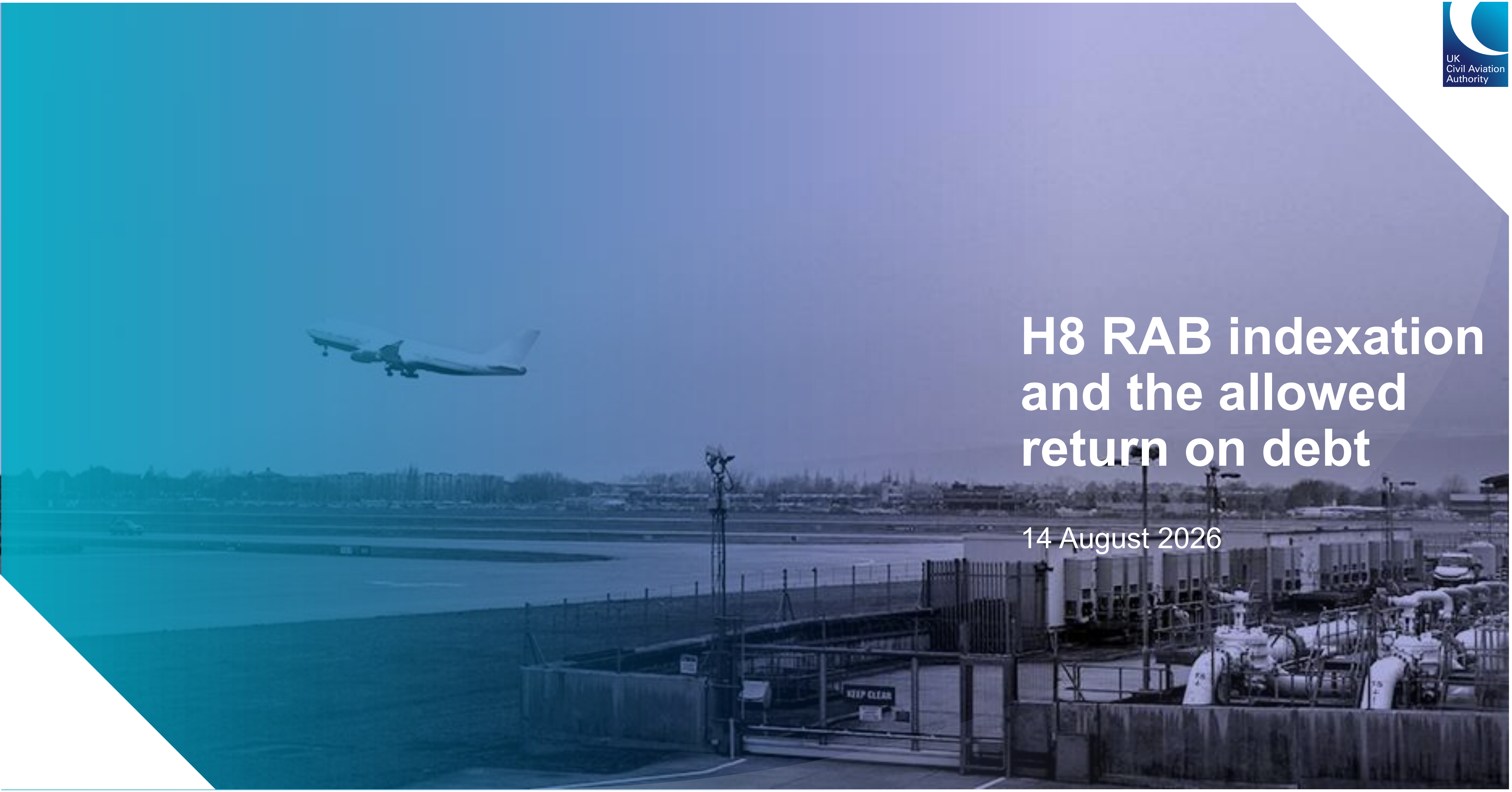

H8 RAB indexation and the allowed return on debt

14 August 2026

Context

- The purpose of this slide pack is to update stakeholders on our emerging policy position on the treatment of RAB indexation in relation to setting the allowed return on debt. This is in response to several stakeholders asking for earlier engagement on this issue, ahead of H8 Final Proposals.
- Under the existing approach, the RAB is indexed to outturn inflation while a significant proportion of a regulated company's financing can be in nominal fixed rate debt, which does not adjust with inflation. In this context, in periods where outturn inflation is higher (or lower) than expected, the RAB fully reflects the variance in outturn inflation, but the cost of servicing any nominal fixed rate debt does not change. This creates the potential for the regulated company to recover more (or less) than its effective cost of debt.
- At H8 IPs we stated our considerations of the following options:
  - We considered that our preferred option would be to maintain our H7 approach of using a medium-term inflation forecast on the cost of debt allowance, which better mitigates the theory of harm relative to using a long-term 2% inflation forecast. The CMA upheld our decision to use this approach for H7.
  - We also outlined another option to be further considered, where the RAB portion financed by fixed-rate debt is indexed to a fixed inflation forecast ('fixed indexation'), with the remaining RAB portion financed by equity and index-linked debt indexed to outturn inflation. We noted that this approach may be more effective in minimising the likelihood of windfall gains or losses arising from inflation mismatches, to the extent that medium-term forecasts may not sufficiently capture the range of potential inflation scenarios.
- We are particularly interested in stakeholder views on our minded to position set out in slide 6, our approach to implementation set out in slides 8 and 9, and any other stakeholder views on alternative approaches we could consider.

- This slide pack sets out our emerging policy thinking in this area. At this stage, we have not sought to address all stakeholder positions or provide responses to all issues raised on this area in consultation responses to H8 Initial Proposals. We intend to continue considering stakeholder views and evidence ahead of H8 Final Proposals.
- We invite stakeholders to share views on the emerging positions set out in this slide pack by **4 September 2026**. We would also be happy to arrange calls with stakeholders who would find it useful to discuss our emerging positions in greater detail. Our next formal update on this policy area is expected to be published as part of H8 Final Proposals.
- If you have any queries, please respond to Myuran Devaraja (Myuran.Devaraja@caa.co.uk) or Laurence Crook (Laurence.crook@caa.co.uk)

Stakeholder responses to H8 Initial Proposals: HAL

	HAL response:	
1	**HAL:** **Further engagement with CAA needed with earlier publication than FPs on this topic**	• HAL welcomes further discussion on option 2 (fixed indexation approach), as our investigations are at an early stage. • This is given that a change in the RAB indexation methodology would represent a significant change to risk allocation that would normally be included in a methodology consultation. • HAL states they expect the CAA to provide details as soon as possible, rather than waiting until the Final Proposals to allow effective consultation.
2	**HAL:** **Assumptions on % of fixed rate and index-linked debt must be clear and applied consistently between controls**	• HAL states it is essential the assumptions on the % of the RAB financed by fixed rate debt and index-linked debt used for the notional company are clear and applied consistently between price controls. • This is so HAL can manage its risks within its own capital structure and debt portfolio.

Stakeholder responses to H8 Initial Proposals: Airlines (1)

UK Civil Aviation Authority

	Airline response:	
3	**IATA/CEPA:** **Recommend outturn inflation indexation is removed for fixed rate debt for HAL.**	• In an accompanying CEPA report on behalf of IATA, they stated that Airlines APB proposal include a materially better method for compensating debt costs for inflation. • Under this approach, the fixed rate nominal debt cost is still deflated by expected inflation, but the same expected inflation is used for RAB inflation indexation (rather than using outturn inflation).
4	**BA: Make any provisional decision available ahead of Final Proposals , to give stakeholders sufficient time to respond to policy changes.**	
5	**BA:** **Support fixed indexation approach for all of RAB, not just the portion funded by fixed-rate debt**	• Supportive of option 2 (fixed indexation approach) • States that this policy should be applied to equity and index-linked debt portion of RAB as well, given the risk of inflation mismatches exists between the other RAB financed portions beyond fixed-rate debt and our methodology for the WACC.
6	**BA:** **Explain why medium-term forecast is better, or why a cap/collar mechanism can't be used**	• They ask the CAA to explain further why: 1) Medium-term inflation forecasts would address this risk, given they "remain subject to some degree of forecast error, particularly during periods of economic disruption". 2) A "cap and collar" mechanism for inflation driven returns or a risk sharing mechanism for inflation windfall gains is too complex to apply, monitor and provide recovery for.

Proposed policy options (1)

Having considered stakeholder responses further, we deem that the central policy question is whether to maintain the status quo approach adopted at H7 or move to the alternative Option 2 approach outlined below. We set our emerging positions on other stakeholder points, including those raised by BA, in the next slide.

Options	Pros	Cons
1 (status quo): • **Medium-term inflation forecasts on allowed cost of debt methodology for fixed rate debt** • **RAB fully indexed to outturn inflation**	• Adopted at H7, which the CMA deemed not wrong, during Covid-19 period. • This approach may be sufficient to avoid the potential for large windfall gains/losses on fixed rate debt in a BAU context without significant inflation shocks.	• Relies on accuracy of inflation forecasts, which may not fully eliminate risk of windfall gains/losses to fixed rate debt, particularly during periods of greater inflation volatility. • Outturn inflation has exceeded medium term forecasts over the past 15 years on average, creating the potential for windfall gains.
2: • **Medium-term inflation forecasts on allowed cost of debt methodology for fixed rate debt** • **RAB indexed in part by outturn inflation (equity, ILD) with remaining fixed rate debt portion indexed to medium-term forecasts**	• More closely reflects actual inflation outcomes within the regulatory framework relative to Option 1, reducing reliance on inflation forecasts and thereby lowering the risk of material windfall gains or losses on fixed-rate debt. • This benefit is particularly pronounced in scenarios where inflation deviates significantly from forecast or exhibits sustained volatility.	• Inflation indexation allowances would rely on more granular assumptions regarding the notional financing structure (e.g. equity, index-linked debt and fixed-rate debt), with additional regulatory commitment to these assumptions over the price control period. • Any changes to the regulatory approach on RAB indexation may result in a regulated company's financing structure not being appropriately aligned to the new notional allowance, as there may be limited flexibility in their current financing structure, which may have been aligned to the previous regulatory approach. This may particularly be the case where inflation swaps form part of the regulated company's inflation risk management.

Proposed policy options (2)

Our minded-to position is to propose Option 2 for H8 Final Proposals, with the following considerations:

- It may more effectively minimise the risk of windfall gains/losses to fixed rate debt in all scenarios. By contrast, Option 1 may retain some residual risk that could arise from forecast error given its greater reliance on OBR inflation forecasts which are not updated after the price control is set.
- We do not consider the requirement that Option 2 has more granular financing assumptions than option 1 to be an impediment to implementing this approach, given the benefits it may provide, as stated above. The assumptions on fixed-rate debt and index-linked debt that are needed are already applied in our allowed cost of debt methodology, which we outline in slide 8.
- Furthermore, we do not deem that the potential impacts our change in RAB indexation approach may have on the company's actual financing structure, outweigh the benefits of Option 2 either. We consider that the RAB indexation approach under option 2 better matches the notional company assumptions we are already applying on the allowed cost of debt. We also consider that there has been sufficient discussion ahead of time about a potential change in RAB indexation approach for H8, for this not to represent an unexpected change in regulatory approach, as stated in the H8 Draft Method Statement and accompanying FTI advisory report. [1,2]

[1] *CAA (2024), Draft H8 method statement and business plan guidance, November, paragraph 2.92.*

[2] *FTI (2024), FTI Consulting: Cost of Capital Strategy for H8, Appendix 1.*

Emerging policy positions on other stakeholder issues

UK Civil Aviation Authority

		CAA emerging policy position
5	**BA:** **Support fixed indexation approach for all of RAB, not just the portion funded by fixed-rate debt**	• The theory of harm is about mismatches between inflation treatment of the RAB and the inflation sensitivity of the financing source it funded by, rather than just pure regulatory mechanics. • **Fixed rate debt -** Has no inflation exposure in nominal terms as the coupon payments are fixed when the debt is issued, so RAB outturn inflation here introduces inflation exposure the company does not actually have • **Index-linked debt -** Nominal coupon payments are fully exposed to outturn inflation, so there is strong justification for RAB outturn inflation to match the company's inflation exposure • **Equity:** We deem it is reasonable for investors to expect the real value of their committed equity to be preserved. Maintaining RAB outturn inflation indexation for equity funded portion may better support this capital maintenance objective, whilst promoting stability and predictability in the regulatory framework
6	**BA:** **Explain why medium-term forecast is better, or why a cap/collar mechanism can't be used**	• See previous slide for policy option 2 recommendation • Policy option 2 could offer a lower complexity means of mitigating the theory of harm that relates to fixed rate debt, so it would be relatively disproportionate to apply a cap and collar option/risk sharing mechanism for inflation windfalls and losses.

Implementation of option 2 ('Fixed indexation') (1)

- Option 2 requires making % assumptions on the RAB funded by fixed-rate debt, index-linked debt and equity.
- This determines the below portions of the RAB that would be indexed to outturn inflation and medium-term inflation forecasts. We set out values below that we would have expected to use based on our positions stated at H8 Initial Proposals.

RAB Assumptions	Description	Source
Notional debt and equity assumptions are 60% and 40% respectively.	• The notional company approach bases regulatory allowances on assumed financing parameters, including notional gearing, rather than actual company financing decisions. • H8 Initial proposals assumes 60% notional gearing, with the remaining 40% of the RAB to be indexed by equity and therefore outturn inflation.	• CAA assumption and modelling
Fixed rate-debt assumption in the RAB over H8: 90%	• 90% of notional debt is assumed as fixed-rate debt in line with our current modelling. The 90% assumption comes from: 1. Embedded and new debt assumptions of ~74%, 26% respectively 2. Fixed-rate debt assumptions in embedded and new debt of ~87%, 100% respectively 3. 90% = (74%*87%)+(26%*100%) = c.90%	• Fixed rate debt assumption comes from FTI modelling of new and embedded fixed-rate debt. This includes constructing a fixed rate proxy for floating-rate debt
Index linked debt assumption in the RAB over H8: 10%	• Consistent with the assumption that 90% of notional debt is fixed-rate debt, the remaining 10% is treated as index-linked debt (1-90% = 10%)	• CAA assumption and modelling
RAB indexed to medium-term forecasts: ~ 54%	• Given our 60% notional gearing assumption and 90% fixed-rate debt assumption, 60%*90% = 54% of all debt in the RAB is indexed to medium-term inflation	• Inflation: OBR medium-term inflation forecasts
Remaining RAB portion indexed to outturn inflation: ~46%	• Given our 40% equity and 10% index-linked debt assumption, 40% +(60%*10%)= ~46%	• Inflation outturn: ONS

Implementation of option 2 (‘Fixed indexation’) (2)

Implementation of RAB indexation approach

- The fixed-rate and index-linked debt proportions shown on the previous slide are consistent with the assumptions underpinning the H8 IPs allowed cost of debt methodology for embedded and new debt (excluding inflation swaps), and with our advisor’s (FTI Consulting) H8 IPs cost of debt estimate
- We consider this financing structure to be consistent with our notional company assumptions for H8 and therefore an appropriate basis for implementation of our RAB inflation indexation policy, though we will continue to assess stakeholder feedback and supporting evidence as policy development progresses and will reconsider the appropriateness of these assumptions for H8 Final Determinations.
- We propose that the proportions of the RAB indexed to medium-term inflation forecasts and to outturn inflation should be applied to the H8 opening RAB value. This would be calculated on an ex post basis once outturn inflation is available and reflected through an end-of-period adjustment.

Medium-term inflation forecasts

- We propose to use OBR medium-term CPIH inflation forecasts as part of this approach. For H8 Final Proposals, this would be the March 2026 forecast, given that the October 2026 update is likely to be released too late to incorporate into our modelling and publication timetable. We will consider the appropriate forecast publication for H8 Final Determinations in due course.