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UK Civil Aviation Authority

[By email only to economicregulation@caa.co.uk]

**Re: UK CAA consultation on economic regulation of Heathrow Airport: H8 initial proposals (CAP3232)**

To whom it concerns,

The Civil Aviation Authority's ("CAA") consultation on *Economic regulation of Heathrow Airport: H8 initial proposals* ("CAP3232") comes at a dynamic point in the development of Heathrow airport and the regulatory regime under which it operates – with both the development of a third runway and supporting terminal capacity, and a review of the economic regulatory framework, in progress. The expectation of an increase of charges at Heathrow resulting from the investment necessary to deliver the third runway makes it even more critical that the price and service levels set for the next regulatory period support operation of Heathrow airport at the optimal cost/output frontier. We therefore welcome the opportunity to respond to CAP3232. While we appreciate the CAA's decision to maintain aeronautical charges approximately flat in H8 compared to H7, we request that the CAA further reviews certain elements of the building block model which could result in a final decision closer to that of the 25% charge level decrease supported by the airlines' alternative business plan for the H8 period.

Delta is proud to operate at London Heathrow as part of its joint venture with Virgin Atlantic Airways ("VAA"), KLM, and Air France. Together we offer more than 180 daily flights connecting to over 220 destinations in North America and 120 destinations in the United Kingdom and Europe. To set the context of Delta's response, Heathrow is the third largest long-haul international hub in Delta's global network, after Delta's international long-haul hubs at Amsterdam (AMS) and Paris-Charles de Gaulle (CDG). Delta currently serves Heathrow from four hubs in the United States, including Atlanta (ATL), New York (JFK), Boston (BOS) and Detroit (DTW), including multiple daily flights from several of these hubs to Heathrow. Additionally, Delta and VAA launched the carriers' original joint venture in 2013, combining our trans-Atlantic networks between the UK and North America. The combined network reach of the Delta/VAA joint venture covers more than 99% of the overall market demand between the continental U.S. and London. It is clear that Delta has a substantial, long-standing and future strategic interest in the sustainable development of Heathrow, which includes the provision of economically viable operations for airlines at this airport.

Delta fully supports the CAA's decision to continue a full single till framework at Heathrow for H8, ensuring that both aeronautical and commercial revenues are reflected in the maximum allowable yield (price cap). Any dilution of the single till framework would drive a higher level of aeronautical charges and therefore not be in the best interest of consumers. Our further comments are in the context of a full single till model being implemented for H8.

Although the CAA has reduced the proposed allowances across several building blocks, including operating expenditure and the cost of capital, the overall proposal still permits a level of expenditure and return that exceeds what airlines consider efficient and necessary. In particular, the proposed operating expenditure allowance remains significantly above airlines' estimates of what would be considered efficient costs, and we request a further review of the operating expenditure levels being proposed in the airlines' alternative business plan to identify opportunities to further reduce this allowance.

We consider the £5.8 billion capital allowance proposed by the CAA for H8 to be a more realistic proposal than the originally requested £10 billion, absent any substantial expansion of capacity (to be delivered outside the scope of H8). However, we ask that a spend oversight process be established to ensure that any capital spend within H8 is only for essential investments that deliver a clear consumer benefit. This is of particular importance given the context of the third runway and potential further expansion of Heathrow that would result in large increases to the Regulated Asset Base ("RAB") and the corresponding allowed return on this larger RAB. As the costs under discussion for capital investment in these other expansion projects are extremely large, it risks shifting the focus away from the necessity of efficient capital spend on the projects within H8, which is why we are requesting that the CAA set out a clear spend oversight process for any H8 capital expenditures.

The approach adopted by the CAA in calculating the allowed return (the "Weighted Average Cost of Capital" approach) also warrants careful consideration, as the cost of capital assumptions appear overstated for a mature, low-risk and regulated asset such as Heathrow. Given Heathrow's already large RAB, even small increases in the cost of capital translate into materially higher charges for airlines and passengers. We request that the CAA reconsider both the adoption of a 60% notional gearing level and the high upper range of the equity beta in setting the allowed return to better reflect Heathrow's risk profile over the H8 period. There remains considerable scope for a justifiable reduction in the level of return on capital allowed on this low-risk asset, and such reduction would be of direct benefit to airlines and consumers without risk to the financial stability and security of the operation and management of the airport.

Delta supports the CAA's proposals to enhance transparency and accountability in relation to Other Regulated Charges ("ORCs"), including improved reporting and strengthened oversight of cost allocation methodologies. While these are important and necessary steps, it is also essential that these measures are reinforced by robust safeguards to ensure costs

are allocated fairly and do not result in unjustified and disproportionate financial burdens on the airlines and ultimately, consumers.

Delta opposes any proposal related to Service Level Agreement ("SLA") rebates based on airline performance failures without additional protections established to review the overall airport operation, taking into consideration any failures that may have occurred that are outside of the airline's control. The SLA rebates are intended to provide a clear, objective mechanism to hold the airport operation accountable, while also compensating users for costs incurred when Heathrow's performance falls short. It should be noted that the airlines already bear significant operational, financial and reputational impacts from poor service quality, and should not face further financial penalties imposed arbitrarily through the withholding of rebates without further discussion around the inclusion of appropriate oversight, review and dispute procedures.

In summary, we appreciate that the CAA is taking a proactive approach to H8 by reducing the proposed increase in charges, the dilution of the single till framework, and the introduction of airline "performance" measurements into the process for SLA rebates. However, we respectfully request that the CAA further improves the outcome for airlines and consumers by reducing operating allowances and the allowed return on the RAB, as well as refining the oversight process for capital expenditures. We urge the CAA to carefully consider these issues as it develops its final proposals to ensure that the regulatory framework strikes the right balance between supporting necessary investments and service improvements while also protecting airlines and Heathrow customers from excessive cost increases.

Thank you for this opportunity to provide feedback on the CAA's initial proposals for H8, and we remain available for further engagement should it be desired.

Yours Sincerely,

*Valerie Ni Fhaolain*

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Cc:

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