance</p> <ul style="list-style-type: none"> • The business plan should be: <ul style="list-style-type: none"> • transparent, including in relation to having a clear and robust narrative covering all key areas, and be publicly available to all stakeholders; • supported by a robust evidence base, drawing on industry best practice; • well-structured and well-integrated between different elements of the plan; • designed to reflect consumers' views and preferences to the fullest extent practicable; • based on efficient costs and financing assumptions; • affordable (in terms of providing value for money charges for airlines and consumers); • should cover all HAL's activities, including those relating to the single till and ORCs; • deliverable (including in respect of financeability). <p>Time-period</p> <ul style="list-style-type: none"> • The business plan should cover the five year period from the end of the existing price control arrangements (2027 to 2031) with higher level projections to demonstrate longer-term financeability and affordability beyond 2031. For some items, historical data for past years is also requested. • Where forecasts are presented, these should be provided in an annual form which is consistent with their presentation in HAL's accounts and figures should be presented for each year of the five year period. <p>Level of Detail</p> <ul style="list-style-type: none"> • The business plan should provide a level of detail on projects which reflects the time periods for delivery: projects that are further in the future will typically have less detail. • The business plan should link revenues and costs to scenarios for passenger numbers, taking account of expected developments in capacity and other matters.

- The business plan should clearly identify risk, contingency and efficiency assumptions throughout.

Price Base and Inflationary Assumptions

- The business plan should present all financial, cost and revenue data in nominal and consistent real prices, with real values in 2024 prices (or an alternative, and consistent, price base with clear justification).
- The business plan should specify what price index it has used to create nominal prices, for example, if industry specific inflationary indices have been used for specific cost items.
- The business plan should specify which indices have been used to convert data from nominal to real prices – typically, we would expect the use of CPI to deflate to 2024 prices, but an alternative may be used, if used consistently and with clear justification.
- The business plan should use a consistent base year when forecasting any quantified elements of the plan.

Assurance

- HAL should ensure that its Board reviews and approves the business plan, certifying that it is consistent with this guidance and fully explaining any divergence from it.

APPENDIX B**Draft business plan guidance – consumer engagement****Consumer engagement****Table B.1: Draft business plan Guidance on Consumer engagement**

Consumer Engagement
<p>General guidance</p> <ul style="list-style-type: none"> • The business plan should take account of, and demonstrate, a deep understanding of consumer preferences based on a wide range of engagement and research. • The business plan should provide strong evidence that consumers have been fully engaged in developing the outcomes that HAL proposes to deliver. The business plan should be clear about how that consumer engagement has shaped and influenced the proposed outcomes. • In addition to robust engagement with consumers, HAL should engage extensively with airlines throughout the process (see separate guidance in relation to CE). Airlines have a vital role to play in helping to deliver service quality and identify potential business plan priorities. So, HAL should develop a coordinated approach to service provision with them. <p>Approach to consumer engagement</p> <ul style="list-style-type: none"> • The business plan should demonstrate that it includes robust assumptions, that possible options have been carefully considered (including any the trade-off between, for example, affordability and service quality), that strategic choices have been made, and that the options proposed are best placed to achieve maximum value for money for consumers. • In ensuring that the business plan is fully informed by consumers' core needs, priorities and preferences. HAL should: <ul style="list-style-type: none"> • consider which elements of its existing consumer research and engagement are relevant to the business plan; • refine and build on its existing consumer evidence base with emerging intelligence and, where appropriate and practicable, through new research and engagement; • update its existing consumer research and engagement strategy, setting out how it intends to engage with consumers to understand their core needs, priorities and preferences; • consider airlines' consumer research and insights; and • follows the principles of good consumer engagement.

- In doing the above, HAL should consult the CAA and airlines on its future research and engagement plans and reflect the feedback it receives in its work on the business plan.
- HAL should consider what the implications of its future scenarios might be for the service quality that consumers and airlines will expect and should receive.
- To the extent practicable, 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.
- HAL should develop an outcomes and MTI strategy over the short term and longer term. As a minimum, this should focus on delivering consumers' and airlines' core needs and priorities so that they continue to receive an appropriate level of service over this time.

Assurance

- HAL should specify what assurance of its own consumer research and engagement to support the development of its business plan it has put in place and the outcome of this assurance.
- We expect HAL to 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.

APPENDIX C**Draft business plan guidance – traffic****Traffic****Table C.1: Draft business plan guidance on traffic**

Traffic
<p>Traffic forecast</p> <ul style="list-style-type: none"> • HAL and airlines should work together to reach a joint view on a reasonable range of forecasts for the H8 period. Doing so will require transparency and engagement and, therefore, HAL and airlines should explore how best to achieve this during CE at the start of the H8 process. • In its business plan, HAL should present a traffic forecast which includes three scenarios (high, low and base case), and explain how it has consulted and engaged airlines on this forecast, and how it has taken airlines' views into account. <p>Traffic scenarios</p> <ul style="list-style-type: none"> • Jointly agreed scenarios should take account of a range of factors, including: <ul style="list-style-type: none"> • scenarios or forecasts of economic activity, both for the UK economy as a whole and for the economies of the key passenger destinations served by air transport services from Heathrow airport; and • relevant capacity constraints at the airport, and interventions designed to address these constraints during the H8 period. • Jointly agreed scenarios should be developed in a way that presents integrated outcomes for passenger numbers, capex, opex and commercial revenues in the business plan at a suitable level of disaggregation. Scenario analysis should be disaggregated, as a minimum, into key geographic markets. <p>Traffic risk sharing</p> <ul style="list-style-type: none"> • HAL should set out its views around any changes needed to the design and/or calibration of the TRS for H8, and where appropriate provide an updated calibration of TRS arrangements.

APPENDIX D**Draft business plan guidance – service quality and resilience****Service quality and resilience****Table D.1: Draft business plan guidance on service quality and resilience**

Service quality
<p>General guidance</p> <ul style="list-style-type: none"> • Following the introduction of an Outcome-Based Regulation approach to service quality for consumers in H7 the framework of Outcomes and Measures, Targets and Incentives (“MTI”) should be reviewed and updated for the H8 period. • Our expectation is that we will take a similar approach in H8 with the existing framework continuing to operate following the extensive programme of work undertaken to introduce the framework in H7. • We would not expect significant changes to Outcomes unless there is clear evidence that consumer priorities have changed significantly since H7. Measures, targets and incentives should cover the elements of operational performance that are important to consumers whilst supporting the business plan priorities. • Updates should take into account any HAL consumer research and engagement (see Appendix B) that informs the business plan and that HAL should work with airlines to understand their own consumer engagement and to review and agree updates to the framework where possible. <p>Approach to Outcomes and MTI scheme framework review and updates</p> <ul style="list-style-type: none"> • HAL should outline its high-level proposals to continue and further develop the framework of Outcomes and the MTI scheme for the H8 period. This should include how its broad approach will enable service improvement both during H8 (the short and medium term) and beyond into the next price control period (the long term). • In making its proposals HAL should demonstrate how it has taken account of consumer insights and other developments in the sector. It should also demonstrate the links between service levels and value for money, and remain responsive to consumers’ evolving needs throughout the H8 period.

- If HAL proposes updated Outcomes for the H8 period it should provide supporting evidence. Outcomes should be high level and should reflect consumers' and airlines' core needs and priorities. HAL should:
 - review existing outcomes and update on progress to date on H7 Outcomes to date and forecast to end period position;
 - explain any proposed updates to existing Outcomes;
 - propose any new Outcomes with rationale and supporting evidence; and
 - explain any proposed discontinuation of existing Outcomes.
- HAL should also propose updated MTI for the H8 period. These should focus on elements of operational service performance that are important to consumers and airlines and cover areas both within HAL's control and where HAL can play a broader coordinating role with other service providers (for example, airlines, UKBF, NATS other transport providers). HAL should:
 - review the existing MTI and performance to date and consider whether they continue to be appropriate and suitable to inform proposals for H8;
 - outline any proposed updates to existing MTI;
 - propose any new MTI with rationale and supporting evidence;
 - explain any proposed discontinuation of existing MTI including any that are no longer needed; and
 - explain how measures align with proposed Outcomes.
- In proposing new or updated measures, these should be accompanied by HAL's view of the appropriate target for each measure during H8 and the type of incentive associated with each, together with supporting evidence justifying the MTI.
- Any modifications to MTI should be coordinated with HAL's approach/suggestions on outcomes.

Resilience

General guidance

- Resilience during H8 and beyond will be an important priority. With passenger numbers back above 80 million per year, and HAL developing plans to expand the capacity within the existing two-runways, it will be essential to both maintain and improve operational and asset resilience and surface access to and from the airport. As an operator of critical national infrastructure, HAL should also consider what actions are needed to ensure that the airport is resilient to climate change.

- HAL should consider how the Outcomes and MTI scheme framework could help maintain and improve operational and asset resilience during the H8 period.

Approach to Resilience

- HAL should set out:
 - whether any new measures, increased financial incentives or changes to incentives are necessary as part of the MTI scheme with supporting evidence; and
 - how operational and asset resilience proposals are integrated with capital and operational expenditure plans for the H8 period, and if and how any proposed surface access improvements support increased resilience.

APPENDIX E**Draft business plan guidance – environmental sustainability****Environmental sustainability****Table E.1: Draft business plan guidance on Environmental sustainability**

Environmental sustainability
<ul style="list-style-type: none"> • Recognising that the transition to net zero is a priority area for the aviation sector, HAL's H8 business plan should clearly set out the journey that it is making to achieve net zero emissions by 2050. <ul style="list-style-type: none"> • HAL should set out the progress that it has already made in this area, including any significant projects and the outcomes that have been delivered as a result of environmental sustainability investment during H7. • HAL should clearly set out any relevant environmental obligations, its environmental objectives and the plans it intends to take to address those obligations and objectives during H8 to support its transition to net zero. • We also expect HAL to set out its longer-term environmental targets (up to 2050) and provide evidence on how its proposals for H8 are linked to these long-term targets, supporting future delivery in this area. • HAL should ensure that its approach to achieving net zero is joined up across the business plan. We expect the plan to include evidence to explain and support HAL's proposals in the following areas: <ul style="list-style-type: none"> • its environmental objectives and targets. For example, HAL should consider whether: <ul style="list-style-type: none"> ○ the proposed H7 reputational measure relating to Heathrow's carbon footprint remains appropriate for H8; and ○ new environmental objectives could be included under the MTI framework. • for environmental sustainability investment: <ul style="list-style-type: none"> ○ we expect HAL to provide evidence to demonstrate that it has considered a range of options to deliver net zero and that it has considered the costs and benefits of each option; ○ evidence to demonstrate that HAL has considered the trade-offs between the investment to support the transition to net zero and affordability during the H8

period, including evidence that these projects are needed during H8 and that they represent value for money for consumers; and

- the objectives (environmental benefits) that this investment is expected to deliver.

APPENDIX F

Draft business plan guidance – cost and cost incentives

Cost

Table F.1: Draft business plan guidance on Cost

Opex
<ul style="list-style-type: none"> • Opex for each year of Q6, H7 and H8 should be provided, split by each category of opex set out in HAL's regulatory accounts. Actual data should be provided up to and including the 2024 financial year, forecast data should be provided for 2025 financial year onwards. • If HAL considers any alternative categorisation of opex to be appropriate for H8 to that currently used for the regulatory accounts, this should be discussed and agreed with the CAA prior to submission of the business plan. A further split of staff costs into security and other named categories should be provided. • HAL should provide all opex data in both nominal terms and in an appropriate and consistent price base as set out in Appendix A on scope, making clear the assumptions it is making on inflation (and including the basis/source for future inflation forecasts). • Where real price effects are assumed in the opex forecasts, the assumptions should be clearly stated and the basis/source for such assumptions should be clearly explained. • HAL should provide forecast opex data on this basis for each of the high, low and base case traffic forecast scenarios discussed in Appendix C on traffic forecasts. • Where future opex (either in aggregate or for individual opex elements) varies across the scenarios, the assumed relationship between opex and traffic (and/or passenger numbers) should be clearly stated and explained. • We expect the business plan to set out consistent historical and forecast data at a level of detail that supports appropriate scrutiny by the CAA and airlines. Forecasts should be fully explained, taking account of past performance and expected operational efficiency and commercial revenue generation. • HAL should provide evidence that costs projections are robust and efficient. For example, we expect costs to have been market-tested or benchmarked, and that all evidence and assumptions relating to costs are clearly outlined. • HAL should demonstrate that its forecasts of opex and commercial revenues are integrated with other areas of the business plan: opex forecasts should be clearly linked to anticipated operational activity (for example, increased use of a particular terminal by passengers) and changes in service quality during the H8 period.

- HAL should show that its opex and commercial revenue forecasts are consistent with planned capital investment. We also expect costs to be transparently linked to outcomes, and that costs reflect past performance together with realistic assumptions about the scope for future efficiency.
- Evidence should be provided to demonstrate that a range of operating and capital solutions have been considered to deliver the activities and levels of service planned for H8 efficiently. The business plan should clearly show how the best and most efficient options have been selected, and how optimum value for money will be achieved.
- Note: further data required to facilitate additional benchmarking may be specified as part of updated guidance issued by the CAA with the final method statement.

Commercial and other revenues

- Commercial and other revenues for each year of Q6, H7 and H8 should be provided, split by each category of revenue set out in HAL's regulatory accounts (plus any additional revenue categories HAL expects to receive during H8).
- Actual data should be provided up to and including the 2024 financial year, forecast data should be provided for the 2025 financial year onwards. For each category of revenue, a breakdown of revenues into sub-categories should be provided to at least the level of disaggregation shown in HAL's regulatory accounts.
- If HAL considers any alternative categorisation of revenues to be appropriate for H8 to that currently used for the regulatory accounts, this should be discussed and agreed with the CAA before submission of the business plan.
- HAL should provide all revenue data in both nominal terms and in an appropriate and consistent price base as set out in Appendix A on scope, making clear the assumptions it is making on inflation (and including the basis/source for future inflation forecasts).
- HAL should provide forecast revenue data on this basis for each of the high, low and base case traffic forecast scenarios as discussed in Appendix C on traffic forecasts. Where future commercial revenue varies across the scenarios, the assumed relationship between the commercial revenue item and traffic (and/or passenger numbers) should be clearly stated and explained.
- We expect the business plan to set out consistent historical and forecast data at a level of detail that supports appropriate scrutiny by the CAA and airlines. Forecasts should be fully explained, and the key driver(s) of each line item of commercial revenues identified, with the relationship between those drivers and the commercial revenues clearly specified.
- HAL should demonstrate that its forecasts are integrated with other areas of the business plan, and that its opex and commercial revenue forecasts are consistent with planned capital investment.

Other Regulated Charges (ORCs)

- In the case of ORCs, forecasts should be provided at the level of each Specified Facility, and in each case distinguish between direct costs and fixed costs.
- Forecast fixed costs and direct costs for each Specified Facility should each be further broken down into airline amounts and non-airline amounts, for each year of the forecast period. (This level of detail is necessary to enable alternative potential options for the recovery of ORC costs for H8 to be assessed.)
- An explanation of the assumptions used to develop these forecasts, including the key drivers of future costs for each Specified Facility, the basis for calculation of fixed and direct costs, the assumptions made regarding business rates, and the basis for cost allocation to users, should be provided. HAL should also set out what it is assuming about the unit pricing for ORC services over H8.
- The relationship of the ORC forecasts to traffic and passenger forecasts should be explained and separate ORC forecasts provided for each of the traffic forecast scenarios.

Note: further data required to facilitate additional benchmarking may be specified as part of updated guidance issued by the CAA with the final method statement.

Capex

- HAL should provide all capex data in both nominal terms and in an appropriate and consistent price base as set out in Appendix A on scope, making clear the assumptions it is making on inflation (and including the basis/source for future inflation forecasts).
- Where real price effects are assumed in the capex forecasts, the assumptions should be clearly stated and the basis/source for such assumptions should be clearly explained.
- HAL should state the capitalisation policies it has adopted in its capex forecasts and, if applicable, identify, explain and quantify any changes from the capitalisation policies adopted for H7.

Total capex

- HAL should provide forecast total capex for each of the high, low and base case traffic forecast scenarios as discussed in Appendix C on traffic forecasts. Where future total capex varies across the scenarios, the assumed relationship between total capex and traffic (and/or passenger numbers) should be clearly stated and explained.
- Total capital expenditure for each year of Q6, H7 and H8 should be provided, with historical information reconciled to HAL's regulatory accounts. Actual data should be provided up to and including the 2024 financial year, forecast data should be provided for the 2025 financial year onwards.

Capex by programme, category and where appropriate scheme

- The business plan should contain detail on the overall capex portfolio and all the capex programmes within this portfolio. Each capex programme should be described in detail

including the work that has supported the development of the programme – including the needs case, strategic optioneering, estimates of efficient costs by each year and key cost drivers, outputs and consumer benefits. Also, HAL’s views on the breakdown of programme costs between “core” and “development” capex should be provided.

- Where HAL has more detailed information available (which is more likely for schemes in the early part of the H8 period) for each capital scheme in excess of £5 million total spend over the course of the scheme for which any capital expenditure is expected to be incurred during any year of H8 (including schemes currently underway or expected to start before H8 but which are expected to continue into H8), costs for each year of the scheme should be identified and a business case should be provided explaining the driver(s) and setting out the impact on capex, opex, revenues and service quality, by year. Scheme outputs should be clearly identified.
- The business plan should set out capex proposals at a sufficiently detailed level of disaggregation. For each programme/project at a sufficiently advanced stage of development, HAL should identify key categories of costs, such as:
 - leadership and logistics; and
 - risk and contingency.
- We will discuss and agree the full list of categories with HAL and airlines in advance of the publication of the final business plan guidance.

Reconciliation of individual capital scheme data to total capex forecast

- For capital schemes for which expenditure is expected to be incurred during H8 which fall below the £5 million total spend threshold for the provision of individual scheme data set out above, a narrative should be provided breaking down the overall amount of such capital expenditure in each year into appropriate headings and explaining the main sources and key drivers of such expenditure.
- For each year of the forecast period, the sum of capital expenditure on projects above and below the £5 million total spend threshold should equal the total forecast capital expenditure in that year.

General

- Please provide an assessment of the level of confidence that HAL has in the capex data, both at aggregate and disaggregated level, and a description of the steps HAL has taken to provide assurance of its forecasts.
- Evidence should be provided that alternative approaches, such as opex solutions, have been considered to achieve maximum value for money in delivering outcomes for consumers.
- HAL should clearly identify risk, contingency and efficiency assumptions in its capex proposals, both:

- at the project level; and
- at the overall level.
- HAL should explain how scheme costs have been estimated and what steps it has taken to ensure the estimated costs represent an efficient level of costs.
- HAL should identify expected outputs and benefits associated with each project. The business plan should set out how the capex programme delivers value for money, on a whole life cost basis, for customers and consumers during H8. This should include an estimation of measurable benefits.

Note: further data required to facilitate additional benchmarking may be specified as part of updated guidance issued by the CAA with the final method statement.

Cost incentives

Table F.2: Draft business plan guidance on cost incentives

Cost incentives
<p>Overall balance of incentives</p> <ul style="list-style-type: none"> • HAL should set out its views on the overall balance of incentives during H7, and how any issues around the balance of incentives should be addressed, including through changes to individual incentive mechanisms. <p>Capex efficiency incentives</p> <ul style="list-style-type: none"> • HAL should set out its views on how the <i>ex ante</i> capex efficiency framework has been operating in H7. This should include information and data on: <ul style="list-style-type: none"> • how many projects have gone through G3 in H7 to date under the new <i>ex ante</i> capex efficiency framework, and what total level of spend has been approved as part of the baseline for those projects. • how many of those projects have reached G5, and HAL’s view of whether the DOs for the projects that have reached G5 were met. If any DO adjustments need to be applied, HAL should set out the total DO-related adjustments to date; and • what percentage of the budgets for those projects relate to development (pre-G3) spend; • HAL should set out its views on any improvements it thinks should be made to the <i>ex ante</i> capex efficiency framework for H8.

APPENDIX G

Draft business plan guidance – financial issues and cost of capital

Financial issues

Table G.1: Draft business plan guidance on financial issues

Financial issues
<p>Requirement to assess financeability</p> <ul style="list-style-type: none"> • HAL should provide robust evidence that its business plan is financeable across a range of plausible scenarios. This assessment should also be undertaken with reference to the CAA's statements on financeability policy in the draft method statement, including assessing financeability on the basis of notionally efficient gearing. • We would expect HAL to examine the same credit metrics as were used in the H7 Final Proposals and Final Decision. Where HAL uses different credit metrics to those used in the H7 Final Proposals and Final Decision, the selection of credit metrics should be justified and supported by evidence. <p>Target credit rating</p> <ul style="list-style-type: none"> • In forming its assessment of whether its business plan is financeable HAL should clearly state and, with reference to its investment program, justify the credit rating that it is targeting, including for a notionally efficient level of gearing. In doing so HAL should describe the relative costs and benefits of different credit rating levels. • To the extent that HAL considers that structural and/or regulatory changes would best support the credit rating it targets in the business plan, these should be clearly stated and justified as being consistent with the interests of stakeholders. • The assessment of the targeted credit rating for each relevant scenario should consider the net impact of having a higher or lower credit rating. <p>Notional gearing</p> <ul style="list-style-type: none"> • HAL should consider the appropriate notional financial structure starting from the assumption that the notional gearing will be 60%, as was used for H7. Any change from the 60% level should be reasoned and justified with reference to evidence. • Analysis should include an evaluation of the advantages and disadvantages of different notional financial structure options developed by HAL.

Financial modelling

- Analysis of financeability should include a baseline assessment using the CAA's price control model ("PCM") on the basis of notionally efficient gearing. If assumptions are not detailed in the business plan itself, a data book detailing the rationale for the assumptions adopted in the business plan should be provided.
- HAL should discuss with the CAA any structural and formula changes required to the PCM in advance of submitting the business plan to agree a version of the PCM for HAL for use in the submission.
- If HAL also uses models other than the PCM in the business plan, they should be accompanied with commentary and analysis reconciling the results to those of the PCM.

Regulatory depreciation

- HAL should clearly state the assumptions it has made in respect of regulatory depreciation. Where the assumed regulatory depreciation differs from the expected accounting depreciation in any year, the reasons for this difference should be clearly presented and justified with reference to evidence.
- The assessment of the appropriate regulatory depreciation assumptions for the H8 period should include analysis of the impact of regulatory depreciation on the level of charges and on the RAB. In considering the impact on the RAB, HAL should assess options over a planning horizon of at least 30 years and comment on the appropriateness of the overall trend in the RAB over that period.

Tax

- HAL can propose an approach to the setting of a regulatory allowance for tax which is different to that adopted in H7. Where HAL does propose a different approach it should clearly explain the rationale for the change and justify, with reference to evidence, how this is in consumers' interests.
- The full calculation of the regulatory allowance for tax that HAL includes within its business plan should be clearly presented in Microsoft Excel. The source of all assumptions should be clearly stated.
- Whichever approach HAL adopts to determining the tax allowance included within its business plan it should also present a forecast of its tax liabilities for the H8 period assuming a notional capital structure. HAL should explain all assumptions underlying this calculation.
- Where the amount that HAL proposes in respect of the regulatory allowance for tax is different from the amount shown in its forecast of tax liabilities, HAL should explain and justify the difference.

RAB

- HAL should present a full calculation showing its view of the evolution of the RAB over the H7 period together with any adjustments which HAL considers are appropriate to be made to the opening RAB for H8.
- This calculation should reconcile to the figures presented in Appendix H of the H7 Final Decision.
- The H8 opening RAB and annual RAB roll forward figures presented in the business plan should assume that the RAB is subject to CPI or CPIH inflation as described below in this business plan guidance.

Cost of Capital

Table G.2: Draft business plan guidance on WACC

WACC
<ul style="list-style-type: none"> • HAL's proposal for the WACC should be consistent with efficient financing and its assumptions on risks and incentives. • HAL should assume a cost of capital for H8 no more than the efficient level necessary to compensate HAL for the business and regulatory risks it faces. • In estimating the efficient cost of capital for its business plan, we expect HAL to demonstrate that its cost of capital takes account of and broadly aligns with the following types of evidence: <ul style="list-style-type: none"> • the precedent from the CMA's decision on the H7 appeals and other recent regulatory decisions on the approach and estimates for components of the cost of capital. For example, we would expect HAL to provide a cost of capital that is estimated using market wide components (such as total market return and risk-free rate) that are consistent with recent regulatory publications, for example, from the water and energy sectors; • assessment of developments in calculation of the cost of capital in other regulated sectors, and the advantages and disadvantages of applying these to the HAL price controls. For example, this should include use of nominal cost of debt, cost of debt indexation, equity financeability; • an early view on the range for the cost of capital for H8 set out in FTI report, which is 3.97% to 5.30% (pre-tax, CPI/CPIH-real), based on updates to the approach and market data at H7; • market evidence on cost of capital parameters; and • information on the business risks it faces.

- We expect HAL to provide its estimate of the cost of capital and underlying calculations in a clearly presented and signposted Microsoft Excel workbook. Any data that is confidential and not for publication should be clearly identified.
- Where HAL provides cost of capital parameters and/or an overall cost of capital that do not align with some or all of the items above, we expect HAL to provide a clear and thorough explanation of why this is the case and provide compelling evidence for its proposed cost of capital.
- As set out in the 2024 Review, consistent with the approach adopted by other economic regulators, we expect to move from the RPI to CPI or CPIH indexation of the RAB at the next round of price reviews. We expect HAL to propose a change in indexation of the RAB from RPI to CPI or CPIH and to apply a consistent approach to calculation of the real WACC. It should also estimate the RPI-deflated real WACC to illustrate the comparison with H7. We expect HAL to set out how it proposes to manage the consequential impacts of this change on charges and financeability.

APPENDIX H

Our Duties

1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (AOS) are set out in the Civil Aviation Act 2012 (“CAA12”).
2. CAA12 gives the CAA a general (‘primary’) duty to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of ‘consumers’.
4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
5. In discharging this primary duty, the CAA must also have regard to a range of other matters specified in CAA12. These include:
 - the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the Better Regulation principles.
6. CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the market power test as set out in CAA12. Airport operators that do not fulfil the test are not subject to economic regulation. As a result of the market power determinations we completed in 2014, the airport operators of both Heathrow and Gatwick airports are subject to economic regulation.

7. We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

APPENDIX I

Abbreviations and Acronyms

A4A	Airlines for America
ACL	Airport Coordination Limited
AOC	Airline Operators Committee
AOS	Airport Operation Services
BPI	Business Plan Incentive
Capex	capital expenditure
CE	Constructive Engagement
CPI	Consumer Price Index
CPIH	Consumer Price Index with Housing
CMA	Competition and Markets Authority
Comrev	Commercial Revenue
DfT	Department for Transport
EU	European Union
GAL	Gatwick Airport Limited
H7	Heathrow Price Control 2022-2026
H8	Heathrow Price Control 2027-2031
HAL	Heathrow Airport Limited
LACC	London Airline Consultative Committee
MPD	market power determination
MTI	Measures Targets Incentive
NERL	NATS (En Route) Plc
OBR	Outcome based regulation
Ofgem	Office of Gas and Electricity Markets
Ofwat	Water Services Regulation Authority
ONS	Office for National Statistics

Opex	operational expenditure
ORC	Other regulated charges
PCM	Price Control Model
Q1, Q2, etc.	The first, second etc. quinquennium review periods
RAB	regulatory asset base
RORE	Return on regulatory equity
RPI	Retail Prices Index
the Act	Civil Aviation Act 2012
TRS	Traffic Risk Sharing
UKRN	UK Regulators Network
WACC	weighted average cost of capital