UK Civil Aviation Authority

H8 method statement and business plan guidance: Appendices

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Contents

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APPENDIX A

Final business plan guidance

Introduction

A1 As set out in the method statement, we are publishing this business plan guidance also on the assumption that large investment programmes related to the significant expansion of the airport should be considered in the round as part of our wider work on capacity expansion, to make sure there is a coherent regulatory package for both terminal and runway expansion.

A2 We have assumed that the business plan should focus on the operation of the two runway airport, with significant capacity expansion of terminals and the third runway to be dealt with separately. To the extent that HAL wants or needs to provide additional information on capacity expansion, it should do so separately and highlight this as additional information. HAL should separate out any impact of expansion on its H8 forecasts of costs, revenue, traffic and other building blocks.

A3 This Business Plan Guidance includes the following sections:

- scope;
- consumer engagement;
- traffic;
- service quality and resilience;
- environmental sustainability;
- costs, revenues and cost incentives;
- financial issues; and
- cost of capital.

Scope

Introduction

A4 The Draft Method Statement and Business Plan Guidance included general guidance on the form and content of HAL's H8 business plan. This was designed to help ensure that the information provided in the business plan is fit for purpose in terms of properly supporting the price control review and provides complete, well-evidenced and accurate information. It also included specific guidance on the:

- scope of the plan and 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 assumptions for inflation which should be used; and
- form and level of assurance that should be provided with the business plan as a whole.

Stakeholder views

A5 A number of airlines said that we should mandate the use of CPI as the standard price base to ensure consistency across the business plan and that use of alternative indices should be part of supplementary information.

A6 HAL's preference would be a change from RPI to CPIH, consistent with the approach in other sectors and to align with index-linked debt costs, reducing cost risks.

A7 Stakeholders raised a number of other detailed comments that related to the scope of the review: these are covered in the later sections of this guidance.

Update on our approach

A8 As set out in chapter 6, our current intention is to use CPI as the primary measure of inflation for H8. We have updated our business plan guidance to reflect this.

A9 We have not made any other changes to the business plan guidance on scope.

Draft business plan guidance on scope

General

The business plan should be:

- 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; and
- deliverable (including in respect of financeability).

Time-period

- 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.

Level of detail

- 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 assumptions for inflation

- The business plan should present all financial, cost and revenue data in nominal and consistent real prices, with real values in 2024 CPI prices.
- 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 CPI index has been used to convert data from nominal to real prices.
- 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.

Consumer engagement

Introduction

A10 Our draft guidance set out our expectation that HAL should provide evidence on consumer priorities and show how this has informed its business plan and its approach to assurance on its consumer engagement.

A11 As part of the Draft Method Statement and Business Plan Guidance, we asked for stakeholders' views on potential focus areas for future consumer research and engagement, as well as views on our approach to seeking assurance that HAL's business plan appropriately reflects all relevant and available evidence.

Stakeholder views

A12 Some airlines said we should specify the minimum information on consumer engagement that should be shared by HAL with relevant stakeholders. They requested that there be a requirement for full transparency of information, allowing for access to all relevant data and analysis underpinning the business plan. They considered that this was essential to ensure confidence in the process and that HAL's plans are based on accurate information.

A13 Some airlines also said we should provide clearer requirements for the level of explanation and justification needed from HAL if its approach is found to not fully align with the outcome of consumer engagement.

A14 HAL said that Round 4 of the Constructive Engagement process would allow the CAA to engage with a range of stakeholders to test the business plan, and that this should be supplemented by community engagement and future engagement with the Heathrow Passenger Forum.

Update on our approach

A15 We agree HAL should be transparent in providing all relevant evidence and information used to inform its business plan to us and to stakeholders. We have added a bullet point to the business plan guidance to clarify our expectation on this. We also encourage airlines to make available any of their own, or third-party, consumer research which they consider may be informative to HAL, the CAA and where relevant other stakeholders.

A16 HAL should also highlight any gaps or inconsistencies between the consumer research and its business plan together with the likely implications of these gaps or inconsistencies. We have added a bullet point to the business plan guidance to clarify our expectations in relation to these matters.

Final business plan guidance on consumer engagement

General

- 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 Constructive Engagement). 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.
- HAL should share with airlines, the CAA and other interested stakeholders, all relevant underlying information in relation to the consumer engagement and research activities which have been used to inform its business plan. It should make clear where and how this information has been taken into account.

Approach to consumer engagement

- 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 designed 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:
    - 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
    - follow 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 HAL 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.
- Part of the outcome of HAL's assurance activities should be the provision of information within its business plan which clearly allows CAA to identify the extent to which it has appropriately drawn on all available and relevant consumer research to identify consumer priorities and to align the content of its business plan submission with these priorities.

Traffic

Introduction

A17 The Draft Method Statement and Business Plan Guidance on the area of 'Traffic', alongside engagement between HAL and airlines as part of the Constructive Engagement process, was intended to support an improved process of setting passenger traffic forecasts for H8. 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.

A18 Our draft guidance on traffic in respect of HAL's traffic forecasts specified that:

- HAL and airlines should try to reach a joint view on a reasonable range of forecasts for the H8 period;
- HAL should include traffic scenarios in its business plan and show how these are integrated with the wider plan; and
- HAL should consider whether there is scope for improving TRS arrangements and to make proposals for updating the calibration of the existing TRS mechanism for H8.

A19 As part of the Draft Method Statement and Business Plan Guidance, we asked stakeholders if they agreed that the factors we had identified are those which reflect the key issues that HAL should take account of in developing the H8 traffic forecast.

Stakeholder views

A20 In its response, BA highlighted the importance of HAL presenting its traffic scenarios in a way that allows the CAA's consultants to scrutinise them properly and critically evaluate them so that they might develop an independent traffic forecast.

A21 The AOC/LACC welcomed the approach of HAL using scenarios, which it considered will be important in understanding varying volume effects on individual ‘building blocks’, and the business plan more generally. It considered that ensuring those clear linkages will be critical in supporting a high quality business plan.

A22 It also asked for more information on how the CAA has identified the factors and the extent to which these will have a bearing on its own, independent assessment. It was noted that long term airline capacity growth plans are an important factor in Heathrow’s traffic forecast and should be considered by HAL as part of its traffic forecast.

A23 HAL and airlines commented in response to the draft method statement that we should consider the balance and calibration of the current TRS.

Update on our approach

A24 We continue to support the use of scenarios and HAL should provide sufficient detail to allow for these to be properly scrutinised. We have added a bullet point to the final business plan guidance to make clear the information and assumptions used to develop these scenarios.

A25 Our consultants, Steer will engage with HAL and the airlines in due course in relation to its work to develop an independent traffic forecast and relevant factors can be considered as part of this engagement. The business plan guidance has been updated to clarify that the identified factors are ‘indicative’ and will be clarified and agreed in due course.

A26 We have not made any change from the Draft Method Statement and Business Plan Guidance in respect of the TRS mechanism, but we have added guidance to request that HAL provides evidence that the TRS mechanism provides a balanced set of risks and provides benefits to consumers.

Final business plan guidance on traffic

Traffic forecast

- 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 Constructive Engagement 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.
- HAL should provide sufficient detail to allow for its traffic scenarios to be properly scrutinised and understood. It should make clear the information and assumptions used to develop these scenarios and make these available where possible subject to commercial confidentiality.

Traffic scenarios

- Jointly agreed scenarios should take account of a range of factors, which should be discussed and agreed between HAL, airlines and the CAA’s independent consultants. Indicative factors, which should be clarified and agreed in due course, could include:
  - 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 and long-term airline capacity growth plans.
- 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.

Traffic risk sharing ("TRS")

- 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.
- HAL should provide evidence to show that the TRS mechanism provides a balanced set of risk protection and provides benefits to consumers.

Service quality and resilience

Introduction

A27 The Draft Method Statement and Business Plan Guidance said that HAL's business plan should set out proposals to update the service quality Outcomes and the Measures, Targets and Incentives ("MTI") scheme framework. Updates should be supported by evidence and include links between the business plan and consumer research and engagement undertaken by HAL and airlines.

A28 We said the business plan should set out how HAL will maintain and improve operational resilience and how this would relate to service quality outcomes and the MTI scheme. We noted that operational resilience would continue to be important in H8 as passenger traffic levels had returned to over 80 million per year and HAL plans to maximise use of the existing runway and terminal capacity. We also said that the business plan should set out how any surface access improvements would contribute to resilience.

A29 We asked stakeholders if they agreed with:

- our proposed approach to update the existing Outcomes and MTI framework and that HAL should take account of both its own and airlines' consumer research and engagement in developing its business plan; and
- the guidance for resilience covering operations and assets being adequate to address the planned growth in H8 within the existing airport capacity.

Stakeholder views

A30 HAL agreed with our overall approach, the need for its business plan to outline how to maintain and improve operational resilience, as well as ensuring there is consideration for passenger and airline insights to support the development of the MTI scheme. It said there was a need to adequately benchmark and reflect the emerging view on H8 priorities from Constructive Engagement.

A31 BA said there should be more specific resilience guidance to show how runway, terminal and airfield infrastructure would cope, adapt and recover quickly from disruption with a view to reducing the likelihood of such events, mitigating their impact and increasing recovery.

A32 The LACC/AOC said it was important that HAL demonstrate it is taking into account feedback from airlines on changes to the MTI scheme, to avoid undue reliance on just its own consumer research. It said the business planning guidance should reflect this.

A33 The LACC/AOC said the resilience objectives should be to: reduce/avoid on the day cancellations; reduce missed bags; and support the return to normal operations during disruption. It said specific consideration should be given to baggage, flow and airfield performance as underpinning drivers for these objectives.

Update on our approach

A34 We have discussed HAL's suggestion that the outcomes and MTI framework should reflect a more "collective approach" to service quality in chapter 5 of the final method statement. The business planning guidance has been amended so that HAL considers "comparator airport service quality measures" in developing its Business Plan.

A35 We have also amended the guidance to reflect that HAL needs to demonstrate how it has taken into account airlines' feedback and consumer research and engagement, as outlined in the method statement.[1]

A36 We note BA's views on resilience and the need for the business plan to demonstrate how the airport recovers from disruption. This is addressed on an ongoing basis by Service Quality Condition D2 in the Licence, which outlines the requirement for the HAL to publish resilience plans. We have also amended the business planning guidance to include a requirement for HAL to set out an assessment of resilience in H7 and how the business plan will contribute to increase resilience levels during H8.

A37 In the final guidance below, we have also made changes to provide further clarity on two important matters:

- special assistance and PRMs: as discussed during Round 1 of Constructive Engagement, HAL should consider how special assistance for passengers is reflected in the MTI scheme; and
- in response to the NATS Independent Review recommendations,[2] we have said that HAL should consider whether a consumer resilience plan to deal with major disruptions could be introduced.

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1 See CAP3044, chapter 4, para 4.15.

2 See CAP2993 Independent Review of NATS (En Route) Plc's Flight Planning System Failure on 28 August 2023 Final report, Chapter 3, para 3.23. It included a recommendation for CAA to "*consider whether major airports should develop a consumer resilience plan which identifies risks, contingencies and mitigations to deal with major disruptions*" (Recommendation 27).

Final business plan guidance on service quality and resilience

Service quality

General

- 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, including those passengers requiring assistance, while supporting the business plan priorities.
- Updates should take into account any HAL and airline consumer research and engagement 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.

Approach to Outcomes and MTI scheme framework review and updates

- 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, feedback from airlines and other developments in the sector including comparator airport service quality measures. It should also demonstrate the links between service levels and value for money, and remain responsive to consumers' and airlines 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, including those passengers requiring assistance, 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, special assistance services, 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.
- Where HAL has discussed and agreed KPIs with airlines or other airport users, it should set out details of these arrangements and how these are taken into account in proposed MTI updates.
- 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:
    - an assessment of operational and asset resilience in H7 and how the business plan will contribute to the maintenance, improvement and increase of resilience levels in H8;

- whether any new measures, increased financial incentives or changes to incentives are necessary as part of the MTI scheme with supporting evidence;
- 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; and
- what consumer resilience plans are already in place and what additional planning is needed.

Environmental sustainability

Introduction

A38 This section covers our business plan guidance on environmental sustainability, updated to reflect stakeholder feedback that we received in response to the draft guidance.

Stakeholder views

A39 Stakeholders supported new guidance in this area, which sets out the information and evidence that we expect from HAL's business plan on environmental targets and investment.

A40 We received some specific comments on the Draft Method Statement and Business Plan Guidance for example:

- Heathrow Strategic Planning Group (a local authority group) suggested that our guidance should cover wider environmental issues such as noise, air quality and indicators of nature positively;
- HAL said that:
  - our guidance should better reflect any legislation or policy decisions on net zero, and
  - a more streamlined capex governance process is needed for capex projects that support the transition to net zero, reflecting the importance of these projects;
- Airlines made some specific comments including that our guidance should:
  - include clear definitions of environmental performance and targets, and
  - require HAL to demonstrate how it will enable the sector to work together to achieve sustainability outcomes, for example how it will enable airlines to meet their own net zero targets by reducing emissions through operational improvements and enhanced resilience;
- the AOC/LACC suggested that HAL should clearly set out where it is complying with legal or regulatory objectives as well as where it is seeking to push beyond these obligations, either in terms of scale and/or delivery timescales.

Update on our approach

A41 HAL has several long-standing obligations it must meet on environmental matters, for example on water course protection, air quality and noise mitigation.

We consider that this ongoing activity has been built into HAL's business planning for several years so does not warrant new guidance. HAL should continue to reflect these wider environmental activities in its forecast operating costs and capex plans (see guidance on costs later in this appendix).

A42 Our guidance here focuses on HAL's plans to transition to net zero. An important part of HAL's business plan will be its how it will make appropriate progress with its transition to net zero in the H8 period.

A43 We have also made some changes to the guidance to reflect comments from stakeholders, for example on environmental obligations and cross-sector working.

Final business plan guidance on environmental sustainability

Environmental sustainability: transition to net zero

- 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.
    - 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 the overarching statutory environmental obligations (in relation to net zero) that it has considered when developing its plan for H8. HAL should clearly demonstrate whether it plans to meet these statutory obligations or whether it plans to go beyond them.
    - HAL should demonstrate how it plans to work with stakeholders at the airport to support the sector to achieve sustainability outcomes.
    - HAL should clearly set out 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:
    - its environmental objectives and targets to transition to net zero. For example, HAL should consider whether:

(i) the proposed H7 reputational measure relating to Heathrow's carbon footprint remains appropriate for H8; and

(ii) new environmental objectives could be included under the MTI framework.

- its plans for investment to support its transition to net zero:

(i) 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;

(ii) 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

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

- In terms of the capex incentive framework and HAL-airline governance arrangements, if HAL considers that a bespoke approach to capex efficiency is important and justified for sustainability investments, it should propose this as part of its H8 business plan so that we can carefully consider this as part of our initial proposals. We expect to see evidence that HAL has worked together with airlines to agree any bespoke arrangements and HAL will need to demonstrate that the proposed approach does not compromise the overarching criteria of investment being well evidenced and justified.
- Further business plan guidance on capex is set out under the 'costs, revenues and capex incentives' section of this appendix.

Costs, revenues and cost incentives

Introduction

A44 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 building blocks, including by allowing us to carry out benchmarking and bottom-up assessment of these costs and revenues where appropriate. Providing details of costs and revenues at the prescribed level of detail should also support the Constructive Engagement process and HAL's engagement with wider stakeholders on these matters.

A45 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 will facilitate the CAA's assessment of the effectiveness of capex efficiency incentives in H7, with a view to making improvements for H8.

A46 This section updates the guidance on costs, revenues and cost incentives for H8, with detailed business plan guidance set out in Table A.6 below.

Stakeholder views

A47 The AOC/LACC and BA noted that the breakdown of opex available in the current regulatory accounts lacks granularity in several critical areas, which impedes meaningful analysis and benchmarking. They proposed that 'people costs' be broken down into 'security', 'operational', 'non-operational', 'pensions', and 'consultancy', with 'security' costs further split between 'passenger security' and 'security control posts'. They also proposed that 'other operating costs' be broken down into 'airfield management', 'cleaning', 'baggage system maintenance', and 'building management'.

A48 These stakeholders went on to recommend that the business plan provides information on key external contracts, giving as examples contracts with NATS, UK Power Networks and consultancy and, where applicable, evidence of market testing should also be included. The AOC/LACC and BA also said that the guidance should require enhanced disclosure of any opex and revenue items where HAL is proposing substantial deviations from historical performance to allow for appropriate understanding and scrutiny (for example, business rates).

A49 On commercial revenues, airlines (AOC/LACC and BA) were of the view that the breakdowns in the regulatory accounts were generally acceptable but property-related revenues required further granularity by specific development project to allow for further assessment of property yields, identify asset where performance was suboptimal and adopt appropriate remediation.

A50 The AOC/LACC and BA also said that the business plan guidance should mandate CPI as the standard price base and require that analysis using different indices to be presented as supplementary information, rather than replacing the standard CPI-based analysis. They argued that this approach would ensure consistency across different elements of the business plan and enable meaningful comparisons over time.

A51 They went on to say that the guidance was unclear about the treatment of real price effects ("RPEs") and efficiency assumptions and suggested that the guidance should require HAL to explicitly separate: (i) base cost projections; (ii) pure inflation effects using CPI; (iii) any real price effects; (iv) efficiency assumptions; and (v) other adjustments.

A52 They also expressed concerns about the absence of any requirement for HAL to set out its assumptions on ongoing efficiency (also known as 'frontier shift') for opex and commercial revenues (also known as 'management stretching'), while there were multiple references to RPEs assumptions. They said that the CAA should seek independent advice on an appropriate assumption for ongoing efficiency.

A53 BA said that the capex estimates should be broken down by project and to a level of detail that allows the CAA to understand and benchmark key cost drivers. The AOC/LACC and BA went on to say that the breakdown of capex for each project should also identify the amount covering 'risk', 'leadership and logistics', and 'programme costs'.

A54 The AOC/LACC and BA noted that the guidance did not set a requirement for HAL to demonstrate the opex and revenue improvements expected in H8 as a result of investments made in H7. They gave the example of the purchase of the Compass Centre (post H7 settlement), which, in their view, should lead to material reductions in opex in H8. They also noted the case of the Next Generation Security programme, which is being delivered in H7 and is expected to reduce opex in H8.

A55 HAL did not make any explicit comment regarding the draft business plan guidance on costs and revenues assessment.

Update on our approach

A56 For opex and revenues, we are publishing a set of Excel-based data tables as part of our method statement and business plan guidance. These give HAL further clarity about the form, contents and granularity of information we expect to see in the H8 business plan and in reporting of information during the remainder of H7 and the H8 period. We expect HAL to populate these data tables and submit them to us alongside its business plan. We also expect HAL to ensure that the same level of data granularity is adopted as a minimum in any opex and revenue information provided alongside its H8 business plan, including modelling suites. The level of granularity requested in the data tables mostly aligns with the regulatory accounting guidelines, which were issued in 2015. We request some further data breakdowns by exception and where we see greatest benefits to consumers from more detailed assessment (for example, in maintenance costs and retail concessions revenue).

A57 The opex and revenue data tables and the business plan guidance also provide further clarity on the information that we expect to see regarding price bases, assumptions related to RPEs and assumptions about ongoing efficiencies.

A58 For capex, we have expanded the guidance to further detail the type and granularity of information that we expect to see for each capex project planned for H8. We expect Round 2 of Constructive Engagement to give us a better understanding of the size, composition, and key choices around HAL's H8 capex envelope. We will consider if data tables are also appropriate for capex, following the Round 2 of Constructive Engagement, and we would share any such tables with HAL by April 2025 to inform HAL's business plan and therefore discussions in Round 3 of Constructive Engagement.

Final business plan guidance on costs, revenues and cost incentives

Opex

- Opex for each year of Q6, H7 and H8 should be provided, split by each category of opex set out in the opex and revenues data tables. 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 set out in the opex and revenues data tables, this should be discussed and agreed with the CAA prior to submission of the business plan.
- HAL should provide all opex data in both nominal terms and in real terms. Real values should be presented in 2024 prices using the Consumer Price Index ("CPI") for the 12 months ending 31 December 2024.
- We expect HAL to explain the assumptions it makes on inflation and to document in the business plan the basis/source for future inflation forecasts.
- As set out in the opex and revenue data tables, opex forecasts should be provided as follows:
    - For each of the "high", "low" and "base" case traffic forecast scenarios discussed in the Traffic section of this guidance;

- Before and after real price effects[3] and ongoing efficiency[4] assumptions;
- Where real price effects are assumed in the opex forecasts, the index alternative to CPI assumed in the opex forecasts should be used consistently across the forecasts of the item it applies to, the assumptions should be clearly stated, and the basis/source for such assumptions should be clearly explained; and
- Where ongoing efficiencies are assumed in the opex forecasts, the assumptions should be clearly stated and the basis/source for such assumptions should be clearly explained.

- The opex and revenues data tables specify a base level of cost information that HAL should provide to us as part of the H8 process. We expect HAL to 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 opex data. Examples of further information include:
  - Stating what is included in each cost item; when categorisation has changed and in what way; when changes from outsourcing to in-house or vice-versa have happened; and which cost items were impacted by these changes.
  - Evidence that cost projections are robust and efficient. For example, we expect costs to have been benchmarked or market tested. For third party contracts and outsourcing contracts, we expect to see evidence of competitive tendering.
  - Explanation and evidence supporting the assumptions used in opex forecasts.
  - Where future opex (either in aggregate or for individual opex elements) varies across the traffic scenarios, the assumed relationship between opex and traffic (and/or passenger numbers) should be clearly stated and explained.
  - Explanation of how the opex forecasts take account of past performance and assumptions about future operational efficiency gains from past capex investments.

3 Real price effects account for HAL's exposure to input price inflation that differ from general price inflation, as measured by CPI

4 Ongoing efficiency (also known as 'frontier shift') accounts for cost savings owing to improvements in HAL's productivity as a result of adopting new technologies and new ways of working so that it emulates overall productivity improvements that we see elsewhere in the economy.

- Evidence that opex forecasts are consistent with planned capital investment. HAL should quantify the impact on opex of any changes it is proposing to its capitalisation policy.
- Evidence that opex forecasts are linked to anticipated operational activity (for example, increased use of a particular terminal by passengers) and changes in service quality during the H8 period.

- Further opex information may be required following business plan submission to facilitate additional assessment and benchmarking.

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 the opex and revenues data tables, 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.
- If HAL considers any alternative categorisation of revenues to be appropriate for H8 to that set out in the opex and revenues data tables, this should be discussed and agreed with the CAA before submission of the business plan.
- HAL should provide commercial and other revenue data in both nominal terms and in real terms. Real values should be presented in 2024 prices using the Consumer Price Index ("CPI") for the 12 months ended 31 December 2024.
- We expect HAL to explain the assumptions it makes on inflation and to document in the business plan the basis/source for future inflation forecasts.
- As set out in the opex and revenue data tables, commercial and other revenue forecasts should be provided as follows:
  - for each of the high, low and base case traffic forecast scenarios discussed in the Traffic section of this guidance;
  - before and after real price effects[5] and management stretch[6] assumptions;
  - where real price effects are assumed in the commercial and other revenue forecasts, the index alternative to CPI assumed should be used consistently across the forecasts of the item it applies; the assumptions should be clearly

[5] Real price effects account for HAL's exposure to input price inflation that differ from general price inflation, as measured by CPI.

[6] Management stretch (also known as 'management challenge') reflects the improvement in HAL management's ability to increase revenue over and above the increase in revenue drivers.

stated; and the basis/source for such assumptions should be clearly explained; and

    - where management stretch challenge is assumed in the commercial and other revenue forecasts, the assumptions should be clearly stated and the basis/source for such assumptions should be clearly explained.

- The opex and revenues data tables specify a base level of revenue information that HAL should provide to us as part of the H8 process. We expect HAL to 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 commercial and other revenue data. Examples of further information include:
    - Stating what is included in each revenue item and when categorisation has changed and in what way and which revenue items were impacted by these changes.
    - Explanation and evidence supporting the assumptions used in commercial and other revenue forecasts. The key driver(s) of each line item of commercial revenues should be identified, with the relationship between those drivers and the commercial revenues clearly specified.
    - Where future commercial revenue varies across the traffic scenarios, the assumed relationship between the commercial revenue item and traffic (and/or passenger numbers) should be clearly stated and explained.
    - Evidence that commercial revenue forecasts are consistent with planned capital investment.
- Further commercial and other revenue information may be required following business plan submission to facilitate additional assessment and benchmarking.

Other Regulated Charges (ORCs)

- ORCs for each year of H7 and H8 should be provided, split by each Specified Facility set out in the opex and revenues data tables, and split between direct costs, allocated costs and annuity.
- Direct costs, allocated costs and annuity for each Specified Facility should each be further broken down into airline amounts and non-airline amounts, for each year of H7 and H8. This level of detail is necessary to assess alternative potential options for the recovery of ORC costs in 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.
- An explanation of the assumptions used to develop ORC forecasts, including the key drivers of future costs for each Specified Facility, the basis for calculation of direct

costs, allocated costs and annuity, 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.
- Further ORCs information may be required following business plan submission to facilitate additional assessment.

Capex

Price base, real price effects and ongoing efficiency

- HAL should provide all capex data in both nominal terms and in real terms. Real values should be presented in 2024 prices using the Consumer Price Index (CPI) for the 12 months ended 31 December 2024.
- We expect HAL to explain the assumptions it makes on inflation and to document in the business plan the basis/source for future inflation forecasts.
- Where real price effects[7] and ongoing efficiency[8] are assumed in the capex forecasts, the assumptions should be clearly stated and the basis/source for such assumptions should be clearly explained.
- Capex forecasts should be provided before and after real price effects and ongoing efficiency assumptions.
- 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

- As set out at the start of this business plan guidance, the business plan should focus on the operation of a two runway airport and capex related to significant capacity expansion of terminals and the third runway will be dealt with separately.
- 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 included the 2024 financial year: forecast data should be provided for the 2025 financial year onwards.

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7 Real price effects account for HAL's exposure to input price inflation that differ from general price inflation, as measured by CPI.

8 Ongoing efficiency (also known as 'frontier shift') accounts for cost savings owing to improvements in HAL's productivity as a result of adopting new technologies and new ways of working so that it emulates overall productivity improvements that we see elsewhere in the economy

- HAL should provide forecast total capex for each of the high, low and base case traffic forecast scenarios as discussed in the Traffic section of this guidance. 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.

Capex by category and by project

- The business plan should contain detail on the overall capex portfolio and all the capex projects within this portfolio.
- The business plan should include HAL's views on the breakdown of project costs between "core" and "development" capex.
- Each capex project should be described in detail including the work that has supported the development of the project. For each capex project, we expect to receive the following information:
    - Evidence that the investment is required ('need case').
    - Evidence that the investment does not overlap or duplicate capex projects already under way.
    - Evidence that an appropriate number of options was considered, including 'do nothing' and opex solutions ('optioneering'), showing how the best and most efficient options have been selected.
    - Indication of expected outputs and benefits for consumers 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.
    - Expected impacts on opex savings and/or revenue increases.
    - Cost disaggregation by key drivers of costs with indication of cost and design maturity. For each project at a sufficiently advanced stage of maturity, HAL should identify key categories of costs, including:

      (i) Direct project costs, with further breakdown at a sufficiently detailed level of disaggregation;

      (ii) 'leadership and logistics' mark-up;

      (iii) 'risk and contingency' mark-up; and

      (iv) other mark-ups.
    - HAL should explain how project costs have been estimated and what steps it has taken to ensure the estimated costs represent an efficient level of costs. We expect to see evidence that the costs estimates are efficient by, for example:

(i) using similar scheme outturn data as benchmarks;

(ii) industry and/or external cost benchmarking;

(iii) third party assurance of the robustness of cost estimates; and/or

(iv) evidence that costs have been market-tested.

- For projects in excess of £5 million total spend over the course of the project for which any capital expenditure is 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), in addition to the individual project data set out above, we expect to see the following information:
  - costs for each year of the project;
  - a business case explaining the driver(s) and setting out the impact on capex, opex, revenues and service quality, by year; and
  - clear identification of project outputs.
- For capital projects for which expenditure is expected to be incurred during H8 which fall below the £5 million total spend threshold, in addition to the individual project data set out above, we expect to see a narrative 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.

Reconciliation of individual capital project data to total capex forecast

- 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

- The business plan should contain an assessment of the level of confidence that HAL has in the capex data, both at aggregate and at project 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.
- We will consider if it is necessary developing data templates for capex following the Round 2 of constructive engagement by April 2025, building on the information shared

at the Round 2 of Constructive Engagement. Further capex information may be required following business plan submission to facilitate additional assessment and benchmarking.

Cost incentives

Overall balance of incentives

- 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.

Capex efficiency incentives

- HAL should set out its views on how the *ex ante* capex efficiency framework has been operating in H7. This should include information and data on:
    - how many projects have gone through G3 in H7 to date under the new ex ante 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 ex ante capex efficiency framework for H8.

Financial issues

Introduction

Financeability and gearing

A59 In the Draft Method Statement and Business Plan Guidance, we stated that HAL should start from the assumption of a notional gearing level of 60% and any change from this level should be justified. We also stated that HAL should consider the advantages and disadvantages of different notional financial structures.

A60 The Draft Method Statement and Business Plan Guidance also stated that HAL should provide robust evidence that its business plan is financeable across a range of plausible scenarios: this should be consistent with our statements in the Draft Method Statement and Business Plan Guidance which would include HAL assessing its financeability on the basis of notionally efficient gearing.

Target credit rating

A61 The Draft Method Statement and Business Plan Guidance stated that we would expect HAL's business plan to examine the same credit metrics as we used for the H7 Final Proposals and Final Decision. We also said that, where HAL uses different credit metrics from those used in the H7 Final Proposals and Final Decision, the selection of credit metrics should be justified and supported by evidence.

A62 It also stated that:

- HAL should justify, with reference to its investment program, the credit rating that it is targeting and 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; and
- the assessment of the targeted credit rating for each relevant scenario should consider the net impact of having a higher or lower credit rating.

Financial modelling

A63 The Draft Method Statement and Business Plan Guidance stated that the assumptions HAL uses for its financial modelling should be detailed in the model itself or in a related data book. It proposed requiring HAL to discuss any proposed changes to the PCM with us in advance of submission of the business plan. Finally, we proposed that, if HAL uses another model in addition to the

PCM, then HAL should provide a reconciliation between the results of the two models.

Regulatory depreciation

A64 The Draft Method Statement and Business Plan Guidance said that HAL should clearly state the assumptions it makes 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 by evidence.

A65 It also required HAL to assess in its business plan the impact of regulatory depreciation on the RAB and the level of charges. This should be conducted over a planning horizon of at least 30 years and include commentary about the overall trend in the RAB over that period. This guidance was in the context of a two runway airport and before the Government's recent announcement supporting capacity expansion and the development of a third runway at Heathrow.

Corporation tax

A66 The Draft Method Statement and Business Plan Guidance left it open for HAL to follow the same approach used in H7 or to propose a different approach to setting the allowance for tax. We required that, where HAL proposes a different approach, it should clearly explain the rationale for the change and provide evidence to justify how this is in consumers' interests.

A67 We also required that HAL's business plan include an excel spreadsheet version of its tax allowance calculation. The Draft Method Statement and Business Plan Guidance also required HAL to present a forecast of its tax liabilities for the H8 period assuming a notional capital structure. Finally, we proposed that, where HAL's suggested a tax allowance different from the forecast tax liability, the difference should be explained and justified.

The RAB

A68 The Draft Method Statement and Business Plan Guidance stated that HAL should provide the calculation of the RAB in its business plan and index the RAB to either CPI or CPIH.

The treatment of and compensation for traffic risk

A69 Although the Draft Method Statement and Business Plan Guidance included guidance on the TRS, it did not refer specifically to the treatment of and compensation for traffic risk.

Stakeholder views

A70 In respect of the credit rating that we should consider in our financeability assessment, HAL suggested that an A- rating would be required to deliver the necessary investment in H8. HAL also explained that the CAA should target a BBB+ credit rating in the financeability assessment of the notional company[9] and use FFO/debt as the primary credit metric.

A71 HAL supported our intention to use 60% as the level of gearing in our modelling of the notional entity.

A72 Airline and other respondents did not comment on the specifics of the draft guidance in respect of financeability assessment.

A73 No substantive comments were made in response to our draft guidance in respect of regulatory depreciation.

A74 Stakeholders did not comment on the draft guidance in respect of tax.

A75 We received views from stakeholders on our approach to the RAB framework and indexation, though not on the specific wording of the guidance.

A76 We did not receive any comments on the treatment of and compensation for traffic risk.

Update on our approach

A77 We note the need to ensure that the financeability assessment allows the notional company to raise the capital that would be required to fund the investment program. At this point, the scale of the investment program is uncertain, so it would be premature to specify a particular credit rating that HAL should target in its business plan. We therefore do not propose to change the business plan guidance in respect of credit ratings.

A78 We are also not making any changes to the guidance on financeability, gearing and financial modelling, or regulatory depreciation and tax.

A79 As set out in chapter 6 of the method statement, our current intention is to use CPI as the primary measure of inflation for H8. We have updated our business plan guidance to reflect this. We do not propose any other changes to the business plan guidance in respect of the RAB.

A80 We have added guidance to HAL on evidence it should provide on compensation for traffic risk. Although we do not see a strong case for a fundamental reconsideration of the compensation for traffic risk, we consider that it will be important for HAL to clearly specify in its business plan whether it has included an asymmetric risk allowance and/or an adjustment to the WACC to reflect the impact of the TRS mechanism and how it has calibrated these allowances. We

9 HAL have previously argued that HAL's financial structure benefits from a one notch uplift due to the various credit protections it entails. Consequently, HAL argue, a BBB+ rating for the notional entity is equivalent to an A- credit rating for the actual entity.

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also expect it to be clear from HAL's business plan how it has applied the TRS mechanism under alternative traffic scenarios.

Final business plan guidance on financial issues

Financial issues

Requirement to assess financeability

- 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 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 from those used in the H7 Final Proposals and Final Decision, the selection of credit metrics should be justified and supported by evidence.

Target credit rating

- 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 better support the credit rating it targets in the business plan, these should be clearly stated and justified as being consistent with the interests of consumers.
- The assessment of the targeted credit rating for each relevant scenario should consider the net impact of having a higher or lower credit rating.

Notional gearing

- 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.

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- 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 from 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 inflation, as described in this guidance.

The treatment of and compensation for traffic risk

- We expect HAL to clearly specify in its business plan whether it has included an asymmetric risk allowance and/or an adjustment to the WACC to reflect the impact of the TRS mechanism, how it has calibrated these allowances and why these are in the interest of consumers.
- We also expect it to be clear from HAL's business plan how it has applied the TRS mechanism under alternative traffic scenarios.

Cost of capital

Introduction

A81 The Draft Method Statement and Business Plan Guidance stated that we expect HAL to take into account the guidance that we provided based on initial analysis by FTI Consulting in its business plan.

Stakeholder views

A82 Stakeholders did not provide views regarding how we should update the business plan guidance for HAL in respect of the cost of capital.

Update on our approach

A83 We consider that it will be important for HAL to ensure that its approach to the issues that have been raised by stakeholders in respect of the Draft Method Statement and Business Plan Guidance is clear when presenting its estimate of the cost of capital in its business plan.

A84 We therefore expect HAL to set out how it has approached issues around the estimation of the equity beta, the allowed cost of debt and HAL's actual cost of debt in its business plan. We have added these requirements to the final guidance below.

A85 We note that HAL has already provided substantial detail in respect of several of these issues in its response to the Draft Method Statement and Business Plan Guidance.

Final business plan guidance on WACC

WACC

- 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:
    - 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/CMA 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 HAL's price control. 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 the FTI Consulting report, which is 3.97% to 5.30% (pre-tax, CPI/CPIH-real), based on updates to the approach and market data used for H7;
- market evidence on cost of capital parameters; and
- information on the business risks it faces.

- In respect of the equity beta, we expect HAL to make clear:
  - the choice of comparators;
  - the basis for comparator equity beta estimation, including the period over which the beta is estimated; data frequency; whether net or gross debt has been used to estimate comparator gearing levels; the stock market index used; and whether trailing averages have been used where appropriate.
  - an assessment of the relative risk of comparator airports compared with Heathrow;
  - the impact of the capacity constraint at Heathrow, in addition to any capacity constraints it identifies at comparator airports;
  - the impact of any Traffic Risk Sharing arrangements for HAL that it includes in its business plan on the asset beta.
- In respect of the cost of debt, we expect HAL to make clear:
  - the notional gearing level used to estimate the cost of capital, and why this is appropriate;
  - the inflation forecasts that have been used to deflate the nominal cost of debt (if applicable);
  - detail in respect of how any issuance and liquidity costs have been estimated;
  - assumptions it is making and its approach to index linked debt.
- In respect of HAL's actual cost of debt, we expect HAL to provide information on its debt securities, including its foreign currency bonds and swap instruments. In respect of its Class A and Class B bonds, this should include:
  - the instrument's International Securities Information Number (ISIN);
  - the date of issuance;

  - the maturity date;
  - the currency denomination;
  - the coupon rate;
  - whether there are any embedded options, and what kind; and
  - whether the debt instrument is an amortising or bullet bond.
- 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.
- We expect to move from the RPI to CPI indexation of the RAB for H8. We expect HAL to propose a change in indexation of the RAB from RPI to CPI 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 any consequential impacts of this change on charges and financeability.

APPENDIX B

Further guidance on areas to consider at Initial Proposals: cost of capital

B1 To provide further guidance to stakeholders in respect of our approach to the cost of capital, we have set out a non-exhaustive list of issues that we will consider at Initial Proposals below, grouped by parameter.

Notional gearing:

- which considerations are relevant in determining the level of notional gearing; and
- whether there is a justification for changing the level of notional gearing.

Risk free rate:

- which reference instrument should be used to estimate the risk free rate – for example, index-linked gilts or AAA-rated corporate bonds;
- whether an adjustment is needed to reflect a "convenience yield" such as that proposed in the Diamond and Van Tassel (2021) paper;
- whether to place weight on a framework that supposes different lending and borrowing rates such as that proposed in the Brennan (1971) paper; and
- how to reflate RPI-linked instruments to a CPI basis.

TMR:

- whether to place weight on *ex post*, *ex ante* and/or forward-looking approaches when estimating the TMR;
- which inflation series and averaging technique should be used to estimate the *ex post* and *ex ante* TMR;
- which approaches to use when estimating the *ex ante* TMR (for example, the decomposition and Fama French approaches, respectively);
- whether to introduce adjustments to reflect differences in averaging approaches, differences in the inflation series used and/or serial correlation when estimating the *ex ante* TMR; and
- whether and how to reflect historical movements in the risk free rate.

Equity beta:

- which comparators should be used;

- how to estimate comparator equity and asset betas;
- whether comparators are exposed to a different degree of systematic risk relative to HAL, and to what extent;
- whether it is appropriate to apply an adjustment to reflect investor expectations of future pandemics, and, if so, how such an adjustment should be applied;
- whether the TRS arrangements in H8 affect the level of the equity beta, and to what extent; and
- whether there is an impact of de-levering and re-levering comparator equity betas to the assumed level of notional gearing, and the implications of any such impact.

Cost of debt:

- whether the cost of embedded debt should be based on HAL's actual cost of debt or a notional index;
- where an estimate is based on HAL's actual cost of debt, what the appropriate scope should be in terms of securities that should be included in the assessment (for example, Class A debt, Class B debt, currency swaps and inflation swaps);
- where an estimate is based on a notional index, the index that should be used, and what adjustments to the index should be applied;
- whether we should set a nominal cost of debt and only index the proportion of the RAB corresponding to equity and index-linked debt;
- how we should estimate the proportion of the RAB corresponding to index-linked debt;
- how we should estimate the CPI-real cost of index-linked debt;
- whether to apply an adjustment to compensate for basis risk (the risk that the wedge between RPI and CPI/CPIH is different than forecast), and how this should be estimated, if relevant;
- how we should estimate the proportion of new debt;
- what the level of the allowance should be in respect of issuance costs in H8;
- what the level of the allowance should be in respect of the cost of liquidity facilities in H8; and
- what the level of the allowance should be, if any, in respect of cost of carry in H8.

APPENDIX C

Data tables on opex and revenues

C1 We have published a set of Excel data tables as an appendix to the H8 method statement and business planning guidance. We request that HAL populates these opex and revenue data tables and submits the populated tables to us alongside their business plan.

C2 HAL should adopt this level of data granularity as a minimum in any opex and revenue information submitted in its H8 business plan.

C3 HAL should refer to the Business planning guidance for more details about further explanation and supporting evidence we expect to see in the documentation accompanying the business plan.

C4 The data tables were developed to be compliant with Excel best practice (so called FAST standards), hence the colour coding and structure.

APPENDIX D

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 E

Abbreviations and Acronyms

A4A	Airlines for America
ACL	Airport Coordination Limited
AOC	Airline Operators Committee
AOS	Airport Operation Services
BA	British Airways
BPI	Business Plan Incentive
CAA12	Civil Aviation Act 2012
Capex	capital expenditure
Constructive Engagement	A process involving both high-level and more detailed discussions between the regulated company and its airline customers which informs the price control process.
CPI	Consumer Price Index
CPIH	Consumer Price Index with Housing
CMA	Competition and Markets Authority
DO	Delivery Obligation. These are key indicators that will show if a capital project has delivered what was intended and agreed by HAL and airlines. A key feature of the H7 capital efficiency frame.
DfT	Department for Transport
The Draft Method Statement and Business Plan Guidance	The CAA's draft business plan guidance to assist HAL in producing an H8 business plan, published in November 2024 (See: https://www.caa.co.uk/cap3044/).
EU	European Union
GAL	Gatwick Airport Limited
H7	Heathrow Price Control 2022-2026
H8	Heathrow Price Control 2027-2031

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HAL	Heathrow Airport Limited
IAG	International Airlines Group
KPI	Key performance indicator
LACC	London Airline Consultative Committee
Licence	The licences granted to HAL under CAA12
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, provided for in Condition C2 (Charges for Other Services) of the Licence
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
Single till	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.
TRS	Traffic Risk Sharing
UKRN	UK Regulators Network
Virgin / VAA	Virgin Atlantic
WACC	weighted average cost of capital

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