Heathrow response to CAA's consultation on a holding price cap for 2027 (CAP3279)

CAA-H8-065

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Contents

1. Executive Summary

1. Heathrow welcomes the opportunity to respond to the Civil Aviation Authority's (CAA) consultation on the proposed holding price cap for 2027 (CAP3279).

2. We support the CAA's objective of providing regulatory certainty for airlines and consumers pending publication of the H8 Final Decision. A holding price cap can provide an effective mechanism for protecting consumers while maintaining an appropriate balance between financeability and affordability.

3. Heathrow considers that the proposed holding cap should be amended in six key areas:

   - the level of the holding cap;
   - the treatment of expansion expenditure;
   - correction factor
   - consistency between the holding cap and the H8 Final Decision, including treatment of adjustment mechanisms.
   - inflation
   - the treatment of ex-ante capital expenditure incentives.

4. Two of these amendments can be implemented immediately using information already available to the CAA:

   - using the midpoint building-block charge from the Initial Proposals; and
   - updating the correction factor to reflect the actual outturn value of M_{2025}.

5. Together these changes increase the holding cap from £28.398 to **£30.077** (2027p) per passenger before any adjustment for expansion expenditure.

6. This value is derived from:

   - a building-block based charge of £30.370 per passenger, reflecting the midpoint building-block assumptions from the H8 Initial Proposals;
   - a service quality bonus adjustment of £0.063 per passenger; and
   - a correction factor of £0.356 per passenger based on the latest outturn information for M_{2025}.

7. Heathrow is concerned that the CAA's proposed holding cap relies on a financeability assessment that does not reflect the expenditure associated with Heathrow's expansion programme[1] and proposes a charge that is below the midpoint building-block charge implied by the CAA's own Initial Proposals. Heathrow considers that this approach places unnecessary pressure on financeability and is not consistent with the CAA's duty to have regard to Heathrow's ability to finance its operations.

8. Heathrow also considers that the holding cap should include provision for:

   - the return on early expansion expenditure incurred prior to 2027;
   - depreciation associated with expenditure already incurred; and
   - the return on expansion expenditure expected to be incurred during 2027.

[1] See Heathrow's response to CAP3232 about the need for the CAA to have regards to the actual company as well as the notional.

9. While we recognise that aspects of the CAA's policy on early cost recovery remain under consideration, this does not preclude the inclusion of a mechanism that can subsequently be updated or reconciled through established true-up processes.

10. In addition, Heathrow considers that the correction factor should be updated to reflect the now-available outturn value of M_{2025}. Using the current value of £26.179 rather than the historical forecast value used by the CAA results in a materially different correction factor and ensures the holding cap reflects the most accurate information available.

11. Heathrow also considers that the adjustment mechanisms contained within the licence should be retained and assumed to be zero for the purposes of setting the holding cap. This would provide a practical means of maintaining consistency between the holding cap and the H8 Final Decision while allowing any differences to be addressed through existing correction-factor mechanisms.

12. Consistency between the holding cap and the H8 Final Decision is particularly important in areas such as inflation forecasting, adjustment mechanisms and licence parameters. Inconsistent assumptions risk creating windfall gains or losses that are unrelated to regulatory policy objectives.

13. Finally, Heathrow considers that the licence should include an enabling mechanism to allow ex-ante capital expenditure incentive outcomes to be reflected in charges from the start of H8. This would strengthen incentive properties, improve regulatory consistency and ensure incentive outcomes are reflected on a timely basis.

Table 1: Key issues with CAP3279 and Heathrow's proposed amendment

Issue	Heathrow's position
Level of the holding cap	Use the midpoint building-block charge from the H8 Initial Proposals rather than the stepped-flat charge.
Expansion expenditure	Include provision for the return and depreciation associated with expansion expenditure incurred before 2027 and the return on expenditure incurred during 2027.
Correction factor (K_{2027})	Update using the actual outturn value of M2025 (£26.179), resulting in a correction factor of approximately £0.356 per passenger.
Adjustment terms	Retain adjustment mechanisms in the licence and assume a value of zero for holding-cap purposes, with any differences reconciled through existing correction arrangements.
Inflation assumptions	Align assumptions used for Heathrow's charging decision and the H8 Final Decision to avoid unintended transfers of value.
Ex-ante capex incentives	Introduce an enabling adjustment mechanism from the start of H8, assumed to be zero when setting the holding cap.

2. Introduction

14. The H7 price control concludes at the end of 2026, while the CAA's H8 Final Decision will not be issued until Q1 2027. Heathrow therefore recognises the rationale for establishing a holding price cap for 2027.

15. In setting that holding cap and in line with its statutory duties, the CAA should seek to balance:
    - protection of consumers;
    - regulatory stability and predictability;
    - consistency with the H8 Final Decision; and
    - Heathrow's ability to finance its activities.

16. Heathrow is concerned that aspects of the proposed holding cap do not yet achieve this balance. In particular, the consultation does not adequately reflect expansion-related expenditure that is already being incurred and is expected to increase materially during 2027.

17. As the CAA has recognised in other areas of the H8 review, timely and efficient delivery of expansion is in consumers' interests. The holding cap framework should therefore avoid creating unintended barriers to investment or introducing unnecessary financeability pressure during the transition into H8.

18. This response addresses:
    - the appropriate level of the 2027 holding cap;
    - the treatment of expansion expenditure;
    - the approach to adjustment mechanisms;
    - the correction factor calculation;
    - inflation assumptions; and
    - the treatment of ex-ante capex incentives.

3. Level of the 2027 Holding Cap

19. Heathrow agrees that the H8 Initial Proposals provide the appropriate starting point for establishing the 2027 holding price cap.

20. However, Heathrow does not consider that the stepped-flat charge profile is the most appropriate basis for the holding cap without further consideration of financeability implications.

21. The financeability analysis underpinning the Initial Proposals[2] did not take account of expansion expenditure already incurred, nor expenditure expected to be incurred before and during 2027. Consequently, the assessment does not reflect the circumstances of the regulated business that will actually exist during the period covered by the holding cap.

22. Heathrow's concern is not simply that the proposed charge is below the building-block charge. Rather, it is that the proposed charge is below the building-block charge whilst relying on a financeability assessment that does not reflect the expenditure profile of the regulated business that will exist in 2027.

23. This is particularly important because the proposed midpoint stepped-flat charge of £26.615 (2024 CPIH-real) is lower than the midpoint building-block charge of £27.917 implied by the CAA's own Initial Proposals.

24. The consultation therefore proposes a charge that is below the costs reflected in the underlying regulatory building blocks whilst simultaneously excluding material expansion-related expenditure.

25. Heathrow does not consider that this approach appropriately balances consumer interests and financeability considerations. The CAA's primary duty requires it to further the interests of consumers, while also having regard to Heathrow's ability to finance its regulated activities. A holding cap set below the costs recognised in the regulatory settlement creates a risk of unnecessary future volatility in charges. Such volatility would not be in the interests of consumers and appears inconsistent with the desire expressed by several airlines[3] for greater visibility of future charge paths.

26. Heathrow therefore considers that the midpoint building-block charge of £27.917[4] should be adopted as the starting point for the 2027 holding cap.

Heathrow's position

Heathrow therefore considers that the midpoint building-block charge of £27.917 (2024 CPIH-real) should be adopted as the starting point for the 2027 holding cap.

[2] CAP3232, H8 Initial Proposals
[3] Such as in their response to CAP3251
[4] 2024p (CPIH-real), CAA assumed CPIH index of 144.501 for 2027 and 132.842 for 2024

4. Treatment of Expansion Expenditure in the 2027 Holding Cap

4.1 Overview

27. Heathrow does not agree with the CAA's proposal to exclude expansion expenditure from the 2027 holding price cap.

28. The consultation states that it would be inappropriate to adjust the holding price cap at this stage because wider policy decisions relating to early cost recovery have not yet been finalised. Heathrow recognises the CAA's desire to avoid prejudging future decisions. However, the absence of final decisions does not justify the complete exclusion of material expenditure from the holding cap framework.

29. The key issue is not whether every aspect of expansion cost recovery can be determined with precision at this stage. Rather, it is whether the holding cap should contain a mechanism capable of reflecting costs that are already being incurred and which will continue to be incurred during 2027.

30. The importance of maintaining an appropriate framework for recovering efficient expansion expenditure has become more significant following publication of the draft Heathrow Expansion National Policy Statement[5] (HENPS). The draft HENPS reinforces the Government's policy support for expansion and the expectation that Heathrow should progress the activities necessary to secure development consent and deliver additional capacity. In this context, a holding cap framework that does not recognise material expansion expenditure risks creating a disconnect between Government policy objectives, the expenditure required to deliver them and the regulatory arrangements governing Heathrow's revenues.

31. Heathrow recognises the CAA's duty to protect consumers from inefficient expenditure. However, where expenditure is being incurred in support of a Government-backed expansion programme that is intended to deliver substantial long-term consumer benefits, the regulatory framework should also ensure that efficient expenditure can be financed and recovered in an appropriate and predictable manner.

32. Heathrow considers that a mechanism should be included[6]. Such an approach would be consistent with established regulatory practice, whereby forecast expenditure is incorporated into prices and subsequently reconciled through correction factors once outturn information becomes available.

4.2 Recovery of early cost expenditure incurred in 2025/2026

33. The CAA's Draft Decision on the regulatory treatment of early costs (CAP3238) establishes the principle that efficiently incurred expansion expenditure should be recoverable. In particular, the CAA introduced the Return on Provisional Early Costs (RPEC) adjustment mechanism to provide recovery of financing costs associated with qualifying early expenditure incurred during 2025 and 2026.

34. Heathrow welcomed the recognition within CAP3238 that efficient early expenditure should attract an appropriate return, and that timely recovery of financing costs is an

[5] Draft Heathrow Expansion National Policy Statement - GOV.UK
[6] As detailed in Appendix A

important component of supporting investment. The holding cap consultation should therefore be considered in the context of that established policy direction.

35. Once expenditure has been determined to be efficiently incurred and eligible for recovery, it is appropriate that associated financing costs and depreciation are reflected within the regulatory framework. Excluding these elements from the holding cap creates a disconnect between the expenditure that Heathrow is required to undertake and the regulatory revenues available to support that expenditure.

36. Heathrow therefore considers that the holding cap should include provision for:

- the return on early expenditure incurred up to the end of 2026; and
- depreciation associated with that expenditure from the start of 2027.

4.3 Recovery of early cost expenditure incurred during 2027

37. The same principle applies to expenditure expected to be incurred during 2027. Expansion activity is expected to accelerate materially during 2027 as Heathrow progresses work required to support the DCO process and associated delivery activities.

38. While the precise level of expenditure will remain uncertain until delivery progresses, regulatory frameworks routinely accommodate forecast expenditure through forecast allowances and true-up mechanisms.

39. While Heathrow recognises the uncertainty associated with future expenditure forecasts, we do not consider that uncertainty alone justifies excluding these costs entirely from the holding cap framework. A more proportionate approach would be to include a forecast allowance for financing costs associated with 2027 expenditure and reconcile any differences through the existing correction-factor framework once actual expenditure becomes known.

Heathrow's position

Heathrow therefore considers that the holding cap should incorporate:

- the return on early costs incurred before 2027;
- depreciation on expenditure incurred before 2027; and
- the return on forecast expansion expenditure during 2027.

While Heathrow recognises the uncertainty associated with future expenditure forecasts, we do not consider that uncertainty alone justifies excluding these costs entirely from the holding cap framework. The detailed mechanics can be determined through the finalisation of the wider early cost recovery framework and reconciled through established true-up arrangements.

5. Adjustment mechanisms

5.1 Retaining Existing Regulatory Frameworks

40. The consultation proposes to remove the adjustment terms associated with the allowed capex adjustment, capital triggers, terminal drop-off charges and traffic risk sharing. Heathrow understands the CAA's concern that policies in these areas have not yet been finalised. However, Heathrow does not consider that non-finalisation requires the removal of the underlying mechanisms from the licence.

41. Regulatory certainty is best served by maintaining continuity in established licence structures wherever possible. Removing mechanisms from the licence only to reintroduce them through the H8 Final Decision would create unnecessary complexity and risk unintended inconsistencies between the holding cap and the final settlement. A more practical approach would be to retain the relevant mechanisms within the licence while assuming a value of zero for the purpose of setting the holding cap.

5.2 Retaining Existing Regulatory Frameworks

42. A key objective of the holding cap should be to ensure that 2027 outcomes remain aligned with the assumptions underpinning the H8 Final Decision. If adjustment mechanisms are removed entirely, the subsequent treatment of these items may differ materially from the assumptions incorporated within the Final Decision. This would create a risk of windfall gains or losses which are unrelated to either regulatory intent or operational performance.

43. Heathrow therefore considers that:

- the relevant adjustment mechanisms should remain within the licence;
- forecast values should be assumed to be zero when establishing the holding cap; and
- final parameters should be determined through the H8 Final Decision.

44. This would ensure that any subsequent true-up is undertaken against the same assumptions used in establishing H8 allowed revenues.

Heathrow's position

Heathrow supports retaining the existing adjustment mechanisms in the licence and setting them initially to zero for holding-cap purposes.

This approach provides both regulatory certainty and consistency with the eventual H8 settlement.

6. Correction factor for 2027

45. Heathrow agrees that the correction-factor mechanism should continue to form part of the holding cap for 2027. The correction factor plays an important role in ensuring that over- or under-recovery against the allowed yield is returned to consumers or recovered by Heathrow as appropriate.

46. However, Heathrow does not agree with the specific value proposed by the CAA. In calculating the correction factor, the consultation uses the forecast value of M_{2025} that was included within Heathrow's October 2024 charges decision.

47. Since publication of that decision, updated outturn information has become available. The actual value of M_{2025} is now known to be £26.179 per passenger[7].

48. This reflects:
    - updated inflation outturns;
    - completion of licence adjustment mechanisms; and
    - the most recent regulatory account information.

49. Heathrow therefore considers that the correction factor should be calculated using the current and most accurate information available. Applying the outturn value of M_{2025} produces a correction factor of approximately £0.356 per passenger rather than £0.616 per passenger.

50. This results in an increase of approximately £0.26 per passenger relative to the consultation proposal.

Heathrow's position

The correction factor should be updated using the actual outturn value of M_{2025} to ensure that the holding cap reflects the most accurate information available.

[7] Our calculations underpinning a value for M_{2025} of £26.179 are detailed in CAA-H8-065b.

7. Inflation Assumptions and Regulatory Consistency

51. Heathrow agrees with the CAA's objective of introducing a more structured approach to inflation true-up. However, experience from previous holding cap arrangements demonstrates that consistency between the holding cap and the final regulatory settlement is critical.

52. The key issue is not whether inflation forecasts subsequently prove accurate. Rather, it is whether the assumptions used when establishing the holding cap remain aligned with those used in the Final Decision.

53. If different inflation assumptions are used, the real level of the charge assumed in the Final Decision will differ from the charge collected in practice.

54. This risks creating unintended transfers between Heathrow and consumers that are unrelated to regulatory policy objectives.

55. Heathrow has consistently used the Bank of England's September forecast update when finalising airport charges. This approach provides the most up-to-date information available prior to publication of charges and minimises the need for subsequent correction.

56. Heathrow therefore proposes that:

- the October 2026 charging decision should use the Bank of England's September 2026 forecast; and
- the H8 Final Decision should adopt the same forecast assumptions for inflation in both 2026 and 2027.

57. This approach would improve consistency across regulatory processes and minimise the risk of windfall gains or losses arising solely from differences in forecasting assumptions.

Heathrow's position

The inflation assumptions used in Heathrow's 2027 charging decision and the H8 Final Decision should be aligned to avoid unintended outcomes and preserve regulatory consistency.

8. Ex-Ante Capital Expenditure Incentives

58. The increasing number of projects reaching completion under the ex-ante capex framework means that a mechanism will be required during H8 to reflect incentive outcomes in prices.

59. Heathrow supports the principle of incentive mechanisms that reward efficient delivery and improve consumer outcomes. However, the effectiveness of any incentive depends on a sufficiently close connection between performance and financial consequences.

60. Under an approach where performance outcomes are not reflected until the beginning of the next regulatory period, there could be significant delays between expenditure decisions and financial rewards or penalties. Such delays weaken incentive properties and reduce their effectiveness in driving delivery behaviour.

61. Heathrow therefore considers that incentive outcomes should be reflected through an annual adjustment mechanism within the charging framework[8].

62. Under this approach:
    - forecast incentive performance would be assumed to be zero when setting charges;
    - actual outcomes would subsequently be calculated using outturn information; and
    - any resulting adjustment would be incorporated through the correction-factor process.

63. This would maintain consistency with existing regulatory mechanisms while ensuring that incentive outcomes are reflected on a timely basis.

Heathrow's position

The licence should contain an enabling mechanism for incorporation of ex-ante capex incentive outcomes from the start of H8, with initial values assumed to be zero for purposes of setting the 2027 holding cap.

[8] As detailed in Appendix B

9. Conclusion

64. Heathrow supports the CAA's objective of implementing a holding price cap for 2027 in advance of the H8 Final Decision. A holding cap can provide an effective mechanism for protecting consumers while providing regulatory certainty for Heathrow and its airline customers.

65. However, Heathrow considers that several aspects of the consultation proposal should be amended to ensure that the holding cap appropriately reflects the costs of the regulated business, remains consistent with the H8 Final Decision and supports Heathrow's ability to finance its licensed activities.

66. Heathrow therefore requests that the CAA:

- adopts the midpoint building-block charge from the Initial Proposals;
- updates the correction factor using the actual outturn value of M_{2025};
- introduces an appropriate mechanism for recovery of expansion expenditure incurred before and during 2027;
- retains adjustment mechanisms within the licence;
- aligns inflation and adjustment assumptions with the H8 Final Decision; and
- introduces an enabling mechanism for ex-ante capex incentives.

67. Adopting the midpoint building-block charge and updating the correction factor using actual outturn information in the CAA’s final decision would result in a holding cap of £30.077 per passenger (2027 prices) before any adjustment to reflect expansion expenditure.

68. Heathrow considers that these changes would improve consistency, support financeability, reduce the risk of unintended windfall gains or losses and provide a more robust basis for the transition into H8.

10. Appendix

Appendix A: Illustrative mechanism for incorporating expansion expenditure into the 2027 holding cap

69. Heathrow considers that the holding price cap should include provision to reflect the costs associated with expansion expenditure incurred before and during 2027.

70. As set out in Section 4 of this response, Heathrow does not consider that the absence of a final decision on all aspects of expansion cost recovery justifies exclusion of those costs from the holding cap framework. A holding cap is intended to provide an interim regulatory arrangement pending the H8 Final Decision and should therefore include mechanisms capable of reflecting material expenditure that is expected to be incurred during that period.

71. In CAP3238[9], the CAA established the principle that efficiently incurred early expansion expenditure should be recoverable and introduced the Return on Provisional Early Costs (RPEC) mechanism to provide recovery of financing costs associated with qualifying early expenditure incurred during 2025 and 2026. Heathrow considers that the holding price cap should build on this established policy approach.

72. Heathrow therefore proposes a mechanism that reflects:

    - the return on expansion expenditure incurred during 2025 and 2026;
    - depreciation on expansion expenditure incurred during 2025 and 2026; and
    - the return on forecast expansion expenditure incurred during 2027.

73. Heathrow considers that the holding price cap formula should include two additional adjustment terms:

    - an Early Cost Recovery Adjustment (EC_1) to reflect the return and depreciation associated with efficiently incurred expansion expenditure prior to 2027; and
    - an Expansion Financing Adjustment (EC_2) to reflect the financing costs associated with forecast expansion expenditure during 2027.

74. The holding cap would therefore be expressed[10] as:

$$Holding\ cap = existing\ holding\ cap + \frac{EC_1}{Q_{2027}} + \frac{EC_2}{Q_{2027}}$$

75. The purpose of EC_1 is to ensure that efficient early expenditure incurred before 2027 receives treatment consistent with the policy framework established in CAP3238 while also reflecting the fact that such expenditure will begin contributing to Heathrow's regulatory asset base from the start of H8.

76. Heathrow proposes that EC_1 should reflect:

    - the opening value of eligible expansion expenditure at the start of 2027;
    - the return on that expenditure during 2027; and

[9] CAA, CAP3238, Draft Decision on the regulatory treatment of early costs of capacity expansion at Heathrow airport, April 2026

[10] Q_{2027} is the number of passengers using the Airport in the Regulatory Year 2027

- depreciation associated with that expenditure.

77. One possible implementation would be to calculate[11] EC_1 as follows:

$$EC_1 = ECD + \left(ESO + \frac{ESE}{1 + WACC}\right) x\, WACC$$

78. The opening and closing values of expansion expenditure would be determined based on efficient expenditure incurred during 2025 and 2026 and updated for inflation in a manner consistent with the H8 Final Decision.

79. Heathrow also considers that the holding cap should reflect forecast financing costs associated with expansion expenditure expected to be incurred during 2027. While the precise level of expenditure will remain uncertain until outturn information becomes available, this is not materially different from other forecast-based regulatory mechanisms which are subsequently corrected through established reconciliation processes.

80. Heathrow therefore considers that a forecast adjustment should be included within the holding cap and reconciled through a future correction-factor mechanism if necessary.

81. One possible implementation would be to calculate[12] EC_2 as follows:

$$EC_2 = ES_{2027}\, x \frac{1}{2} x\, WACC$$

82. The use of a half-year convention reflects the assumption that expenditure is incurred evenly throughout the year and therefore receives, on average, six months of financing-cost recovery.

83. Heathrow considers that this approach is consistent with the principles underpinning the CAA's CAP3238 decision, including the RPEC mechanism and the broader principle that efficiently incurred early expansion expenditure should receive an appropriate return. Any differences between forecast and outturn expenditure could subsequently be reconciled through the established correction-factor framework, ensuring consumers are protected while maintaining appropriate financeability and regulatory consistency.

84. Heathrow therefore considers that the holding cap should contain an enabling mechanism of this nature, with the detailed calibration capable of being finalised alongside the wider H8 Final Decision.

[11] Where ESO is the opening value of expansion expenditure at the start of 2027;
ESE is the closing value of expansion expenditure at the end of 2027;
ECD is regulatory depreciation associated with expansion expenditure; and
WACC is the applicable allowed rate of return.

[12] Where ES_{2027} is the forecast efficient expansion expenditure incurred during 2027.

Appendix B: Illustrative mechanism for incorporating ex-ante capital expenditure incentives into the H8 charging framework

85. Heathrow considers that the introduction of ex-ante capital expenditure incentives at Gateway 3 has created a need for a clear and transparent mechanism for reflecting incentive outcomes within airport charges during H8.

86. To date, relatively few schemes have progressed sufficiently for the practical implementation of the incentive framework to become material. However, during H8 increasing numbers of projects are expected to reach Gateway 5, at which point the outcome of the incentive mechanism will need to be reflected in the regulatory framework.

87. Heathrow supports the principle of ex-ante capital expenditure incentives. Such incentives can promote efficiency and strengthen alignment between Heathrow and consumers. However, the effectiveness of any incentive framework depends on the timing with which rewards and penalties are reflected in regulatory outcomes.

Alternative Approaches

Accumulation within the RAB

88. One possible approach would be to accumulate the net outcome of incentive performance during a regulatory period and include the resulting adjustment within the opening RAB of the subsequent regulatory period.

89. Under this approach:

- incentive outcomes for projects reaching Gateway 5 before the start of H8 would be reflected in the opening RAB for H8; and
- incentive outcomes achieved during H8 would be incorporated into the opening RAB for H9.

90. While straightforward, this approach would create a potentially significant delay between project performance and the associated financial consequence. For projects with long delivery cycles, rewards or penalties could be reflected several years after expenditure decisions were made. This would weaken the incentive properties of the framework and reduce its effectiveness as a tool for promoting efficient delivery. Over time, this could reduce the effectiveness of the incentive framework in driving efficient delivery and therefore diminish the consumer benefits that the ex-ante regime was intended to support.

In-Period Adjustment Mechanism

91. Heathrow considers that a more effective approach would be to reflect incentive outcomes during the regulatory period in which projects reach Gateway 5.

92. Under this approach, incentive outcomes would be incorporated into airport charges through an annual adjustment mechanism that operates in a similar manner to existing correction-factor arrangements. This would create a clearer and timelier link between project performance and financial outcomes, thereby strengthening incentive effects and improving transparency.

Proposed Mechanism

93. Heathrow proposes that the licence should contain an additional adjustment term capable of reflecting ex-ante capital expenditure incentive outcomes.

94. For the purposes of setting airport charges in advance of a charging year, the value of this term would be assumed to be zero. Once actual project outcomes become available, the adjustment would be calculated and subsequently reflected through the existing correction-factor process.

95. The holding cap for 2027 could therefore include an enabling adjustment term without requiring any forecast value to be included in charges. This approach would be consistent with the wider principle of using forecast values when setting charges and correcting for differences once outturn information becomes available.

96. Heathrow envisages that the annual adjustment would be based on an Ex-Ante Incentive Factor (EX) representing the aggregate performance of projects reaching Gateway 5 during the relevant year.

97. The adjustment included within charges could be represented as:

$$Charge\ adjustment = \frac{EX}{Q_{2027}}$$

98. The Ex-Ante Incentive Factor would be derived from the sum of the incentive outcomes associated with projects reaching Gateway 5[13] during that year.

$$EX = \Sigma OVi\ x\ WACC$$

99. The adjustment would be positive where schemes outperform approved expenditure baselines and negative where schemes underperform those baselines.

100. Heathrow considers that the incentive outcome for each project should reflect both the scale and timing of expenditure. One possible approach would be to determine an outperformance factor based on the difference between the approved expenditure profile and actual expenditure[14].

$$OPi = (TXi - TZi)/4$$

101. The resulting outperformance value would then be adjusted for:
- inflation;
- the timing of expenditure; and
- the cost of capital.

[13] OVi represents the outperformance value associated with project *i*
[14] where:
TX represents approved expenditure;
TZ represents actual expenditure; and
the calculation would be adjusted appropriately for programmes of different duration.

102. This ensures consistency with the way expenditure is reflected within the underlying regulatory settlement and avoids incentivising outcomes solely due to expenditure timing differences.

103. Heathrow considers that any mechanism introduced for reflecting incentive outcomes in airport charges should also remain consistent with the treatment of those outcomes within the RAB. Accordingly:

- incentive outcomes associated with projects reaching Gateway 5 before the start of H8 should be reflected in the opening RAB for H8;
- annual charge adjustments during H8 should reflect current-period performance outcomes; and
- the cumulative effect of incentive performance during H8 should be reflected in the opening RAB for H9.

104. This approach avoids double counting while ensuring that incentive effects are reflected both in-year and over the longer term.

105. Heathrow considers that the H8 licence should contain an enabling mechanism allowing ex-ante capital expenditure incentive outcomes to be reflected in airport charges.

106. The value of the adjustment should be assumed to be zero when setting charges in advance, with actual outcomes subsequently incorporated through the existing correction-factor framework. This approach would provide a timely and transparent link between delivery performance and regulatory outcomes, strengthen incentive properties and ensure consistency between the charging framework and the wider regulatory settlement.