Mr Stewart Carter
Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD
By email: economicregulation@caa.co.uk

15 January 2025

Dear Stewart,

IAG response to CAP3044a
FTI WACC report for H8 and other financial issues

We are writing in response to the CAA's guidance on cost of capital and the FTI Consulting (FTI) report on WACC methodology for the H8 price control. This follows our earlier response, dated 13 December 2024, to the CAA's draft method statement and business plan guidance for Heathrow Airport Limited (HAL).

IAG fully supports the detailed analysis and recommendations presented in the CEPA report, prepared for IATA on behalf of the airline community. We have identified several significant concerns regarding the CAA and FTI's initial WACC assessment which are outlined below.

In estimating the proposed increase of 140 basis points to the WACC (from 3.16% to 4.56% RPI-real), based on market data to 31 July 2024, the CAA and FTI have failed to address several factors which raises serious concerns on potential overestimation of certain parameters. The absence of stakeholder consultation during the preparation of the FTI report is particularly concerning, as early engagement could have addressed these issues more effectively.

The financial implications of this proposed increase are substantial:

- an additional charge exceeding £3 per passenger (using H7 assumptions);
- approximately £300 million in additional returns to HAL, which we consider unjustified.

When combined with the extent of the proposed investment programme, these increases would impact Heathrow's charges at staggering proportions as well as Heathrow's competitive position as a global hub, compromising UK air connectivity and, most critically, affecting consumer affordability, particularly for price-sensitive visiting friends and relatives (VFR) traffic.

The following critical issues have so far been unaddressed and require attention:

- CPI/CPIH indexation transition;
- beta implications of capacity constraints;
- removal of pandemic-related liquidity costs;
- comparative risk assessment of asset beta benchmarks, noting that ADP and Fraport have lower asset betas in the estimation window used by FTI than that in Q6 when HAL's asset beta was assumed to be lower than the range estimated by FTI for H8.

We note concerning inconsistencies, particularly regarding FTI's asset beta calculations. Their analysis suggests HAL's asset beta with minimal demand risk would exceed the CAA's Q6 and H7 pre-pandemic beta, despite the latter scenarios incorporating full demand risk exposure.

As consistently stated throughout H7 and in our response to the draft H8 method statement, we believe that HAL, as the licensee, should not be over-compensated. Nor should HAL be insulated from **all** eventualities as this would be inconsistent with the risk of a regulated business and the cost paid by consumers. The current WACC adjustments provide HAL with approximately £150-275 million annually for partial demand risk due to the existence of the Traffic Risk Sharing mechanism. This level of financial benefit would only be forfeited in the event of a reduction of passenger volumes to the extent experienced during the Covid pandemic.

In line with CEPA's recommendations, for the final method statement due in February 2025 we request the CAA commit to:

1. conducting a comprehensive assessment of comparator airports' relative risk
2. providing airlines with a detailed workbook on Heathrow's cost of debt
3. calculating asset beta assuming all traffic risk was allocated to airlines, and addressing the CAA's current position which sets Heathrow with no traffic risk 0.18 higher than a regulated utility network with no demand risk
4. enhancing the transparency and usability of the H8 price control financial model, ensuring it is able to be understood by stakeholders
5. conducting a fresh assessment for H8 rather than defaulting to H7 parameters, as inferred by FTI
6. evaluating incentives and ensuring the balance of incentives do not disproportionately favour HAL; conducting an appropriate evaluation and taking into account that shielding HAL from **all** potential risks is inconsistent with the challenges faced by the airport or a regulated business
7. clearly explaining how the determination of various parameters aligns with its statutory duties to ensure efficient costs, when estimating the cost of capital.

We support CEPA's recommendations regarding depreciation, inflation, and affordability policies.

Furthermore, we urge the CAA to thoroughly evaluate how such substantial increases would affect consumers in the long-term, as they risk severely limiting product choice, reducing affordability, and restricting connectivity options for consumers.

We welcome continued engagement as the CAA develops its final method statement and remain available to discuss any aspects of our response.

Yours sincerely,

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