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British Airways response to CAA emerging policy position on the H8 RAB indexation and the allowed return on debt

Dear Myuran

British Airways welcomes the opportunity to comment on the CAA's emerging policy position on the treatment of RAB indexation and the allowed return on debt for Heathrow Airport Limited (HAL) ahead of the H8 Final Proposals.

The CAA sets out its minded-to position to apply a fixed inflation forecast to the notional fixed-rate debt share of the RAB and retain outturn CPIH indexation of the remainder (the 'fixed indexation' approach). The CAA's stated objective is to reduce windfall gains or losses caused by the mismatch between a real debt allowance and nominal fixed rate debt financing.

We support the CAA's proposed fixed indexation approach for H8. This recognises and seeks to address the concerns we have previously expressed to the CAA, including in response to the H8 Initial Proposals, the H8 method statement and during the H7 lessons learned exercise. Our response below should therefore be read in conjunction with those comments.

The CAA's proposal delivers a material improvement to the current framework and is consistent with the principle that the regulatory framework should not introduce unnecessary inflation risk by indexing the portion of the RAB intended to represent nominal fixed-rate debt to outturn inflation. Fixed-rate debt does not have direct exposure to inflation once issued, and therefore there is limited justification for allowing returns on that portion of the RAB to vary with inflation outcomes.

The existing approach has contributed to the accrual of windfall gains for HAL's investors when outturn inflation materially exceeded forecast inflation[1], contributing to a significant growth in the RAB and therefore unjustified higher charges for consumers. In fact, between 2014 and 2025, the RAB increased by almost £6.5 billion despite depreciation, with indexation alone contributing £8.4 billion. Of this, £2.3 billion was added in 2022 alone

[1] Equally, where outturn inflation is below forecast inflation, investors may bear windfall losses.

following the inflationary shock generated by the Russia-Ukraine war[2]. These outcomes demonstrate that inflation outperformance can have a material impact on the RAB and charges under the current framework.

We therefore consider the CAA's proposal to be an appropriate and proportionate response to the risk of windfall gains arising under the existing framework. It would help prevent unnecessary inflation of the RAB, thereby reducing the risk of consumers bearing higher charges that are not justified by efficient risk allocation, which in turn impact affordability and consumer choice. Relative to the status quo, the proposed approach would provide stronger protections for consumers.

Our response sets out why we consider the proposed fixed indexation approach to be more consistent with the principles of efficient risk allocation, avoiding creating exposures that neither consumers nor investors need to bear and delivering improved regulatory policy to the consumers' benefit. We also set out our views on the implementation of the approach.

Principles

The CAA's proposed approach constitutes a targeted, proportionate and material improvement to the status quo, in the interest of consumers

A fair price control should not expose consumers or investors to risks that neither party needs to bear. Even if the current approach were designed to be symmetric, it would still expose consumers and investors to unnecessary inflation risk over the course of a five-year price control and create costs that do not need to arise under the regulatory framework.

Under the current approach, the share of the RAB intended to represent nominal fixed-rate debt remains indexed to outturn inflation despite fixed-rate debt costs not increasing when inflation rises. If that share of the RAB is indexed to outturn inflation, this creates scope for an unnecessary mismatch for the notional company. The fixed indexation approach removes that artificial exposure directly. The forecast can turn out to be above or below actual inflation without creating the same inflation-driven gain or loss. In other words, it aligns RAB indexation more closely with the characteristics of the underlying financing assumption.

This is especially the case where inflation forecasts used to set a real return are imperfect. The CAA has indicated that forecasts produced in March 2026 may inform a final decision taken in late November 2026, despite material changes in macroeconomic conditions during that period, such as an increase in oil prices following the outbreak of the US/Israel-Iran war and the change in UK government. This highlights the scope for forecast error under the current approach as macro-economic conditions shift, not just within a year but across a five-year price control.

This uncertainty is also relevant to HAL's debt covenants. A fixed indexation approach provides greater certainty around the future path of the RAB and may support financeability. We note that this is a secondary benefit and should not determine policy.

[2] Using HAL regulatory accounts 2014-2025.

The CAA states that the fixed indexation approach "*may more effectively minimise the risk of windfall gains/losses to fixed rate debt in all scenarios.*" We consider that the proposed approach clearly reduces the risk of windfall gains/losses relative to the status quo, based on the above logic.

The CAA presents the additional granularity required under a fixed indexation approach, including assumptions regarding the proportions of fixed-rate debt and index-linked debt, as a potential drawback. We consider this to be a benefit as it improves alignment between underlying returns and the assumptions used within the financeability assessment. At present, a fully real (index-linked) debt allowance is utilised, with the financial model and financeability modelling using a different assumption. The fixed indexation approach, including the greater granularity, removes this internal inconsistency and therefore improves transparency and certainty.

The fixed indexation approach is also internally consistent with how the CAA considered debt allowances for H7. The financing proportions needed for fixed indexation are not new regulatory parameters. Indeed, the CAA already employs fixed-rate and index-linked debt assumptions in its cost of capital methodology. If those assumptions are considered sufficiently robust to determine the debt allowance, it follows that they should be equally robust to be used for RAB indexation.

Taken together, these factors suggest that the fixed indexation approach is a targeted and proportionate response to a genuine and empirical harm within the current framework. Its implementation relies on a limited number of transparent and auditable assumptions that are already used elsewhere in the CAA's methodology and have been tested through the H7 process and subsequent CMA review. The approach is therefore both practical and evidence-based, with support from regulatory precedent in other sectors and will deliver improved outcomes for the consumer.

Comparison to a semi-nominal approach

We recognise that a semi-nominal approach, whereby a nominal allowance is set with no inflation indexation of the RAB for fixed rate nominal debt, alongside a real allowance and indexed RCV for index-linked debt and equity, could potentially address the mismatch between fixed-rate debt and RAB indexation. However, we consider that the fixed indexation approach has significant benefits over such an approach.

The semi-nominal approach has not been consulted on as a solution by the CAA, and we consider it problematic if such an approach were to be applied ahead of H8 Final Proposals after having consulted on a different approach.

Secondly, whilst a semi-nominal approach may be economically equivalent in Net Present Value terms over the long term, it would increase current charges by bringing forward revenues. This would place a greater burden on current airport users and weaken the principle of intergenerational fairness.

It is therefore reasonable for the CAA to prefer fixed indexation, which maintains the existing real price control architecture, avoids unnecessarily front-loading charges and preserves intergenerational fairness. It also reduces pressure on near-term airport charges, which is

particularly important given the affordability challenges facing both consumers and airlines. We would welcome further clarity from the CAA on the potential trajectory of airport charges in response to this broader question.

Similarly, a semi-nominal approach may introduce additional complexity over time. Changes in the relative shares of nominal debt, index-linked debt and equity would require ongoing adjustments to the framework and would introduce modelling complexities even if the same principles are preserved in a time-consistent manner. At the same time, hybrid WACC estimates required for a semi-nominal approach are generally less transparent, predictable and intuitive for stakeholders.

A semi-nominal approach would still rely on many of the same underlying assumptions regarding debt composition as the proposed fixed indexation approach. It therefore does not materially reduce the dependence on regulatory assumptions.

The acceleration of revenues could in principle improve short-term financeability ratios. However, this comes at the cost of future financeability, and we have seen for regulated energy networks that rating agencies can revise their ratings methodology to negate any short-term gain. Accelerating revenues also increases risks around financial resilience if restrictions are not in place around equity distributions from Heathrow.

Other principles

We agree with HAL that the shares of fixed rate and index-linked debt in the RAB should be clear and transparent. In doing so, the proposed policy should accept the premise that companies' actual financial structures have been and continue to be their choice. The CAA should look to assess relevant shares on a notional basis. If this is to be informed by Heathrow's actual debt portfolio, we would request Heathrow's debt portfolio be made public, including derivatives (especially inflation swaps). To date, this information has not been disclosed by the CAA as part of the H8 process and requests for its release have been refused by HAL, limiting stakeholders' ability to assess the basis for any such assumptions. We have previously written to the CAA with these concerns, including the airline community letter of 8th May 2026.

We agree with the CAA's characterisation of the relevance of the CMA's H7 appeal decision. Whilst the CMA found that the H7 approach was not wrong, it did not assess whether that approach remained optimal or whether superior alternatives may be available. Regulatory stability is an important consideration and can promote predictability within the regulatory framework. However, it should not prevent the adoption of materially better approaches where there is a clear case for doing so based on empirical evidence. In our view, the fixed indexation approach represents such an improvement by better aligning RAB indexation with the inflation exposure of the financing it is intended to remunerate, and reducing the potential for inflation-driven windfall gains or losses.

A change to a fixed indexation approach is not a clawback of any historical gains or a retroactive adjustment to the regulatory framework. Rather, it reflects the lessons arising from a period of sustained and unexpected inflation in the H7 period and represents a proportionate refinement to the regulatory framework in the setting of a forward-looking price control. In this context, the ability of the CAA to evolve its framework in response to

experience and changing market conditions should be seen as enhancing regulatory robustness rather than increasing regulatory risk.

Implementation

A key question when assigning weights (e.g. share of fixed rate and index-linked debt) is whether those weights should be assumed to apply over time or apply to the opening RAB 'stock' and then apply for marginal investments. We understand from the CAA that its preferred approach is the latter. If this is the case, this implies that periods of unexpectedly high inflation (versus the inflation measure used) should lead to lower gearing, and vice-versa. This is because the index-linked share of equity is growing faster than the predominantly nominal fixed-rate debt balance, through inflation indexation.

This dynamic means that the CAA should seek the most appropriate inflation forecast to use for deflating nominal debt costs. We consider that market-based inflation estimates (e.g. swaps, breakeven) are most appropriate for index-linked debt. The argument is less clear on nominal debt, though we consider that market-based inflation instruments have advantages over medium-term forecasts (i.e. using forecasts over expected inflation across the next five years).

We disagree with the logic behind the CAA's assumption that all new debt should be treated as fixed-rate nominal debt. The logic appears to be based on the modelling used by FTI to inform the debt allowances. This modelling will not have considered the implications for risk allocation that exist under the fixed indexation approach, notably exposure to different degrees of inflation indexation irrespective of the inflation exposure of the underlying instrument. While this is unlikely to have a significant impact for H8, the decision will establish the baseline for future regulatory periods and should therefore be considered carefully.

In addition, the fixed indexation approach reduces risk to investors and consumers. The reduction in systematic risk should be considered in the beta relative risk assessment.

There would also be value in the CAA signalling whether the fixed indexation approach is intended to endure across future price controls as well as expansion.

We also consider that there would be merit in the CAA supplementing its rationale for the fixed indexation approach with an indication of the potential scale of harm associated with maintaining the status quo. Whilst the theoretical case for reducing inflation mismatches is compelling, illustrating the magnitude of potential windfall gains or losses under status quo would help stakeholders better assess the significance of the issue and the benefits associated with adopting fixed indexation.

We welcome the opportunity to discuss these issues further with the CAA and remain available to provide any additional information or clarification that may assist the development of the policy for the Final Proposals.

Yours sincerely,

Michael Petrides

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