JANUARY 2026

# IMPACT OF EXPANSION ON CHARGES AT HEATHROW

## 1. Introduction

On the 29th January 2025, the UK Government announced its support for the development of a third runway and capacity expansion at Heathrow airport. In support of this, and following the Government's confirmation that the north-west runway scheme promoted by Heathrow Airport Limited (HAL) will be taken forward as part of its review of the Airports National Policy Statement (ANPS), the CAA has published several working papers and consultation documents which consider potential changes to the regulatory framework at Heathrow.

The CAA's most recent consultation on regulatory models (CAP3195[1]) was published in November 2025 and, amongst a range of issues, considers the case for changing the current regulatory framework for HAL. The consultation presents a longlist of options which the CAA considers might be applied at Heathrow to manage its expansion and explains how the CAA intends to evaluate a shortlist of preferred regulatory models.

**There is a real risk of an inconsistency between the level of charges that may result from HAL's expansion plans and the level of charges that would provide consumers with more choice, more routes and more frequent flights under expansion options for Heathrow airport. Through the potential impacts on the services run and level of future passenger growth at Heathrow, the level of charges for airlines and consumers at the airport is also inherently linked to the financeability of HAL.**

**The CAA should give close consideration to the current path of charges under the proposed expansion plans and the current regulatory model. Pre-COVID, the ANPS and expansion case had targeted flat (real) per passenger charges. Options to allow this to remain the ambition under expansion, to the extent possible, should be explored thoroughly. The CAA must evaluate the case for alternative regulatory models at Heathrow with this outturn scenario in mind, and how this fits with its primary duty.**

We have reached this conclusion based on IAG's Charges Model ('the Charges Model'). IAG initially developed this model to project the Maximum Allowable Yield (MAY) per passenger at Heathrow under a baseline and alternative set of scenarios and sensitivities for the H8 – H12 price control periods.

The IAG Charges model uses input data from public sources and engagement with HAL (including Heathrow Financials, Heathrow Expansion Proposal and RAB depreciation profiles supplied by HAL). However, IAG has not had sight of the HAL charges model and all its relevant inputs. We understand that capex information was provided for each 5-year regulatory period, while detailed depreciation profiles were given for the existing RAB and H8 proposed capex, but not for capacity expansion capex. We encourage the CAA to gather relevant inputs as part of its regulatory option assessment and to develop its own charges model. Such a model should be made available to stakeholders to see the expected impact on charges under different policy options.

We have tested whether the IAG Charges Model provides a plausible projection and illustration of MAY per passenger under HAL's expansion proposal and under sensitivities to key assumptions in the modelling. We have then used the results to set out possible implications of this modelling for the evaluation framework and regulatory models the CAA is currently consulting on as part of CAP3195.

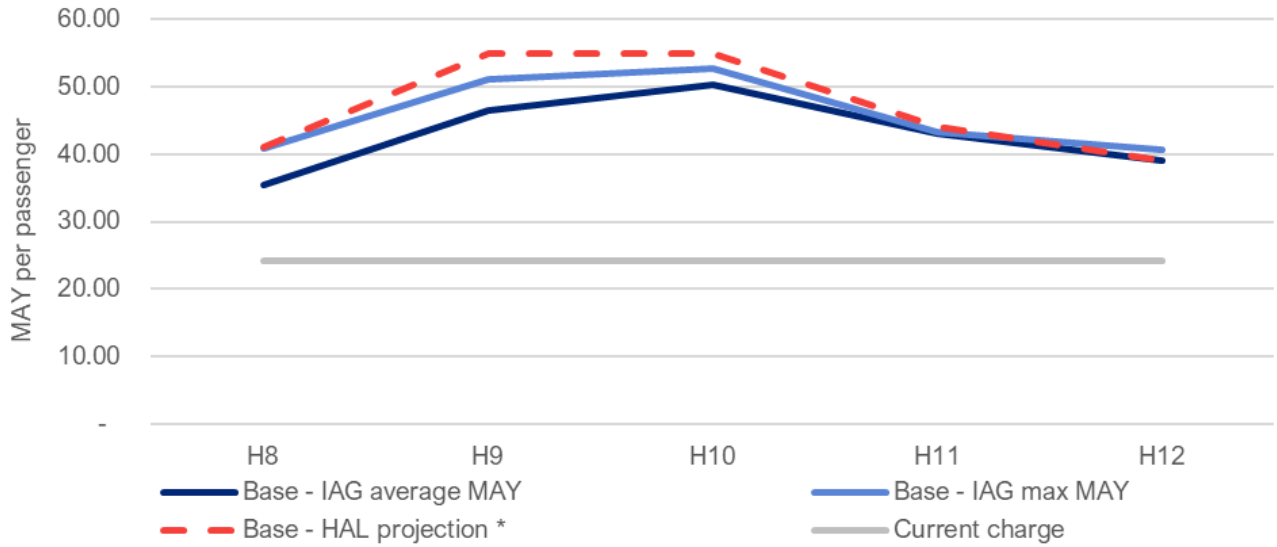
## 2. Testing the baseline model and its sensitivity to key assumptions

The logic of the Charges Model is sound. While there remains some discrepancy[2] with HAL's own projections, it produces a MAY per passenger projection that is broadly consistent with HAL's forecast trajectory using input assumptions that are understood to be consistent with HAL's model - see Figure 1.

[1] CAA (2025): 'Working paper on regulatory models'

[2] The baseline Charges Model currently produces a lower modelled MAY projection than HAL's reported projection for 3R.

**Figure 1: Modelled Maximum Allowable Yield (MAY) (real 2024 prices)**




*Source: HAL, CEPA analysis of IAG Charges Model, * interpolated from a figure in HAL's expansion plan document*

The current charge reflects the final year of H7 (real 2024 prices), equivalent to £24.28 MAY per passenger.

In this baseline, the average price control MAY per passenger is projected in 2024 real (CPI) prices to increase to c.£35 per passenger in H8, increasing by a further £11 and then £4 per passenger in H9 (c. £46) and H10 (c.£50) respectively, before reducing to c. £39-43 per passenger in H11 and H12. The maximum MAY per passenger within a given price control period is slightly higher. In contrast, HAL's modelling projects a higher MAY[3] per passenger. It is not clear whether HAL's projections are an average price control MAY per passenger or the maximum MAY per passenger during a given period.

This finding gives comfort that the baseline Charges Model provides a plausible estimate (albeit more likely to be an underestimate given HAL's own modelling) of the baseline impact of HAL's current capacity expansion plans on the level of Heathrow's per passenger charges. It is a reasonable basis for testing how sensitive the modelled MAY per passenger projection could be to several of the key input assumptions in the Charges Model.

There are many input assumptions to the baseline Charging Model's MAY projection.

Amongst the most important, are the real allowed WACC of 6.76% in H8 (as per HAL's H8 Business Plan) followed by 7.0% from 2032 – 2041, a projected expansion capex of £49bn (2024 prices) and a depreciation period for new assets of 60 years for runway and 30 years for terminal buildings. We understand that these assumptions align with HAL's own stated modelling as is summarised in the table below (we understand that IAG engaged with HAL to discuss these assumptions). These assumptions reflect the cost of capital and capex at the airport both increasing during the development period of the expansion scheme.

**Table 1: Summary of input assumptions for modelling**

| Input | Description |
|---|---|
| RAB | Assume a real RAB model with charges indexed to inflation. |
| Inflation | Use long-term CPI inflation of 2.0% from 2030 onwards, with March 2025 Office of Budget Responsibility (OBR) projections from the OBR used up to that point. |

[3] A range of factors may be driving the observed discrepancy between the baseline in the Charges Model and HAL's MAY projection. This warrants further investigation.

| Input | Description |
|---|---|
| Real WACC | We use a 6.76% real CPI WACC as per Heathrow's H8 business plan, followed by 7.00% from 2032 to 2041, with a 6.00% figure used thereafter. We understand that this is consistent with HAL's own projections. |
| Passengers | We assume an existing passenger capacity of 96m pa. Passenger ramp-up from expansion takes 10yrs to occur. We present our base case passengers in Appendix A. |
| Expansion Capex | We assume £49bn of capex in real 2024 prices. This covers the runway, Terminal 5 expansion and a new Terminal 2. We present our base case capex build-up in Appendix A. |
| BAU Capex | We assume £9 of annual capex per passenger per annum. |
| Depreciation | We assume for new assets: 60yrs for runway and 30yrs for terminal. All BAU assets are depreciated using 20yrs. |
| Opex and Commercial Revenues | We use HAL's H8 business plan assumptions, with opex higher than commercial revenues.<br>For subsequent years, we use HAL's assumptions. Opex is lower than commercial revenues from H9 onwards (by £0.50/pax in H9, by £1.25/pax in H10, by £2.00/pax in H11 and by £3.00/pax from H12 and thereafter – figures all in 2024 prices). |
| Business rates | Business rates are excluded from the baseline modelling case. For one individual sensitivity (see discussion below), these are added. For this sensitivity, we assume a £951m Rateable Valuation with 52.8p multiplier throughout, with a 25% cap on the annual increase in business rates from the start of H8 onwards. |

*Source: IAG Charges Model*

It is important to note that the baseline assumptions may be influenced by the regulatory model the CAA decides to apply at Heathrow. For example, variations to the current model may strengthen capex governance and pressure on costs, or apply greater competitive pressure to scheme design and costs. Competitive models that involve third party financing may influence the required depreciation periods as well as returns to match financing duration.[4] Choices on allocation of risk to the scheme promotor would also be expected to influence the WACC.

Alongside the baseline model, which we have compared to HAL's published MAY projections (see Figure 1), we have, therefore, also developed a series of sensitivities to test how passenger charges could vary.

**Table 2: Description of sensitivities**

| | Description |
|---|---|
| Sen1 | 20yr asset lives for all assets. |
| Sen2 | Real pre-tax WACC is 1% lower than the base assumption. |
| Sen3 | Expansion capex is 140% of the base assumption. |
| Sen4 | Passenger volumes 10% lower than the baseline projection. |
| Sen5 | Business rates are included in the charge projection, with the approach as set out in Table 1. |
| Sen6 | Opex-commercial revenue per passenger differential at £2.30 / passenger, its assumed current level. |

*Source: CEPA analysis*

The results for each of these individual sensitivities relative to the baseline are summarised in Figure 2 and Table 3 below which shows the MAY per passenger. Appendix B shows how each sensitivity differs to the baseline.

[4] Alternatively, a residual value payment may be required in the contract, so that the asset can be depreciated over a longer economic life than the duration of the required / optimal period for debt finance.

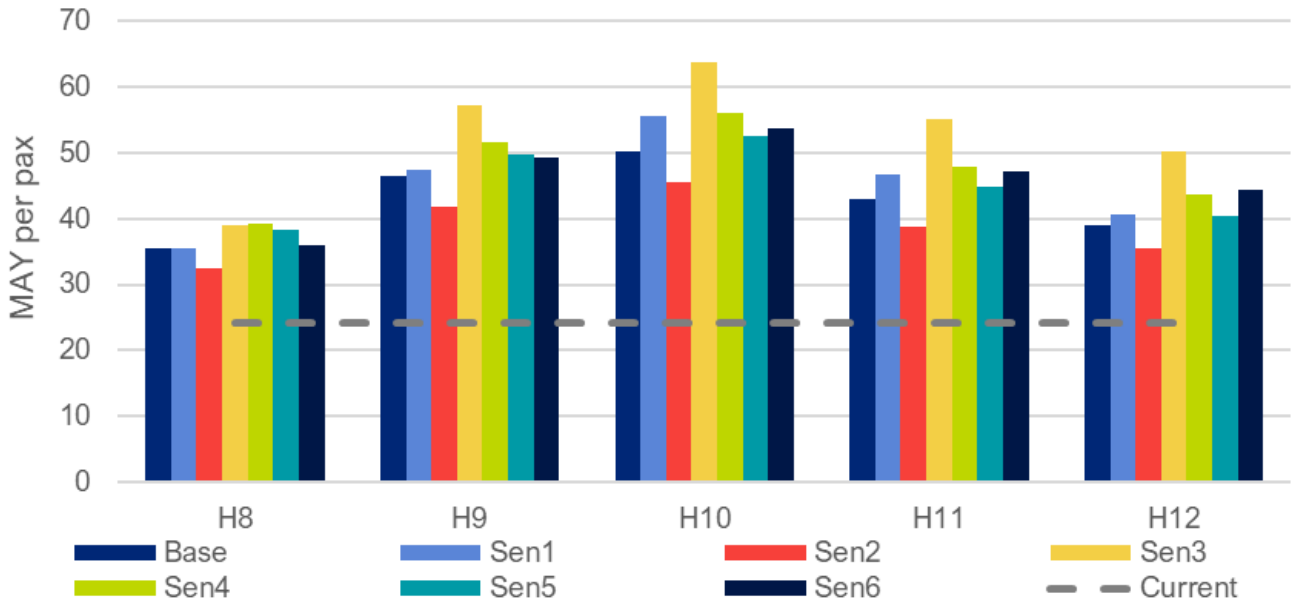
This has been a key issue in competitive delivery models in energy (CATOs) and water (DPC) where the expected economic life of the competed asset is longer than the optimal contract length for financing.

**Table 3: Modelled Maximum Allowed Yield per passenger (2024 real prices)**

| | Base | Sen1 Depn 20y | Sen2 WACC -1% | Sen3 Capex 140% | Sen4 Pax -10% | Sen5 Business Rates | Sen6 Opex-Comm Rev. |
|---|---|---|---|---|---|---|---|
| H8 | 35.41 | 35.41 | 32.45 | 38.98 | 39.15 | 38.30 | 35.92 |
| H9 | 46.44 | 47.49 | 41.86 | 57.25 | 51.66 | 49.70 | 49.24 |
| H10 | 50.26 | 55.51 | 45.64 | 63.86 | 55.98 | 52.63 | 53.81 |
| H11 | 42.99 | 46.69 | 38.89 | 55.14 | 47.99 | 44.80 | 47.29 |
| H12 | 39.06 | 40.61 | 35.41 | 50.13 | 43.73 | 40.46 | 44.36 |

*Source: CEPA analysis of IAG Charges Model. Note: figures represent price control average MAY.*

**Figure 2: Modelled Maximum Allowable Yield (MAY) (real 2024 prices) – baseline vs. individual scenarios**




*Source: CEPA analysis of IAG Charges Model. Note: figures represent price control average MAY.*

The last year of the H7 price control has charges equivalent to £24.28 per passenger (real 2024 prices). All charges modelled for H8-H12 are notably higher than this level. The peak charge in the baseline is just above twice this level.

This analysis shows that the MAY per passenger is highly sensitive to several key assumptions in the Charges Model which could potentially drive per passenger charges significantly higher than the baseline.

## Cost of capital, financeability and depreciation

We have previously submitted our assessment of HAL's proposed cost of capital at H8 under a two-runway solution. We consider that HAL's estimate is materially above an efficient level of financing.

HAL's expansion model includes a significant premium in the allowed WACC compared to H7, which it considers necessary for the scheme to be financeable and investible for its shareholders given the scale and complexity of the expansion project. It is not clear the basis for the premium and the expected evolution over time to comment in more detail on those estimates. However, it will be critical for the CAA to set a reasonable allowed WACC to keep charges at a level that delivers benefits for consumers.

We consider that an outcome consistent with Sen2 is preferable, but the CAA has not yet set out its own view on any uplift or how it will consider financeability – therefore, it is unclear what level of WACC can be expected under

the current regulatory model and whether cashflows would or may need to be advanced via depreciation to support financeability. However, it is possible – depending on how a commercial model was structured – that a competitive delivery model might reduce the realised cost of capital relative to the baseline.

The financeability of HAL is inherently linked to affordable charges at Heathrow to generate the passenger volume growth that is likely to be necessary to cover the costs of expansion over time. Therefore, the issues of affordability and financeability are interlinked. We discuss financeability in further detail below, but also note that assuming high levels of gearing for the notional company would put additional pressure on financeability.

## Level of capex

The MAY per passenger projection above also assumes that the capital cost of the scheme will be delivered to HAL's current projected capex and passenger forecasts. Experience of delivery of large capital projects would suggest that the cost of expansion will increase materially from current projections, particularly given experience with the current regulatory model and HAL's track record in delivering large capex schemes as referenced by the CAA in CAP3195.[5] [6] Again, contestable delivery models, including a number of the models discussed in the CAA's CAP3195 working paper, may be viewed as a mechanism to protect consumers from this risk.[7]

We note that the Heathrow £49bn capex figure does not include any spend in relation to T4, cargo or any rail scheme costs that may be planned to be recovered through user charges. This is another route by which the capex envelope could increase.

## Passenger volumes

There are several issues to note in relation to the passenger volume assumptions in the baseline.

First, the baseline passenger projections are dependent on airlines that use Heathrow committing considerable capex to deliver the aircraft capacity that will be needed to deliver the passenger forecasts assumed in the baseline modelling case above. We understand from IAG that to deliver the growth and the replacement aircraft capacity to Heathrow, airlines may need to invest £45bn or more (2024 prices) of their own capex during the 10-year period of ramp up of their aircraft to enable the passenger forecast projections. This is additional to the expansion capex at Heathrow that will be recovered from passenger charges that would need to be paid to HAL.

This raises several dependencies to consider when interpreting the modelling:

- As with the airport, for airlines to make the required capex investment, they will need to expect to earn a required return on their investment. The level of increase in aeronautical charges at Heathrow will be an important input to determining whether that investment (both for replacement and new incremental aircraft capacity) is sufficiently profitable, and that the airlines can expect to realise (at least) their cost of capital in undertaking the investment.

  As a result, the passenger forecasts in the baseline would not be independent of the level of Heathrow's charges in the baseline.

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[5] See Flyvbjerg B. & Gardner D. (2023): 'How Big Things Get Done'. In Appendix A, they report that the mean cost overrun for airports is 39% increasingly to 88% for projects in the tail. They note that this cost overrun is calculated not including inflation and baselined as late in the project cycle as possible, just before the go ahead (i.e., final business case at final investment decision). This leads to them to state the figures are conservative and if inflation had been included, and early business cases used as the baseline, cost overrun would be much higher, sometimes several times higher.

[6] The CAA states that "*there are characteristics of major capital projects that may limit the effectiveness of the current regulatory model in protecting the interests of consumers*" and "*although we have not, to date, found direct evidence of material inefficiency on HAL's part, we have raised concerns in the past regarding the processes under which HAL has historically undertaken large capital projects.*" CAA (2025): 'Working paper on regulatory models', para 1.13

[7] Although it remains to be seen whether an opportunity, when put to market, can prevent escalation of project cost above the current £49bn projection, given this will be heavily influenced by HAL's early-stage design and development work.

- There is a risk, therefore, of an inconsistency between the level of charges that may result from HAL's expansion plan, and the level of charges necessary to deliver a sufficient return on investment for the airlines to be willing to invest in the capex which supports the passenger projections in the baseline.

  The risk is that expansion at Heathrow increases per passenger charges, and in doing so this damages airline economics which prevents airlines from earning their cost of capital on their new investment. This creates the risk that airlines will not invest, lower passenger volumes will result, and this then places further upward pressure on per passenger charges, and further downward pressure on demand and connectivity at Heathrow. This results in weaker financeability of the airport.

Given this dynamic there is a real prospect of outturn scenarios where the growth in passengers at the airport could lag the 10-year ramp up from expansion which is assumed in the baseline case. In such a scenario, which Sen4 is intended to help to illustrate, this would add further upward pressure on the MAY per passenger as the costs of the airport are recovered over a smaller passenger base than in the baseline. This could put further pressure on both airport charges and airline margins, and start to give rise to the dynamics outlined above.[8]

A second issue and scenario to recognise is that the recent experience with the COVID pandemic would indicate there may also be periods during H8-H12 when passenger numbers are lower than Heathrow's projections due to external shock events. For a period, this could also have a significant effect on the economics at Heathrow, and there is plausibly the risk of a similar ratchet effect where increases in charges to compensate, lead to passenger volumes remaining depressed[9]. If the period of reduced passenger demand came at a time when capex was high, CAA could face material challenges in calibrating an affordable and financeable price control package.

### Other assumptions

It is also plausible that the baseline assumption of the balance between commercial revenues and opex per passenger may turn out less favourable in future than is assumed in the baseline, particularly if during the initial establishment period of the expanded operations at the airport there is a drag on commercial revenue generation. The assumed change runs contrary to HAL's forecast for opex to materially exceed commercial revenues for H8 after assumed equivalence during H7. We also note the risk of 'hold-up' issues if an acceptable level of charges is driven by significant improvements in commercial revenue generation that HAL seeks to argue may only be achievable via a change in the boundary of the single till or a move to dual till under the current regulatory model.

Airlines strongly oppose a move away from the single till model. Airlines argue that if the business cases are robust, they will not block commercial programmes as it is in their interests to see commercial revenues contributing to lower charges.

We also show the impact of the expected increase in business rates. We have not included any increase in the rateable value in our modelling, but it does indicate additional upwards pressures that could influence charges and the economics of air travel.

## 3. Additional scenarios

To reflect the above considerations, we have developed low and high scenarios for MAY per passenger as alternatives to the baseline scenario.

- The **low scenario** – potentially reflecting a scenario where a competitive delivery model involving third party financing is explored by the CAA – assumes a 1% reduction in the allowed rate of return relative to the baseline (Sen2).

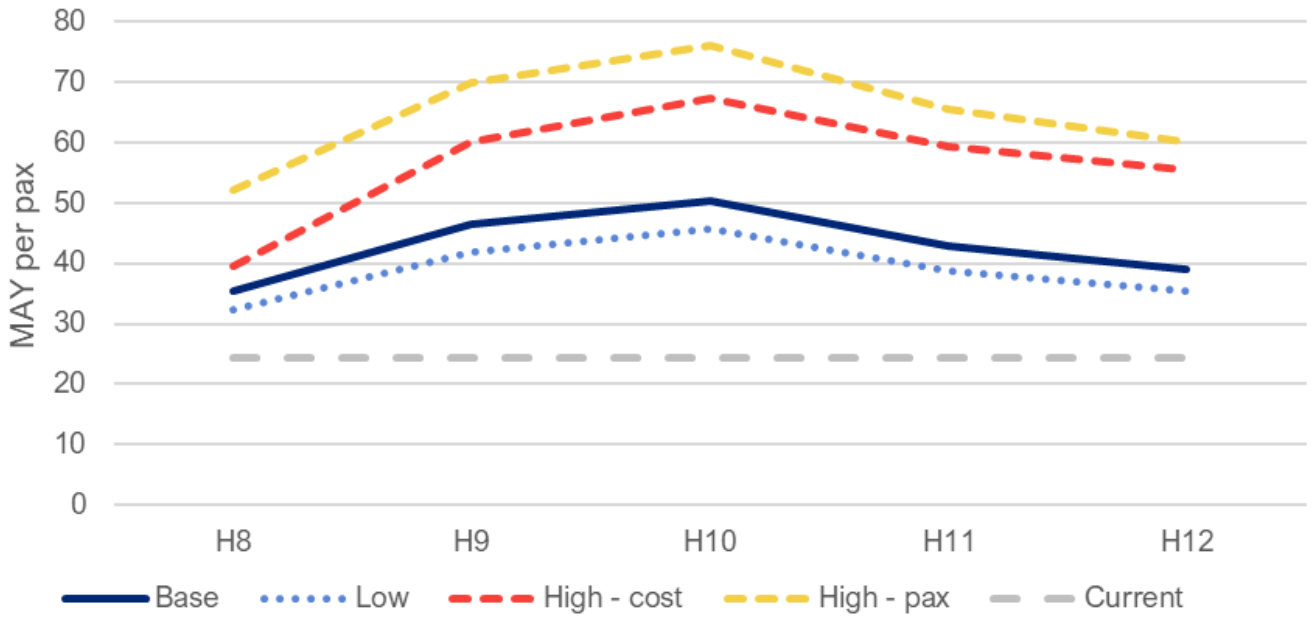
[8] We discuss this dynamic further in Section 5 below.

[9] We note that the airlines have indicated that increased charges could lead to them reducing flights from Heathrow, which create a ratchet effect on airlines, not only from passengers.

- The **'high – cost' scenario** – potentially reflecting a scenario where the CAA decides to introduce more incremental changes to the current regulatory model – reflects a combination of higher capex (Sen3, with 140% of the forecast £49bn capital cost in the baseline) and a more conservative opex-commercial revenue forecast than assumed (Sen6).
- The **'high – passenger' scenario**, where passenger numbers fall by a third relative to the baseline is intended to help illustrate the impact on charges if a passenger shock occurred for several years, as recently illustrated with the Covid 19 pandemic, and to highlight the issue of how such a scenario, potentially alongside an already elevated MAY per passenger, would be managed under the future regulatory model.[10] Note we would not expect this to be a credible scenario for every price control, or potentially even a full 5-year price control period.

Figure 3 below illustrates the results across each of these three scenarios alongside the baseline.

**Figure 3: Modelled Maximum Allowable Yield (MAY) (real 2024 prices) – baseline vs. combined scenarios**




*Source: HAL, CEPA analysis of IAG Charges Model. Note: figures represent price control average MAY.*

This analysis, together with the individual sensitivities in Figure 2 and Table 3, helps to illustrate that:

- There are plausible scenarios where charges per passenger at Heathrow could on an enduring basis be above the baseline scenario, and materially above a relatively flat real charges profile as previously targeted in the Airport Commission review and the last ANPS review of expansion options at the airport.[11]
- The level of charges at Heathrow over H8-H12 are very sensitive to the return on and return of capital assumed in the modelling. This helps to highlight the importance of the CAA's current (CAP3195) consultation on regulatory models given that these models would be expected to influence cost, finance and other important issues to users such as service quality (see discussion below).

[10] The CAA's H7 determination indicated that it considered that the impacts of the Covid pandemic may be a 1-in-20 year event, i.e. that it is likely to recur in the modelled 25-year period (between H8 and H12).

[11] It is also important to note that the IAG Charges Model baseline is *lower* than HAL's published projection. Therefore, it is quite plausible that the modelling is an underestimate of the level of projected charges in real terms over future price controls.

## 4. Implications for Heathrow's regulatory model and policy levers

The main implications for the CAA's consultation on regulatory models at Heathrow are as follows:

- **First**, the Charges Model appears to confirm that capacity expansion will materially increase charges at Heathrow from current levels if the current plans are progressed, with sensitivity analysis of the baseline indicating that even if input assumptions are varied from HAL's assumptions, per passenger charges will not remain flat in real terms.

  This contrasts with the projections published in 2018 around the ANPS which indicated a reasonably flat real MAY per passenger was plausible at Heathrow under an expansion option under a range of scenarios in line with the ambition expressed by the Secretary of State in 2016.

  If there were an expectation that MAY per passenger at Heathrow is likely to exceed a level of charge that supports the range of flights and routes that underpin the case for Heathrow's expansion plans (including associated connectivity benefits – see Section 5 below for further discussion on these issues), there would be a 'funding gap' between HAL's required revenue under its current expansion plans and the cost recovery that is sustainable through its airport charges. Reducing the cost of the scheme to users is likely the primary intervention that would need to be taken. In this instance, the regulatory model adopted by the CAA will need to apply considerable downward pressure to the expansion capex and/or allowed returns. Alternatively, an innovative cost recovery mechanism would need to be considered which alters who would ultimately pay for the expansion at Heathrow and its economic benefits.

- **Second,** the CAA's CAP3195 consultation already highlights how Heathrow's charges are high compared to other major airports. The baseline MAY modelling would indicate, despite the projected passenger growth at Heathrow, that this picture may only deteriorate in forthcoming price controls. This is despite the expansion plans not appearing to provide any clear material improvement in expected service quality[12], although the number of passengers able to access the airport will of course be greater.

  A business operating in a competitive market, would naturally be expected to ask itself what more are customers being offered when the price that is being charged is increasing?

  This provides further support for the CAA and IAG investigating regulatory models that, as well as supporting the delivery and financing of infrastructure and capacity expansion through increased charges, also place pressure on HAL to improve service quality and to moderate the deterioration in service quality which the CAA itself cites in CAP3195, at Heathrow itself and relative to other airports.

- **Third**, as discussed above, one of the key drivers of the projected increase in the MAY per passenger is HAL's proposed increase in the CAA's allowed WACC relative to H7. While we consider that this exceeds efficient financing costs and will be reduced in practice, we however recognise that there is significant pressure for HAL to deliver Heathrow expansion as quickly as possible and the very large investment programme will need to be funded by debt and equity investors that operate in globally competitive markets as is referenced by the CAA in the CAP3195 consultation.

  When faced by a material step-up in capex intensity, regulators typically consider uplifts to cost of capital or using other levers including accelerated depreciation or nominal or semi-nominal returns. Each of these policy choices would increase the level of charge over the H8-H12 period; the first latter two in bringing forward revenues and an uplift to the cost of capital providing an NPV positive return to the regulated company arguably already reflected in the baseline scenario.[13]

[12] Unless expansion increases the diversity of flights and routes that are available from Heathrow.

[13] On the assumption that the expected allowed WACC is above what the market evidence and a more contestable model might imply as the cost of capital for delivery of the expansion programme or a component of that programme.

This has several implications for the regulatory model:

- First, it provides further justification for why contestable approaches should, where possible[14], be explored to market test the cost of the expansion scheme, including the cost of capital in financing the investment, particularly during construction.
- Second, if only incremental changes are eventually introduced by the CAA to the regulatory model, airlines and users might reasonably expect that the quid pro quo is there is effective risk transfer through the regulatory model, in terms of who bears the volume and cost risk from expansion.

There is a risk, however, of a scenario where users of Heathrow receive the worst of all worlds, whereby:

- the regulatory model introduces a premium in the allowed WACC above an efficient level based on market evidence, on the grounds of HAL financeability pressures and uncertainties[15], *and*
- there is limited risk transfer to the airport during its delivery and operation of the expanded airport under the current regulatory model.

The baseline under this line of logic is not a high case for "negotiating down" in future price reviews, rather a *plausible expected case* under the current regulatory model.

- **Fourth**, levers that might be used under the current regulatory model to improve Heathrow's financeability, through advancing or increasing cashflows should there be a material reduction in passenger forecasts, may be more constrained than at present under the projected level of charges above.

  This adds further weight to the argument that it is crucial to ensure that HAL and/or any other infrastructure provider that plays a role in the delivery and financing of capacity expansion under the airport's future regulatory model, is resilient to such shocks and/or that the regulatory models give careful consideration to the appropriate transfer of risks between the airport, airlines and users of the airport.

  The CAA's regulatory model assessment must consider the optimality and performance of its short-listed regulatory models under such shock as well baseline charge and cost projection scenarios (including circumstances where there was a period of significant disruption to financial markets), and this appears to be an avenue of analysis that is not given sufficient weight in the proposed evaluation framework of regulatory models, at least as currently set out in the CAP3195 working paper.

  For example, one issue under some of the more incremental change options in CAP3195 is the level of gearing that HAL is allowed to maintain whilst also delivering the expansion scheme.

  Companies' financing choices reflect their (shareholders') judgements about their exposure to risk. The prolonged debate over Thames Water strongly suggests that these expectations are not always aligned among stakeholders including shareholders, lenders, regulators, Government and end-users. This helps create the conditions for moral hazard: where regulated businesses become – or act or are treated as though they are – too big to fail. One regulatory response to this may be to monitor financial resilience and even seek to control the determinants of financial resilience. But another would be to emphasise the important role that downside risk plays in incentivising financial discipline.

[14] Taking into account the impact this may cause for undue delay to the delivery of expansion and the impacts on Heathrow's ongoing business activities and operations.

[15] Or some of the other levers noted above are introduced that bring forward cashflows to address financeability concerns.

In Heathrow's case, it may require CAA or another body taking a more proactive role to facilitating how expansion is managed, financed and delivered to address the moral hazard risks and greater clarity on the expected allocation of key risks between different stakeholders in Heathrow's expansion programme.[16]

Whilst understandable given the stage of the consultation process, an area that only receives high level discussion in CAP3195 is how different regulatory models would be expected to approach the allocation and exposure of the scheme promotor, infrastructure provider[17], airlines and end-users to different risks in the execution and delivery of the expansion programme. How shocks and risks such as cost overruns compared to the current £49bn estimate would be treated are fundamental to the effective design of the regulatory model at the airport and what may be viewed as a fair level of return for investors.

- **Fifth,** the CAA's current approach to setting depreciation within Heathrow's price control lacks transparency, and given its impact on charges, greater clarity is required. As noted above, HAL has indicated, at a high-level, that it has assumed a 60 year and 30-year asset life in its modelling for the runway and terminal building respectively. The CAA has indicated one of the advantages of competitive (e.g., DBFO or DBT) delivery models are they can apply competitive pressure to the costs of the airport's expansion.

  As discussed above, one of the implications of moving towards competitive models is that there may be pressure for HAL or the CAA to consider a shorter depreciation period than HAL appears to assume under the current regulatory model. Contract lengths for DBFO style models in other contexts have typically been 20-30 years to match infrastructure debt financing requirements. While there are ways to match the profile of cost recovery to the economic life of the asset whilst still maintaining a more optimal 20-30 year duration of non-recourse project financing for the contract duration[18] there is the potential for alternative models to the current regulatory framework to increase pressures to accelerate the period of depreciation.[19]

  Furthermore, one of the risks to the baseline scenario under the current regulatory model (as discussed above), is that despite HAL stating today that it has assumed a 60-year and 30-year depreciation period of runway and terminal infrastructure respectively, when it comes to the time of financing, observed pressures on key financial ratios either lead it to argue for accelerated depreciation or the CAA identifies this as a lever to help alleviate financeability pressures alongside the allowed rate of return. This would lead to notably higher peak charges than modelled under 60-year and 30-year asset lives.

## 5. Implications for the economic case for expansion at Heathrow

Under the Civil Aviation Act 2012, the CAA's primary duty (Section 1(1)) when carrying out its economic regulation function is to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services. Section 1(3) discusses the financeability duty, with the need to secure that licence holders are able to finance activities authorised by the licence. This is not a primary duty, but may be considered a constraint on how the primary duty is exercised[20].

[16] This is perhaps implicitly recognised within the CAP3195 consultation through the long list of models the CAA set out. For example, a price benchmarking or long-run incremental costs ('LRIC') framework may imply a transfer of cost risk to the airport if the required charges based on its outturn costs exceed the external benchmark. The cap and floor model considered by Santander and Freshfields in their analysis for HAL, would imply a more explicit allocation of volume risk than the current model.

[17] If not the same entity as the scheme promotor.

[18] For example, by allowing refinancing with the terms of the contract or by a residual value payment being made by at the end of the contract which reflects the remaining (to be depreciated) RAB value to be financed and recovered in the subsequent regulatory or contract period. Both approaches have been considered in other sectors for other competitive delivery models.

[19] As illustration of the impact of this, we have provided a 20-year depreciation period sensitivity (Sen1).

[20] For example, Heathrow note that in its H8 business plan that they are targeting a minimum 9% FFO / Net Debt ratio.

Any outcome from expansion must ensure that first and foremost the primary duty is met. If expansion is not affordable and not in the interest of consumers, once expansion has been taken forward the financeability duty would also be more challenging to achieve.

It is of paramount importance that any CAA decisions ensure capacity expansion has a positive benefit, as discussed in the CAP3195 consultation. An important perspective on the potential regulatory models in CAP3195 is how these may impact on the economic case for Heathrow expansion, including the impacts the plans may have on airline economics arising from the level of charges at the airport.

Pre-COVID, the ANPS and expansion case had targeted flat (real) per passenger charges. The CAA had set out in 2018 (CAP1658) that it had submitted its final report to the Secretary of State with its analysis indicating[21]:

> "While the range of plausible outcomes with respect to airport charges per passenger remains relatively wide, our initial assessment suggests that there are credible scenarios in which capacity expansion can be delivered affordably and financeably, with **airport charges per passenger remaining close to current levels in real terms and line with the ambition expressed by the SoS on these matters in 2016**." CEPA emphasis added.

As discussed above, passenger projections at Heathrow should not be considered independent of the level of airport charges at Heathrow. Per passenger charges at the level projected above, may risk airlines over time moving flights elsewhere, or choosing not to run routes, as the economics become more challenging for certain market segments, undermining the network effects from running services at Heathrow:

- Heathrow[22] is proposing a major expansion, which the modelling above would suggest will substantially increase the airport's per passenger charges and, therefore, the costs airlines must recover through increased fares and/or other customer-facing charges, or accept as a reduction in margin.
- The airport's charges will be an important input to the commercial dynamics of the airline industry operating at Heathrow and other London airports, disciplined by the competitive dynamics and pressures applying to airline fares and the service of direct and connecting traffic at London airports.
- Where an increase in Heathrow's charges act to compress airline margins, this risks forcing changes in airline behaviour—including route level decisions, and importantly decisions regarding capacity deployment and incremental investment[23]—which then may place passenger forecast growth at risk.
- A weaker passenger forecast then risks feeding back into the regulatory model: lower volumes increase the required per passenger charge to recover a given airport revenue requirement, which may then further depress demand, and further increase the per passenger charge.

This dynamic may risk undermining the economic case for expansion, alongside the risks to a positive CBA around the underlying outcome cost of the scheme[24]. This provides further justification for why expansion at Heathrow cannot come at any cost, and that the regulatory and funding model for expansion matters to the overall public interest case for expansion in mitigating this risk.

[21] CAA (2018) Economic regulation of capacity expansion at Heathrow: policy update and consultation. Available here.

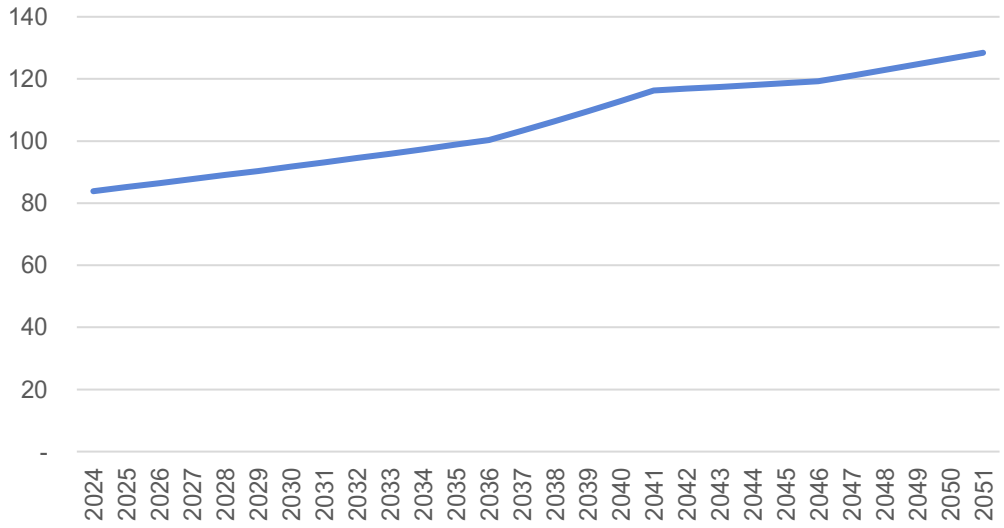
[22] A designated airport with substantial market power.

[23] Where there is a risk that airlines may not expect to realise (at least) their cost of capital when undertaking the investment. See discussion on this point above.

[24] As discussed above, played out over time, this dynamic could also risk Heathrow's financeability.

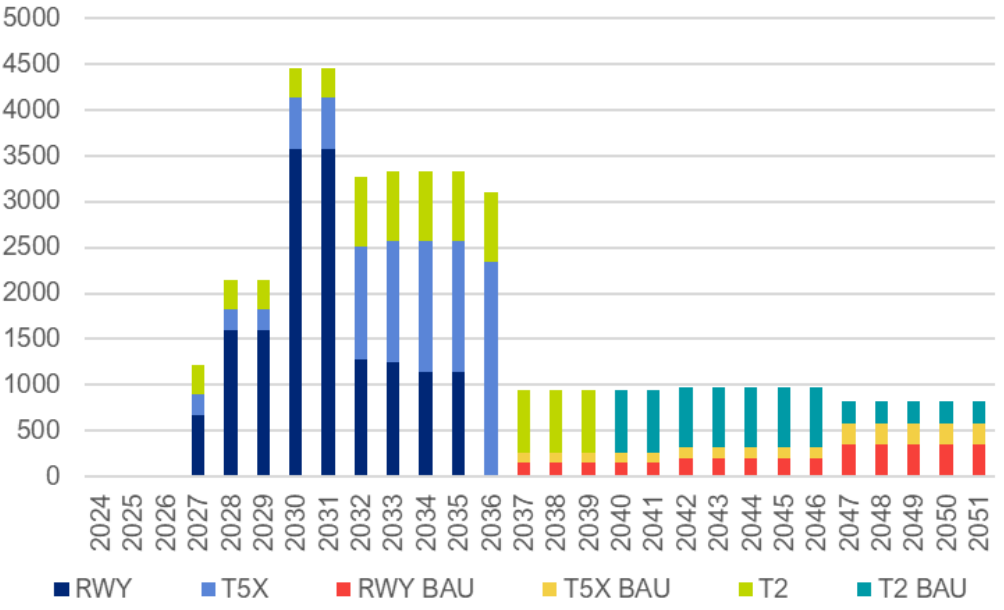
# Appendix A: Passenger and capex projections

*Figure A1: Assumed annual passengers (millions)*




*Source: IAG Charges Model*

*Figure A2: Assumed capex spend (£m, real 2024 prices)*




*Source: IAG Charges Model*

## Appendix B: MAY per passenger, £/pax delta under sensitivity to baseline[25]

| | Sen1 Depn 20y | Sen2 WACC -1% | Sen3 Capex 140% | Sen4 Pax -10% | Sen5 Rates | Sen6 Opex-Comm R. |
|---|---|---|---|---|---|---|
| H8 | 0.00 | -2.96 | 3.57 | 3.74 | 2.89 | 0.51 |
| H9 | 1.05 | -4.58 | 10.81 | 5.22 | 3.26 | 2.80 |
| H10 | 5.25 | -4.62 | 13.60 | 5.72 | 2.37 | 3.55 |
| H11 | 3.70 | -4.10 | 12.15 | 5.00 | 1.81 | 4.30 |
| H12 | 1.55 | -3.65 | 11.07 | 4.67 | 1.40 | 5.30 |

*Source: CEPA analysis of IAG Charges Model. Note: figures represent price control average MAY.*

[25] 2024 prices.

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