HEATHROW'S RESPONSE TO THE CAA'S CONSULTATION ON "H8 RAB INDEXATION AND THE ALLOWED RETURN ON DEBT"

11th SEPTEMBER 2026

1. Introduction

This document sets out Heathrow Airport Limited's (Heathrow) response to the Civil Aviation Authority's (CAA) update to stakeholders on its emerging policy position on the treatment of RAB indexation in relation to setting the allowed return on debt.

Heathrow welcomes engagement on this issue and the opportunity to share its views ahead of the H8 Final Proposals.

The CAA first gave an indication that they were proposing to consider a variation of the approach to RAB indexation within the H8 Initial Proposals ("IP") in March 2026. In its response to the H8 Initial Proposals, Heathrow requested further details from the CAA including its minded-to position and it approach to implementation. Furthermore, Heathrow noted that: "It is essential that the CAA are clear on their assumptions and apply them consistently between price control periods for Heathrow to manage its risks within its own capital structure and debt portfolio." Investors place great weight on regulatory stability, so it is important changes are implemented sensitively.

We note the CAA's minded-to position is that RAB is indexed in part by outturn inflation (equity, inflation linked debt "IL debt") with the remaining fixed rate debt portion indexed to medium-term forecasts.

We will conduct preparatory work to transition to the CAA's minded-to position but urge the regulator to reconsider its proposed implementation. In particular, the CAA should maintain a 30% inflation exposure assumption in the notional structure and set its expectation now for any further change in this assumption. This aligns with expected regulatory stability and will enable implementation over a practical timeframe and in a cost-effective manner.

2. Heathrow's inflation exposure strategy seeks to protect against low inflation.

We disagree with the presumption that Heathrow has made windfall gains because of higher outturn inflation. Heathrow's strategy has historically been to keep a larger proportion of its debt in inflation-linked format to protect against low inflation. Therefore, any upside from higher indexation of the RAB is largely offset by the impact higher indexation has on its debt book. During H7, Heathrow's higher proportion of IL debt than the notional company, combined with the CAA approach to the cost of debt in H7, meant that its interest costs were significantly underestimated.

3. We agree with the CAA (and disagree with airlines) that part of the RAB should continue to be indexed with outturn inflation.

Equity investors expect the real value of their committed equity to be maintained. This is particularly the case for investors, such as pension funds, that have indexed linked liabilities. Using outturn inflation to index the equity proportion of RAB supports this expectation.

Equity investors also value stability and predictability in the regulatory framework. Retaining indexation of the equity proportion of RAB promotes such stability. The importance of such stability is amplified by the significant equity support that will be required for expansion.

The CAA is proposing to retain a real return on the fixed rate debt proportion of the RAB (albeit based on forecast rather than actual inflation). A consequence of this is that interest cash outflows on non-IL debt are greater than the revenue received in year. Retaining a proportion of IL debt in the notional company mitigates this cashflow mismatch and is a common assumption in regulated businesses with real return approaches.

Given that IL debt is indexed by outturn inflation rather than forecast inflation it is appropriate to use outturn inflation to index the proportion of the RAB represented by IL debt. To do otherwise would result in the potential for windfall gains and losses.

4. We agree with the CAA that the minded-to approach does have complexities which need to be carefully considered through implementation.

The approach to RAB indexation can have a significant impact on a regulated company's exposure to inflation deviating from forecast. Under the previous approach where the whole of the RAB was indexed by outturn inflation, if inflation were 1% lower and the notional company (60% gearing) had no IL debt, then the return to equity would be 2.5% lower.

In practice companies can manage this risk by using IL debt. For example, if the notional company had only IL debt, then if inflation was 1% lower, equity returns would also be 1% lower, rather than amplified as in the case above. Therefore, a change in the RAB indexation methodology could create a misalignment between a regulated company's financing structure and the revised notional financing assumptions. This leads to important considerations when changing the basis of indexation:

- Companies will have optimised their capital structure to manage the inflation risks arising from the existing indexation policy in terms of the extent of IL debt;

- It is not possible to change the extent of IL debt quickly without incurring significant break costs;
- Therefore, making changes in the approach to indexation needs to be implemented cautiously with considerations for scale, speed and cost of change.

The key consequence of this is that the CAA should be cautious about reducing its assumption of the proportion of IL debt for the notional company at the same time that it changes its approach to indexation of the RAB. This is particularly the case if the actual company has IL debt at a similar or higher proportion than its previous assumption for the proportion of IL debt in the notional company. To do otherwise would undermine regulatory consistency.

5. Heathrow's actual IL position is tailored to the current RAB indexation policy, to protect against lower inflation, and will take time to naturally unwind

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6. Our view is that the proposed implementation is not consistent with previous CAA policy.

At H7, the CAA assumed 30% of debt, i.e. 18% of the RAB was index-linked. Moreover, the CAA assumed that the proportion of 30% applied to both embedded and new debt and therefore implicitly that the proportion of IL debt remained 30% at the end of H7 and therefore the entry into H8. However, the proposed approach in the consultation reduces the proportion of index-linked debt to 10% from the start of H8.

We consider that a reduction to 10% for H8 is not justified:

- As set out above, we consider the CAA should be cautious about changing assumptions on the proportion of IL debt at the same time that it changes its policy on RAB indexation;
- The CAA has not justified why 10% of debt being IL is appropriate for the notional company;
- The change in inflation exposure from the current 30% was not signalled in advance, and a notional company would require significant time to reduce its level of IL debt by the extent required; and
- The reduction might have been acceptable if it reflected the actual company level of inflation exposure, or if there were demonstrable evidence that the current level of 30% IL debt is inefficient. However, this is not the case.

It is not clear why the CAA regard that 10% is now an appropriate proportion of IL debt for the notional company rather than 30%. Regulators have included an element of IL debt in notional company balance sheets to help manage the cashflow mismatch between the interest paid on fixed debt and the real interest allowance in the revenue allowance. The change in RAB indexation policy does not change this mismatch and is therefore not a reason to change this position.

Any change in the assumption for the notional company should be consistent with the rate of change the notional company could achieve. Given that IL debt tends to have

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long tenors, it is unlikely that the notional company could reduce its IL exposure by more than 10% of debt during a five-year period.

Any change should also be consistent with CAA public positions on the proportion of IL debt in the notional company. The CAA did not signal a potential change in this proportion until August 2026.[2] Up until then the assumption was that the H7 proportion of 30% remained appropriate and the H7 decision implicitly assumed 30% IL until the end of H7.

Given this, the CAA must retain the H7 assumption of 30% IL for the start of H8, or include an allowance for the significant break costs that the notional company would incur to reduce its IL exposure by this extent. Note that these break costs would apply to around c£2.5bn of debt for the notional company and would therefore be material.

If the CAA consider that a lower level of IL debt is appropriate for the notional company, they should set out a clear explanation why they consider this is the case and manage the rate of change so that it would be achievable by the notional company. In practice, this means that the proportion could not reduce by more than around 10% of debt in a 5-year period.[3]

We note that Ofgem justified the reduction in the proportion of IL debt from 30% to 10% for ET companies without a glide path on the basis that "most ET companies supported the lower ILD notional assumption,"[4] which is consistent with taking Heathrow's preferences regarding glide paths into account.

7. Consistency of approach to WACC and notional company assumptions.

We note that in the IP the CAA based its assessment of the cost of debt with 10% of debt being IL. This was based on our debt book before IL swaps.

We consider that it is rational for the CAA to continue this approach even if it has a different assumption for the proportion of IL debt that is in the notional company balance sheet. This is based on an assumption that the real cost of IL debt will be similar to the real cost of fixed debt.

We consider this assumption is reasonable for H8 because:

- The inflation outlook for H8 is consistent with the longer-term inflation outlook underpinning IL yields; and

[2] H8 RAB indexation and allowed return on debt

[3] If 30% of debt were new at the end of a 5-year period, none of the new debt was IL, and the redemption rate of IL debt was the same as non IL debt, then at the end of the period the proportion of IL debt would have reduced to 21%. In practice, IL debt tends to be slightly longer tenor than non-IL debt so the proportion would reduce by less than this.

[4] RIIO-3 Final Determinations – Finance Annex para 2.67.

- Noting the CMA conclusion that the real cost of IL debt was similar to the real cost fixed debt.

Consequently, the assessment of the cost of debt would not materially change if the proportion of IL debt was changed.

Using different assumptions for different elements of a regulatory decision has occurred in other regulated sectors and is a reasonable basis for a regulator to proceed on. For example, in Water the cost of debt is based on the industry average cost of debt, and there is not an explicit assumption of the proportion of IL debt in this assessment. However, in the assessment of financeability an explicit assumption is made.

Moreover, it is conceptually sound to use different assumptions for the cost of debt and for RAB indexation. The cost of debt should reflect the financing costs of the notional company, whereas RAB indexation preserves the real value of the regulatory asset base. These are different objectives.

Consequently, we do not believe that adopting a balance sheet assumption of 30% IL debt requires the CAA to modify its approach to the cost of debt for H8. Taking a uniform approach without considering the real consequences of this is irrational and inconsistent with the CAA's obligation to ensure the ongoing financeability of the company.

8. Summary of our asks:

a) Assuming the CAA implements its minded-to position regarding the RAB indexation, the regulator should assume a proportion of IL debt in the notional company of 30% consistent with the approach in H7.
b) If the CAA considers that over time a lower proportion of IL debt is appropriate, they should justify why a lower proportion is in the interests of consumers.
c) The CAA should signal the proportion of IL debt over time in their decision to enable appropriate preparation work and not lower the rate faster than would be reasonable for the notional company.