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International Airlines Group, S.A. (IAG) Response to CAA Working Paper on Regulatory Models – CAP3195

Note: [redacted]

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Foreword

Acting on CAP3195 represents a critical opportunity to reset Heathrow's regulatory framework. The existing regime has demonstrably failed to protect consumers, has embedded perverse incentives for inefficient capital expenditure, and has resulted in Heathrow becoming the most expensive major airport in the world. Carrying the current framework forward into a capital-intensive project of an unprecedented scale would materially amplify these failures. Incremental change is not sufficient. Fundamental reform is urgently required.

The proposals currently being advanced for Heathrow expansion are unaffordable and require urgent, coordinated intervention by both the Civil Aviation Authority (**CAA**) and Government. Without decisive action, there is a material risk that expansion proceeds on an economically unviable basis – undermining its deliverability, weakening UK connectivity, and failing to deliver the outcomes it is intended to achieve for consumers and the wider economy.

International Airlines Group, S. A. (**IAG**) supports expansion at Heathrow. As the owner of British Airways, the UK's only global hub airline, we recognise the unique role Heathrow plays in connecting the UK to global markets and supporting trade, tourism, and employment. Expansion has the potential to be a major success for the UK. However, that outcome is not a certainty. Expansion will only succeed if it is affordable for airlines and their customers and if it is governed by a regulatory and policy framework that is aligned with economic reality.

At an estimated minimum cost of £49 billion, Heathrow Airport Limited's (**HAL's**) current expansion and masterplan renewal proposals are not affordable. That headline figure materially understates the true cost, which excludes the mandated surface access rail scheme, replacement of Terminal 4, and other significant costs – not least the proposed £9.5 billion for the next price control period (H8) and does not reflect the significant cost uncertainty acknowledged by HAL. Proceeding with expansion on this basis would fundamentally change the economics of operating at Heathrow and place unsustainable pressure on airline profitability, capacity deployment, and long-termanne investment decisions.

Airline affordability is the binding constraint on expansion. Airlines invest entirely at commercial risk in a highly competitive, structurally low-margin global industry. They cannot absorb materially higher airport charges without reducing capacity, withdrawing marginal routes, or reallocating aircraft to competing hubs and markets. Any regulatory or policy framework that assumes otherwise is flawed.

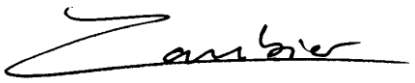
Expansion at the costs muted by HAL brings an extra category of risk because it would raise average airline costs only for one part of the global network, impacting Heathrow's attractiveness (i.e.: airline operating costs would only increase at LHR but not at other airports, contrary to fuel cost increases for example). If expansion is not affordable for airlines, it will not attract the capacity required to deliver the connectivity, trade, and employment benefits sought by the Government and the CAA in the interests of consumers.

This submission is therefore clear that **Heathrow expansion is not simply a planning challenge but an economic and regulatory one**. The success of expansion will be determined jointly by the regulatory framework established by the CAA and by Government decisions on the Airports National Policy Statement (**ANPS**), the Development Consent Order (**DCO**) process, scheme scope, cost discipline, and risk allocation. If these elements are not designed holistically and aligned around affordability, expansion will fail to deliver its objectives and may create systemic financial risk for a major UK critical infrastructure asset.

In this response, IAG sets out why HAL's current proposals are economically unviable, why airline economics must sit at the centre of regulatory design, and how a reformed regulatory

framework (underpinned by a hard and enforceable expansion budget, stronger capital discipline, and greater competition) can enable a viable, financeable and consumer-focused expansion. We also set out the critical actions required of both the CAA and Government to ensure that expansion is delivered in a way that is consistent with statutory duties and long-term UK interests.

IAG stands ready to engage constructively with the CAA and Government. However, we are equally clear that expansion should not proceed unless the regulatory and policy framework is first reformed to make success economically credible and to avoid repeating the well-documented failures of past infrastructure delivery, e.g. High Speed 2.



Yann Cambier
Vice-President Strategic Programmes
International Airlines Group, S. A.

Executive Summary

1. This paper is International Airlines Group S. A.'s (**IAG**) formal response to the Civil Aviation Authority's (**CAA**) CAP3195 Working Paper on potential regulatory models for Heathrow Airport.

2. IAG welcomes the CAA's recognition that the existing regulatory framework is no longer fit for purpose and requires fundamental reform. The evidence is clear; the current regime has delivered persistently poor consumer outcomes through entrenched inefficient investment incentives and failure to impose effective discipline on costs. These failures must now be addressed decisively, not incrementally.

3. Crucially, regulatory reform cannot be separated from the context of Heathrow's plans for expansion. Expansion fundamentally alters the magnitude of financial risk, the scale of consumer harm, and the consequences of regulatory failure. A framework that has significantly harmed consumers under today's operations will lead to further extreme failure if it is allowed to continue largely unchanged into a prolonged period of expansion. CAP3195 therefore represents a critical choice for the CAA; either structural reform is implemented to enable an economically viable, affordable and successful Hub airport, or the status-quo is maintained – risking the failure of the largest infrastructure programme in UK aviation history, due to an economically illiterate and discredited framework.

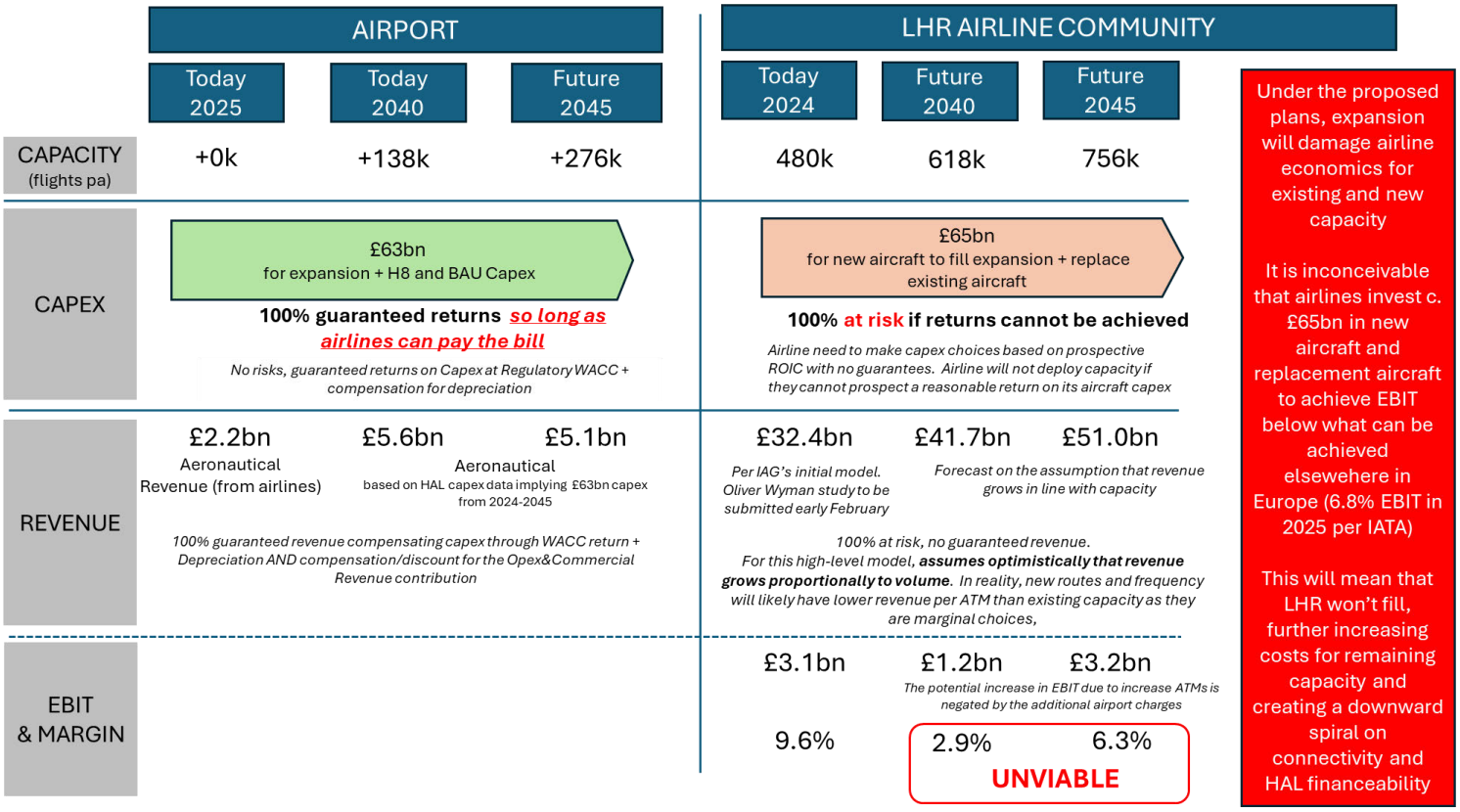
4. IAG supports expansion at Heathrow and is clear that Heathrow's unique role as the UK's only hub airport gives it the potential to deliver material and enduring benefits for consumers, trade, and the wider economy. However, that potential will not be realised under HAL's current proposals. At a cost of at least £49 billion for expansion, excluding mandated surface access schemes, renewal of Terminal 4, the proposed capital for non-expansion related assets[1] and substantial cost uncertainty, the expansion and masterplan renewal as currently conceived are not affordable for airlines or passengers.

5. This is not a marginal affordability concern. Airline affordability is the binding constraint on whether expansion succeeds or fails. Airlines operate in structurally low-margin, highly competitive markets and invest entirely at commercial risk. Unlike HAL, airlines have no guaranteed returns and no ability to pass through costs above market levels without losing market share. If Heathrow expansion and masterplan renewal proceeds at the level proposed by HAL, it will drive airline profitability below sustainable levels. Faced with this flawed business case, airlines will not invest in aircraft to fill new infrastructure, regardless of notional passenger demand.

6. As shown in the below illustration[2], if airlines invested in aircraft to fill capacity created by expansion, and revenue for additional capacity (i.e. marginal routes and frequencies) was in line with revenue for existing capacity (an optimistic assumption), achievable margins would be below the cost of capital. Furthermore, the level of margins airlines achieve at Heathrow would be below what airlines achieve across Europe (6.8% in 2025 according to IATA[3]). It is inconceivable that airlines will invest c. £65 billion in new and replacement aircraft between 2026 and 2045 (over £45 billion during the ramp up period and £20 billion leading up to the ramp up period) to fill Heathrow to achieve lower

[1] HAL propose £9.5 billion for the next five-year price control period (H8)
[2] This is based on IAG's preliminary analysis. A study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion. IAG would welcome the opportunity for Oliver Wyman to present its findings to the CAA and Government.
[3] https://www.iata.org/en/iata-repository/pressroom/fact-sheets/industry-statistics/

margins than what they could achieve by deploying aircraft elsewhere in Europe. Airlines invest at risk and need confidence that they can cover their cost of capital.



7. The consequences of proceeding with expansion under the current regulatory model are severe. Higher charges would undermine airline competitiveness, constrain capacity deployment, and weaken connectivity. Under-utilised infrastructure would follow, placing pressure on revenues, raising financing risk, and ultimately feeding back into even higher charges for remaining users. This self-reinforcing contraction would erode consumer welfare, damage UK connectivity & trade, and create systemic financial risk for a major UK critical infrastructure asset. **Such an outcome would be entirely inconsistent with the CAA's primary duty to further the interests of consumers**.

8. CAP3195 correctly identifies that the existing regulatory model has failed to protect consumers. Heathrow's position as the most expensive major airport in the world, combined with declining customer satisfaction, degrading levels of resilience and persistent evidence of inefficient capital expenditure, demonstrates that the current framework embeds the wrong incentives and provides insufficient ex ante control. These shortcomings are not incidental; they are structural features of a regime that allows unchecked growth of the regulated asset base with inadequate scrutiny of value, efficiency or affordability.

9. Without decisive structural reform, expansion will magnify these problems rather than remedy them. The CAA's evaluation of regulatory models must therefore be grounded in the realities of airline economics and investment behaviour, not in demand-led assumptions that treat airline capacity as a natural default response to passenger willingness to travel. **If expansion is not affordable for airlines, it will present a major**

financeability risk for the airport and will not deliver the consumer benefits on which expansion policy justification rests.

10. IAG is clear that expansion can only succeed if it is governed by a fundamentally different regulatory system. That system must reset incentives, impose firm performance discipline on capital expenditure, and introduce meaningful competition and effective oversight. Central to this is the establishment of a hard enforceable budget cap for expansion and masterplan renewal of no more than £25-30 billion in real terms, coupled with rigorous governance of investment decisions and delivery, leveraging competition at every conceivable juncture, a phased delivery programme aligned with actual demand growth, and a charging profile that ensures charges remain close to today's charges, in real terms. Without these elements, expansion will not attract the airline investment required to make it work.

11. The CAA has clear statutory duties and authority to further consumer interests, promote efficiency and competition. Where Government objectives or timetables risk compromising those duties, the CAA must give primacy to its statutory duties. At the same time, Government must actively support the delivery of an economically viable expansion by embedding affordability and value discipline within the Airports National Policy Statement (**ANPS**), ensuring the Development Consent Order (**DCO**) process enables competition and cost control, and aligning wider policy levers accordingly.

12. IAG fully co-authored and endorses Heathrow Reimagined's response to CAP3195 and this response from IAG is supplemental to that paper.

13. In this supplementary response, IAG addresses each of the questions posed in CAP3195 and sets out a coherent, integrated package of regulatory reforms designed to enable expansion that is affordable, financeable, and aligned with consumer interests (see below illustration). Incremental adjustments to an existing failing framework is no longer credible nor sustainable. Urgent and fundamental structural reform is required now to avoid locking in outcomes that would undermine both expansion and the long-term performance of Heathrow to the detriment of consumers and the UK economy.

[redacted]

1

Capital Investment Committee
- Chaired by the CAA with casting vote
- Other voting members include home based carriers, alliance representatives (1x per Terminal) and airport operators
- Define affordable 15-20year capex envelope
- Agree masterplan priorities, informed by bids/proposed plans
- Approve business cases
- Hold operator(s) accountable for delivery on-time, on-budget
- Has the powers to ultimately freeze dividends and executives' bonuses in case of poor performance

2

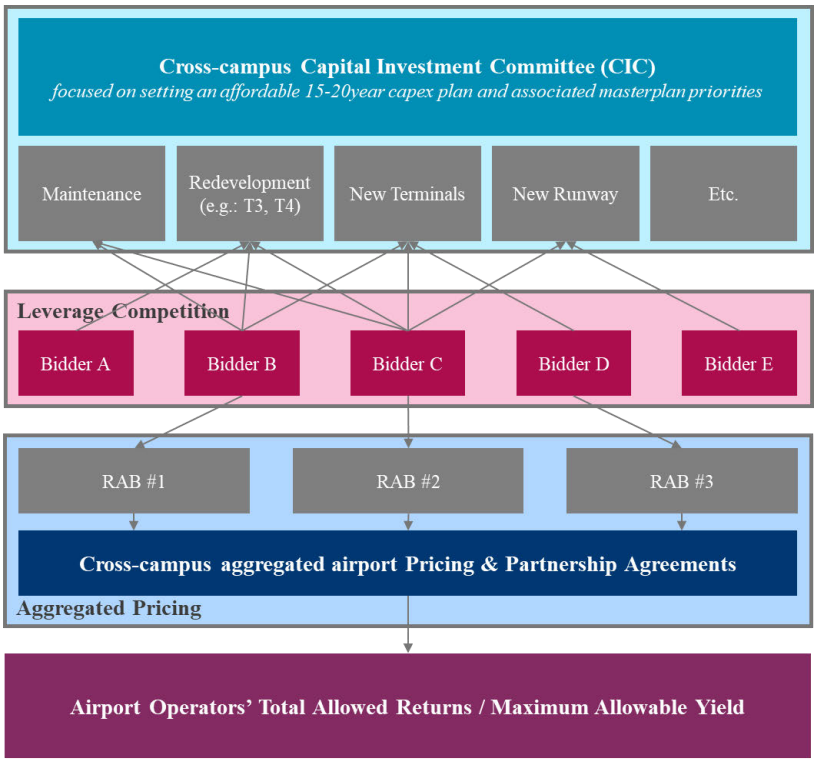
Leverage competition
- Bidders/potential promoters put forward their plans for different packages
- Selected bidders/promoters Design/Build/Operate/Own under a RAB model that reflects their asset base on the campus

3

Aggregated Pricing
- Cross campus, aggregated pricing >>> every airline and its passengers benefit from competition regardless of where the airline operate on the campus
- Single till is retained with incentives on commercial revenue contribution
- Promoters bear the risks of construction (overruns, etc.)
- Airlines bear the demand risks (passenger volumes)

4

Cross Campus Maximum Allowable Yield
- CAA continues to define the Regulatory WACC and associated Allowed Returns every 5-years *(Note: the capex envelope is already defined per item 1 and the CIC)*



14. IAG is equipped to engage constructively with the CAA and UK Government, but is equally clear that expansion should not proceed unless the regulatory framework is first reformed in a way that makes success economically credible and a certainty.

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Introduction

1. International Airlines Group, S.A (IAG) welcomes the decision by the CAA to review the regulatory framework applicable to Heathrow Airport. There are significant issues with the current framework which have led to demonstrably negative consumer outcomes. The CAA has itself acknowledged "*limitations in respect of our present approach to the regulation of HAL*", and is now consulting on its finding that "*there is sufficient evidence to warrant revisiting the current regulatory model"* based on: (i) features of major capital projects that may constrain the effectiveness of the existing framework in protecting consumers; (ii) HAL's airport charges, which are high relative to airports subject to stronger competitive pressure; (iii) evidence that HAL's service quality has deteriorated since the Covid-19 pandemic, with Heathrow underperforming peers; and (iv) longstanding concerns regarding HAL's approach to the delivery of large capital projects. It is therefore imperative, both in the context of H8 and especially in view of the proposed airport expansion, that the current regime is urgently reformed.

2. IAG also welcomes expansion of Heathrow Airport, provided it is affordable and in the interest of consumers. However, the expansion proposals put forward by Heathrow Airport Limited (**HAL**) are unaffordable and require immediate attention from both the CAA and Government. Without urgent coordinated action, there is a material risk that expansion proceeds on an economically unviable basis, undermining its deliverability and the outcomes it is intended to achieve – ultimately damaging the UK economy.

3. The success of Heathrow expansion will be determined both by the regulatory framework established by the CAA (which sets airport charges, investment incentives and approves capex budgets), and by Government decisions on the Airports National Policy Statement (**ANPS**), the Development Consent Order (**DCO**) process, scheme scope, cost discipline and risk allocation.

4. If these elements are not correctly aligned, expansion will not attract the airline capacity investments required to deliver the connectivity, trade and employment benefits sought by both Government and the CAA in the interests of consumers. IAG is seriously concerned that if expansion proceeds on the current proposals, it will not be viable for airlines and consumers to accommodate the associated costs and the scheme will fail.

5. IAG supports and endorses the response to the CAP3195 consultation submitted by Heathrow Reimagined (**Heathrow Reimagined response**). This paper is aligned with the Heathrow Reimagined response, and provides the following supplementary detail:

   - sets out important context to the proposed expansion which must be taken into account in the design of any new regulatory regime (see **Section A**);
   - provides additional detail on several key questions raised in the consultation (see **Section B**); and
   - sets out IAG's proposals for a regulatory framework capable of delivering a viable expansion in line with consumer interests and the CAA's other duties (see **Section C**).

6. IAG supports capacity expansion at Heathrow and will work constructively with the CAA, Government and other stakeholders to ensure that expansion is delivered on time but in a way that is affordable, financeable and aligned with airline economics, consumer interests and the UK's long-term growth objectives.

A. Context to be considered in design of a new regulatory regime

1 HAL's current proposals are economically unviable

1.1 Significant costs

15. At an estimated cost of at least £49 billion[4], HAL's current proposals for Heathrow expansion and its masterplan renewal are not affordable for airlines or their customers. Moreover, the £49 billion figure materially understates the true cost of the expansion project. It excludes the surface access rail scheme mandated by Government under the ANPS (and that we understand HAL intends to promote), does not reflect the significant cost uncertainty acknowledged by HAL (currently expressed as a £40 billion to £63 billion range[5]), and makes no allowance for investment in Terminal 4, which is approaching 40 years of age (and will be circa 60 years old by 2045). Expansion costs will also be on top of further price control periods over the timeframe of expansion. HAL propose the next five-year price control period alone is set at £9.5 billion. This is simply unaffordable and will damage UK trade & connectivity (see **Annex E**).

16. An unaffordable expansion would not simply result in under-utilised existing and new capacity. It would create a high risk of financial failure for the key parties required to deliver the UK's hub operation, namely HAL and British Airways. The consequences of failure would be severe and include loss of jobs and economic growth, higher airfares and increased cost-of-living pressures for consumers.

17. We firmly believe that expansion can be a success provided it is not rushed and the regime governing it is properly and carefully designed and implemented. London is the world's largest aviation market (more passengers fly to and from London than to and from New-York, Tokyo, Beijing, Paris and other major cities.). Heathrow is the UK's only hub airport. In combination, this should represent a clear success story for UK infrastructure and economic growth. Expansion at Heathrow can deliver economic benefits that cannot be replicated through expansion at other London airports. Expansion has the potential to vastly improve UK connectivity, support new trade links and create high-quality UK based employment opportunities.

1.2 A serious lack of consideration of airline affordability

18. It is British Airways, as the UK's hub carrier, that is distinctively positioned to translate additional runway capacity (if delivered at an affordable cost) into enhanced global connectivity, stronger trade links and spur substantial direct and indirect UK employment opportunities. Airlines and not airports invest in aircraft capacity, routes and choice to consumers. If Heathrow expansion is not affordable for airlines, they will be unable to deploy the capacity required to deliver new routes, additional trade links, consumer choice and the associated UK jobs.

19. HAL operates as a regulated monopoly with protected returns and is therefore insulated from commercial risk. Airlines, by contrast, invest in aircraft and networks entirely at their own commercial risk, with no guaranteed returns. Their ability to sustain and grow capacity depends on earning acceptable margins in a highly competitive global market.

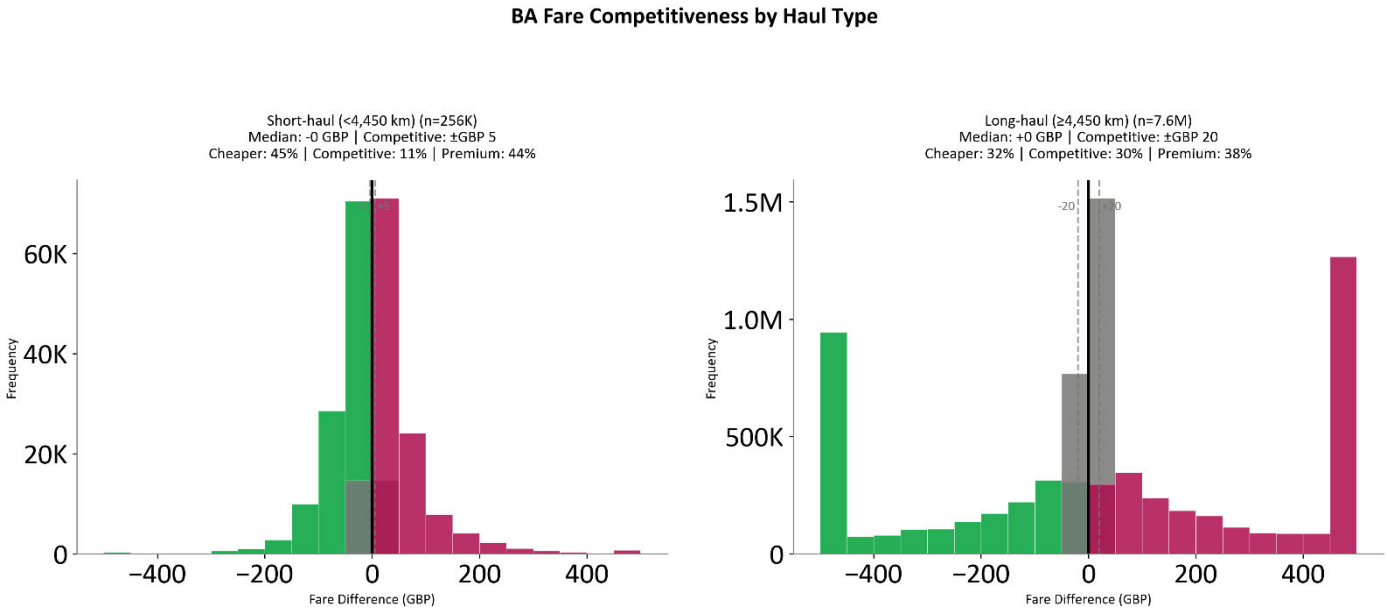
[4] In real terms, 2024 prices
[5] HAL's Long Term Growth Programme Brief, 20 June 2024

20. In 2024, the airline community at Heathrow generated approximately £3.1 billion of EBIT, equivalent to around £37 per passenger or an 9.6% margin[6]. Achieving this level of profitability requires intense price competition, substantial investment in aircraft, engineering, technology, operational efficiency, customer experience, sales and marketing, partnerships, and revenue management capability, to name but a few of the elements of running a profitable airline. Airlines operating from Heathrow compete not only with airlines flying to and from other London airports but also with airlines based at major global hubs, including KLM out of Amsterdam, Air France out of Paris, Lufthansa out of Frankfurt, Turkish Airlines out of Istanbul, Emirates out of Dubai and so on.

21. Airlines are structurally low-margin businesses. In Europe, airlines made a 6.2% EBIT margin in 2024[7]. If airlines could materially increase profitability by charging even a small additional amount per passenger, they would do so. In practice, fares are set by supply and demand in a competitive marketplace and airlines cannot price meaningfully above competitors offering comparable products without losing business. This is illustrated by the consistency of British Airways' long-haul economy fares with those of comparable competitors across a large sample of like-for-like journeys.

Figure 1a and 1b compare BA prices by haul type (short-haul and long-haul) and by cabin class (economy, premium economy, business) against its competitors and sets out the number of time the prices were lower or higher than competitors.

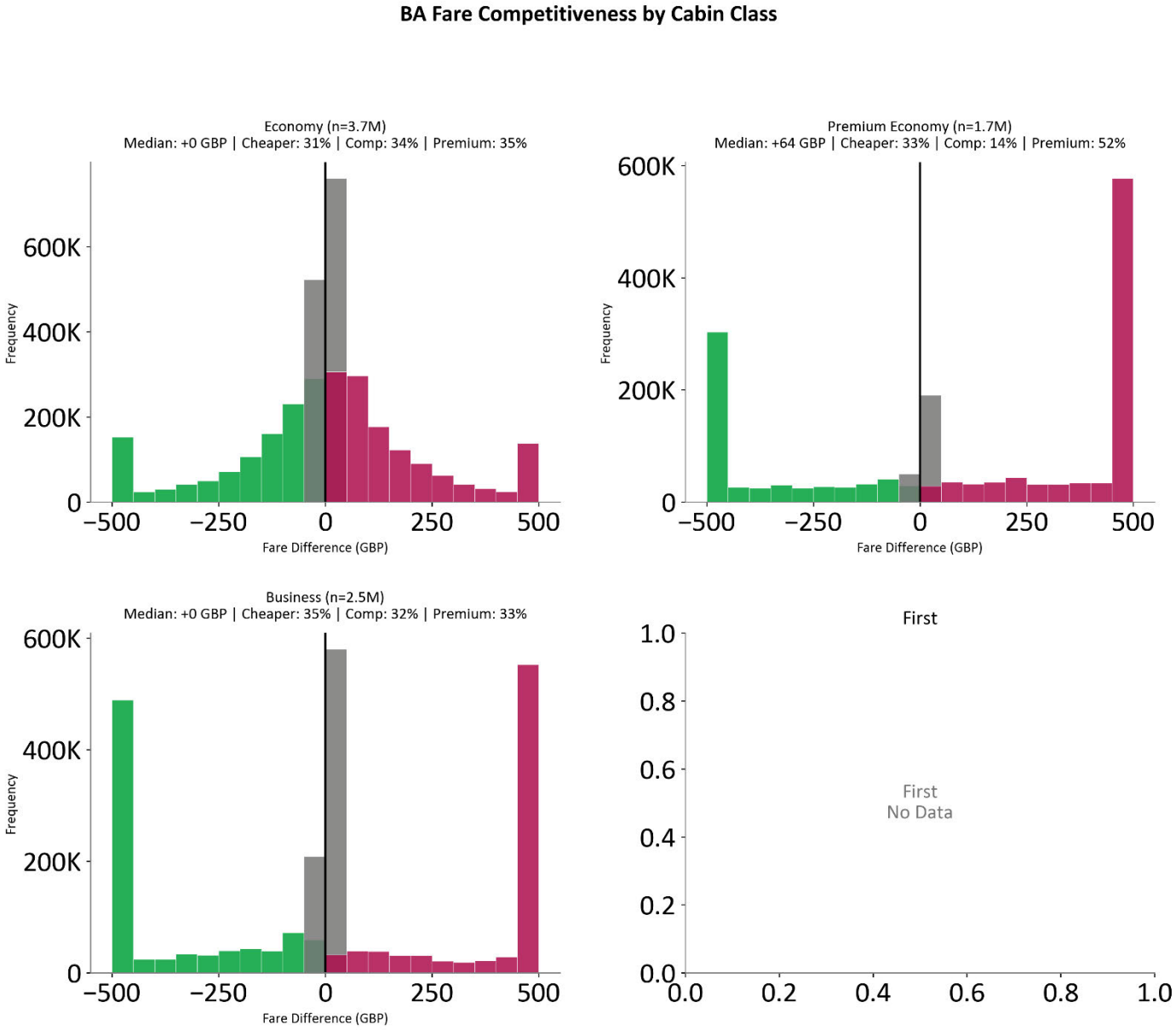
Figure 1a: Comparison of BA's lowest available fare by haul type vs. competitors lowest available fares on a like-for-like travel basis from INFARE[8].



Source: INFARE database
Note: Grey box covers the fares within +/- £5 for short-haul and within +/- £20 for long-haul

[6] This is based on IAG's preliminary analysis. A study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion. IAG would welcome the opportunity for Oliver Wyman to present its findings to the CAA and Government.
[7] https://www.iata.org/en/iata-repository/pressroom/fact-sheets/industry-statistics/
[8] Analysis from INFARE data

Figure 1b: Comparison of BA's lowest available fare by cabin type vs. competitors lowest available fares on a like-for-like travel basis from INFARE



Source: INFARE database
Note: Grey box covers the fares within +/- £5 for short-haul and within +/- £20 for long-haul

22. It clearly shows that BA's long-haul economy products are consistent with the market price for comparable products. Airline price competition is intense, and airlines have to price competitively with the market to fill their aircraft.

23. Airport expansion can generate economic benefits, but it requires substantial airline investment alongside airport investment; airport investment that is ultimately also borne by airlines and consumers. To utilise expanded Heathrow capacity, airlines would need to invest approximately £65 billion in new and replacement aircraft. Such capital

deployment is only rational if airlines can earn sustainable returns[9]. IAG would be pleased to take the CAA and Government through the underlying modelling that supports these estimates.

24. Under a minimum £49 billion expansion scenario, excluding mandated rail investment, Terminal 4 renewal, cost uncertainty and non-expansion related capital expenditure, our modelling suggests that airline profitability would fall below a 5% EBIT margin[10] in the short term. Airlines' profitability at Heathrow would also fall below airline industry profitability in Europe[11] and therefore what airlines may expect to achieve out of other London airports and out of other European hubs. This level of profitability would be insufficient to service debt, finance fleet and other investments, or sustain network growth. It is not economically rational or credible to assume airlines will deploy new, loss-making capacity to support the affordability of the existing operations.

25. Failure of airlines to sustainably deploy capacity would trigger a self-reinforcing contraction cycle; higher airport charges, weaker demand, capacity withdrawal, falling revenues, job losses, higher fares for remaining passengers, and deterioration in the airport's financeability. This is not a theoretical concern but a foreseeable outcome of the current expansion plan that is only viable if airlines act contrary to their economic incentives. Table 1 below provides a simplified and best-case view of the flawed business case associated with a £49 billion programme for expansion and masterplan renewal.

26. If expansion proceeds on the basis of a minimum £49 billion capital programme, HAL's real-terms debt would also rise significantly. Today HAL is one of the largest issuers in the Sterling market (especially if Financial Services issuers are excluded – Table 2). The Sterling market's exposure to HAL's financeability would significantly increase post expansion, issuance to meet the demands of its expansion plans would place HAL in the top 5 of the Sterling market, alongside major state-backed entities. A project of this scale would require airlines to pay around £3 billion per year in additional aeronautical charges in real terms[12]. This resulting increase in operating costs for airlines would materially undermine Heathrow's attractiveness relative to other global hubs and to other London airports such as Gatwick and Stansted.[13] As a result, airlines would be unable to generate the revenues required to fund the additional £3 billion per year that HAL would seek to recover under the current RAB model. This in turn would place HAL at risk of failing to meet its debt obligations.

27. In parallel, British Airways would be forced to structurally reduce its operations at Heathrow, triggering a restructuring of the UK's only hub airline. The consequence would be a loss of hub connectivity, damage to UK trade and employment, and a heightened risk of a broader debt market disruption linked to the failure of a major UK critical infrastructure asset.

28. We have commissioned a study by Oliver Wyman which will model in detail the affordability threshold that needs to be protected to ensure that airlines can fill expansion

[9] Based on IAG's initial modelling. IAG will be happy to take CAA through the modelling to estimate these aircraft capex numbers.
[10] This is based on IAG's preliminary analysis. A detailed study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion and can be made available to the CAA once complete.
[11] https://www.iata.org/en/iata-repository/pressroom/fact-sheets/industry-statistics/
[12] Per IAG and CEPA analysis of aeronautical charges in the context of expansion. See annex B.
[13] The detailed analysis behind these conclusions is being prepared by Oliver Wyman and will be made available once completed.

capacity and provide consumers and the UK with more choice and more connectivity. This will be shared with the CAA and Government.

Table 1: Illustration of the Heathrow expansion business case and why, even in a best case of airline revenue growing in step and in line with capacity, it is flawed.

	AIRPORT			LHR AIRLINE COMMUNITY			
	Today 2025	Today 2040	Future 2045	Today 2024	Future 2040	Future 2045	
CAPACITY (flights pa)	+0k	+138k	+276k	480k	618k	756k	Under the proposed plans, expansion will damage airline economics for existing and new capacity It is inconceivable that airlines invest c. £65bn in new aircraft and replacement aircraft to achieve EBIT below what can be achieved elsewhere in Europe (6.8% EBIT in 2025 per IATA) This will mean that LHR won't fill, further increasing costs for remaining capacity and creating a downward spiral on connectivity and HAL financeability
CAPEX	£63bn for expansion + H8 and BAU Capex **100% guaranteed returns *so long as airlines can pay the bill*** *No risks, guaranteed returns on Capex at Regulatory WACC + compensation for depreciation*			£65bn for new aircraft to fill expansion + replace existing aircraft **100% at risk if returns cannot be achieved** *Airline need to make capex choices based on prospective ROIC with no guarantees. Airline will not deploy capacity if they cannot prospect a reasonable return on its aircraft capex*			
REVENUE	£2.2bn Aeronautical Revenue (from airlines) *100% guaranteed revenue compensating capex through WACC return + Depreciation AND compensation/discount for the Opex&Commercial Revenue contribution*	£5.6bn Aeronautical based on HAL capex data implying £63bn capex from 2024-2045	£5.1bn	£32.4bn *Per IAG's initial model. Oliver Wyman study to be submitted early February*	£41.7bn *Forecast on the assumption that revenue grows in line with capacity*	£51.0bn	
				*100% at risk, no guaranteed revenue. For this high-level model, **assumes optimistically that revenue grows proportionally to volume**. In reality, new routes and frequency will likely have lower revenue per ATM than existing capacity as they are marginal choices,*			
EBIT & MARGIN				£3.1bn 9.6%	£1.2bn *The potential increase in EBIT due to increase ATMs is negated by the additional airport charges* 2.9%	£3.2bn 6.3% **UNVIABLE**	

Table 2: Top 20 largest issuers in the Sterling market

Sector	State-backed	Issuer	Amount(£bn)
Financial Services	Y	European Investment Bank	39.85
Financial Services	Y	Kreditanstaltfuer Wiederaufbau	37.43
Infrastructure	Y	Network Rail Infrastructure Finance PLC	30.44
Financial Services	Y	International Bank for Reconstruction & Development	20.45
Financial Services		Nationwide Building Society	18.93
Financial Services		Lloyds Bank PLC	18.53
Financial Services		Santander UK PLC	16.74
Financial Services		Barclays PLC	16.20
Financial Services		HSBC Holdings PLC	15.68
Utilities	Y	Electricite de France SA	15.57
Financial Services	Y	Asian Development Bank	14.15
Property / Financial		Telereal Securitisation PLC	14.06
Financial Services		Royal Bank of Canada	13.82
Airports		**Heathrow Funding Ltd**	**12.92**
Utilities		Thames Water Utilities Finance PLC	12.36
Financial Services	Y	International Finance Corp	12.11
Financial Services		Coventry Building Society	10.92
Financial Services	Y	Inter-American Development Bank	10.88
Financial Services		NatWest Group PLC	9.94
Financial Services		Clydesdale Bank PLC	9.72

Source: Bloomberg (January 2026)

2. Expansion can succeed if designed correctly

2.1 Potential benefits of expansion

29. IAG supports a third runway and an expanded Heathrow Airport, provided it is affordable and enables profitable growth. In an expanded Heathrow, IAG (via British Airways) would target the following three strategic objectives:

    a. Build a hub operation at LHR that is truly competitive with KLM at AMS, Air France at CDG, Lufthansa at FRA, Turkish Airlines at IST, etc.

        i. In 2R world, connection have been / are being squeezed out in favour of P2P.

        ii. New capacity at LHR will enable the hub and support new destinations.

    b. Growth opportunities across long-haul and short-haul operations.

        i. New destinations on the British Airways map.

        ii. More depth/frequencies in the existing markets.

    c. Improve operational resilience.

        i. The LHR airfield is congested, leading to delays.

        ii. Terminal capacity is scarce (British Airways already needs additional gate capacity).

30. Today, British Airways operates 280 aircraft, of which approximately 230 are deployed at Heathrow, to over 200 destinations across the globe, connecting Britain with the world and the world with Britain. British Airways employs approximately 37,500 people in the UK, making it by far the largest employer in the UK's aviation sector.

31. British Airways generates economic value through its network in numerous ways:

    a. **Connectivity**:

        i. It is the only UK airline providing long haul and short haul routes. Its "hub and spoke" model of operations at Heathrow enables connectivity between UK regions and global markets, with 40% of British Airways passengers connecting. These connecting 'transfer' passengers are critical to sustaining the route network to and from Heathrow. They allow British Airways to operate routes that would not otherwise be commercially viable and connect 21 airports in the UK to its network including through group member Aer Lingus, which provides connections to Cork, Dublin, Knock and Shannon, and other UK airline partners.

        ii. British Airways' hub at Heathrow plays a crucial role in linking UK regions to global markets. Together with its joint business partners American Airlines, Qatar Airways, Japan Airlines, and China Southern, British Airways connects business and premium travellers to key global markets. The connectivity British Airways provides is a key enabler of economic growth, ensuring the UK remains a global hub for trade, investment, and international travel.

iii. Through this activity, IAG supports the UK Government's Industrial Strategy's eight high-growth sectors (Advanced Manufacturing, Defence, Clean Energy Industries, Digital and Technology, Creative Industries, Financial Services, Life Sciences, and Professional and Business Services[14]), particularly Advanced Manufacturing and Professional and Business Services, which have the highest demand for air travel between the UK and the EU.

b. **Air Cargo**:

i. British Airways' hub at Heathrow, the UK's largest airport by value, is vital not only for passenger connectivity but also for maintaining the UK's position on the global trading stage.

ii. Air cargo represents 40% of the UK's imports and exports by value, contributing over £180 billion to the economy.[15] IAG Cargo plays a vital role within this, combining the cargo capacity in the holds of British Airways aircraft and our other airlines, carrying over 500,000 tonnes from Heathrow each year. The launch of a joint business with Qatar Airways Cargo and MASkargo (Malaysia Airlines Cargo) will enable further global connectivity and facilitate air freight movement across Asia, the Middle East, Europe, and the Americas. We support UK exports by transporting high-value goods such as pharmaceuticals and automotive parts, serving over 10,000 businesses across six continents and 250 destinations. IAG Cargo facilitates international trade and enables access to global supply chains. The connectivity we deliver is a catalyst for economic growth, securing the UK's position as a global centre for trade, investment and international travel.

c. **USA trade and tourism**:

i. British Airways is the largest airline operator in the transatlantic market, playing a crucial role in the UK economy. It flies to 26 US destinations helping to facilitate business and commerce with the US, the UK's largest export market,[16] which accounts for 17.8% of total UK trade. Business travel makes up 20% of UK-US air journeys, helping to drive investment as the US remains the largest foreign investor in the UK. The US is also the UK's top inbound tourism market, with American visitors spending £7.3 billion in 2024.[17]

32. Beyond British Airways, IAG also owns Aer Lingus, the fifth largest operator at Heathrow and the second largest short-haul operator behind British Airways. Aer Lingus connects Heathrow to Cork, Dublin, Knock and Shannon.

33. Expansion can be a win-win for consumers, IAG-British Airways, HAL, and the broader UK economy, but only if it is affordable. An unaffordable expansion will mean that the additional benefits sought by Government are not delivered (more jobs, more connectivity, more trade links), but also that the existing value delivered by airlines

[14] UK Government, The UK's Modern Industrial Strategy (CP 1451), November 2025, accessible here.
[15] Airlines UK, *Assessment of the value of air freight services to the UK economy* (October 2018), Figure 4.2, accessible here.
[16] Department for Business & Trade, *Trade and Investment Factsheets: United States* (17 December 2025), p. 1, accessible here.
[17] Visit Britain, *United States of America (USA),* accessible here.

operating at Heathrow will be eroded. Contrary to the CAA's and Secretary of State's primary duty to further the interests of consumers.

3. CAA Duties

34. As is noted in the Heathrow Reimagined response, the CAA's evaluation of the potential regulatory models for Heathrow must be guided by its statutory duties. As an independent regulator, the CAA's assessment of reform options must place primacy on the pursuit of its statutory duties, in particular its primary duty to further the interests of consumers where appropriate by promoting competition. Where the Government's objectives conflict with the CAA's statutory duties under the Civil Aviation Act 2012 (**CAA2012**), the CAA must prioritise the pursuit of its duties. This means that the CAA's assessment must prioritise elements focused on addressing the fundamental problems with the current regulatory model. Prioritising short-term expedience (even to align with the Government's preferred schedule) over the pursuit of reforms that will secure the longer-term interests of consumers cannot be consistent with the CAA's statutory duties. Any decision made otherwise by the CAA would be wrong in law.

4. Actions needed for success

35. For expansion to be economically viable, IAG believes the following coordinated actions are needed by the CAA and Government in order to design a regime that achieves the aims set out above and fulfils the CAA's and Secretary of State's statutory duties. While responsibility for certain actions may rest primarily with one or other of the CAA or Government, it is essential that: (i) the expansion regime is designed holistically; and (ii) the regulatory model is not developed in isolation of broader relevant factors and the context in which it will function, in particular the level of cost that is affordable for airlines and their customers. The CAA needs to take actions to fulfil its statutory duties, and the Government needs to take actions to support this as well as establish the wider framework for expansion through the ANPS and the DCO process.

36. Actions for the CAA:

1. **Set a budget with a hard cap of no more than £25-30 billion for expansion** and masterplan renewal which would replace the £49 billion estimate and cannot be exceeded (see the response to Question 7 below).

2. **Establish a far stronger regulatory regime** that resets Heathrow's incentives, manages capital spend closely and introduces competition (see our proposals for this in response to Question 7 in Section B below).

37. Actions for Government:

1. **Set a budget with a hard cap of no more than £25-30 billion[18] for expansion** and masterplan renewal which would replace the £49 billion estimate.

2. **Set within the ANPS a criterion to value engineer the scheme and include affordability as a policy aim**. The ANPS should explicitly require economic feasibility as a core test of expansion and empower the CAA to enforce strict capital budgets

[18] This is based on IAG's preliminary analysis. A detailed study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion.

aligned with demonstrable investment headroom. It should also require operators to phase terminal capacity investment in line with actual demand growth and to deliver expansion at broadly flat real charges.

3. **Establish a cross government-team with commercial expertise to oversee the DCO process and leverage competition and cost saving opportunities**. Government should establish a dedicated cross-government expansion planning team to shape and maintain an economically deliverable budget over both the short and long term. This body would provide a structured interface with a Capital Investment Committee (the Capital Investment Committee being a core element of the regulatory reform we propose to the CAA) and ensure that scope, phasing and cost performance discipline are maintained throughout the programme.

4. **Ensure the DCO process and other processes within the Government's remit enable a true level playing field between potential promoters to encourage competition and efficiency**. Consistent with a reformed and fit for purpose regulatory regime that promotes competition, Government need to avoid pre-judging HAL as the sole promoter of all elements of the scheme and instead ensure that a wider range of competitors are consulted and invited to bid. Promoters should be selected based on demonstrable and evidenced innovation and efficiency. Given the attractiveness of RAB-based investments to long-dated capital, competition to earn the right to invest can drive innovation and materially reduce costs. In this vein, Government should also support proposals that introduce competition into the regulatory framework for Heathrow (including to reduce and improve design scope, for example, through a shorter runway) since this is essential to keeping costs affordable.

5. **Provide an explicit affordability backstop for aeronautical charges, potentially including the reallocation of Air Passenger Duty (APD) revenues**. Airlines need a guarantee that charges will not exceed a given threshold. Airline capacity deployment is essential for expansion to succeed; Government support should therefore be structured to underwrite the risk associated with delivering the required airline capacity and to ensure expansion remains affordable for airlines and consumers. One way to do this would be to allocate part of APD revenues, which alongside airport charges make up part of the ticket price to consumers, to construction. If a strict, affordable budget is in place, we anticipate that such backstop would be required only during the transition period when capital expenditure (capex) is high, but capacity is not fully released. Government would earn back its APD backstop provision post transition – through increased passenger volumes that would not be realised without an increase in capacity. In other words, the APD amount the government may need to divert to ensure charges are kept affordable for airlines will be vastly offset by the APD increase achieved once the transition period is past (period during which there will be the most pressure on charges due to high capex without the necessary increased traffic level).

B. IAG's detailed responses to the questions raised in CAP3195

1. IAG commends the CAA for recognising the need for regulatory reform arising from HAL's monopoly position and the inadequacy of the current system, and for considering a wide range of potential regulatory frameworks for Heathrow Airport. IAG welcomes the opportunity to respond to the CAA's *Working Paper on Regulatory Models*.

2. Fundamental reform of regulation of Heathrow Airport is essential to address the significant harm to consumers of inappropriate incentives embedded in the current regulatory model. Reform should not be limited solely to capacity expansion but should also apply to the upcoming and subsequent regulatory price control periods.

3. IAG co-authored and endorses the Heathrow Reimagined response and wishes to supplement that response with the following additional comments.

1. Question 1: Do you agree with our assessment of how the regulatory model has performed to date in terms of protecting the interests of consumers?

4. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. We add the following additional comments which should be read as supplementary to that response.

5. IAG believes that the existing regulatory model has performed poorly and has failed to protect consumers' interests. It incentivises inefficient capital expenditure by HAL and allows insufficient oversight and scrutiny by the CAA. This has led to unacceptably high airport charges and therefore has failed to protect consumers' interests.

6. As explained in the Heathrow Reimagined response, the CAA has extensive powers to impose ex ante regulation on HAL to protect consumers and other users from the harm that can result from HAL's substantial market power. In exercising these powers, the CAA has statutory duties and authority that must guide its assessment of whether the current regulatory model is fit for purpose and what reforms are required. The CAA's primary duty is to "*further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services*". The current regulatory model is demonstrably falling short of enabling the CAA to meet this primary duty, as well as its duties to promote economy and efficiency and to carry out its functions in a manner which it considers will promote competition in the provision of airport operation services. The reasons for this are set out in Part B of the Heathrow Reimagined response and we expand on them below.

1.1 Wrong incentives and lack of CAA involvement

7. HAL is subject to RAB based regulation. While, in IAG's view, a well-designed and implemented RAB model *can* support effective regulation at Heathrow, the existing RAB-based approach has widely recognised vulnerabilities and opportunities for exploitation by a monopoly operator. As the Competition Commission observed in its Final Report in the BAA airports market investigation:

    a. "*[T]he bias towards increased use of capital created by RAB-based price regulation may have the undesirable effect of encouraging inefficient investment by the company. It may also provide incentives for strategic behaviour by the airport operator to inflate the size of the RAB and may*

[redacted]

discourage the application of charging structures that make efficient use of capital."

b. "*Price caps set on the basis of allowing a given return on a RAB provide no strong incentive for efficient or effective investment to reflect and respond to customer requirements as, in the longer term, the airport operator earns the cost of capital on all its investments that are allowed in the RAB regardless of how closely they reflect the needs of airlines and passengers, and the greater its investment, the greater its overall returns*."

c. "*As a consequence (and to some extent […] unavoidably in a situation of market power), decisions on investment projects are made on administrative, rather than market-generated, grounds, with criticisms on the resulting quantity, quality, location and timing of investment*."

d. "*For similar reasons, price controls may dull the incentive […] to innovate*."

e. "*Some of the criticisms mentioned above are inherent in RAB-based regulation, which incentivizes BAA to 'play the regulatory game' – ie to invest in order to achieve allowed return – rather than providing what users necessarily want, in terms of quantity, quality, location and timing of investment*."[19]

8. As the CAA sets out in the Working Paper, the level of airport charges is largely a function of the size of the RAB, which in turn is increased through inefficient capital expenditure by HAL, as demonstrated in Figure 2 below.

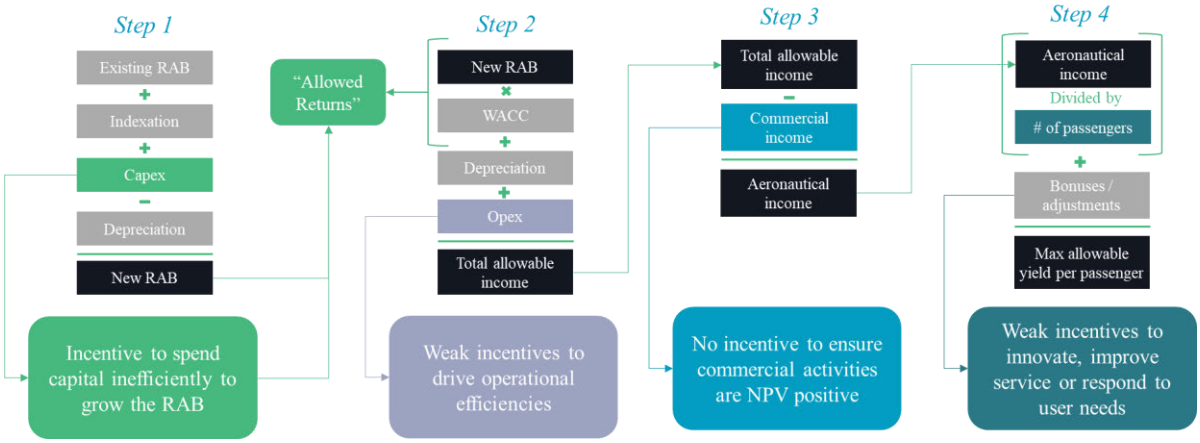
9. In line with the concerns identified by the Competition Commission, the RAB structure incentivises HAL to increase capex in order to grow the RAB and in doing so incentivises inefficient expenditure. Evidence that this has occurred has already been presented to the CAA by us through Heathrow Reimagined, and the CAA has itself acknowledged that the evidence of comparatively high charges indicates that some capital inefficiency has occurred. We elaborate on the evidence for inefficient capex and high airport charges below.

10. Part of the reason for the high costs is the lack of meaningful oversight and rigour by the CAA of HAL's capex, as well as information asymmetries between HAL and the airlines. The CAA has, in effect, over-delegated the role of scrutinising HAL's capex proposals to airlines who are required to “approve” HAL's projects and programmes at Gateway 3. However, HAL controls the supply of information, including data and models, as well as the technical resources needed to define baselines and delivery standards. Airlines face systemic information asymmetries, lack independent access to HAL's cost breakdowns and procurement strategies and performance, and must rely on highly selective information provided by HAL, on HAL's terms and timeline.

11. Most critically, while airlines have approval rights, this is superficial and their role remains largely consultative as HAL retains ultimate control over matters like project scope, delivery approaches, and the approvals process, which allows HAL full latitude and licence to structure projects and programmes in a way that maximises its returns (as detailed in the Heathrow Reimagined presentations to the CAA on the failures of the current capital governance and delivery obligations, dated 8th and 15th December 2025).

[19] Competition Commission, *BAA airports market investigation: A report on the supply of airport services by BA in the UK* (19 March 200), paras 6.17-6.23, accessible here.

Figure 2: Illustration of how the RAB model works at Heathrow Airport and why it drives the wrong incentives



1.2 Inefficient capex and high charges

12. The Jacobs Report[20] on airport charges has identified Heathrow as the most expensive airport globally. Review of the annual reports of a select number of comparable global hub airports confirms the Jacobs Report findings. Heathrow is the most expensive hub airport by a large margin as shown in Figures 3 and 4 below. Heathrow charges have more than doubled in real terms in the last 20 years (see Figure 5 below).

13. While the increase in charges between 2003 and 2014 can be explained by the investment in Terminal 5 and Terminal 2, the last 10 years have seen no meaningful development at the airport and should have led to a reduction in airport charges to create headroom for the next cycle of major renewal and investment. Instead, HAL has spent c. £8 billion in real terms in the last decade on maintenance and "business-as-usual" activities (i.e. no major capital projects). Despite this staggering spend, customer satisfaction has reduced over the same period (see Figure 6 below), calling into question the utility and efficiency of this significant expenditure.

14. HAL is now proposing to increase its aeronautical charges by 47% in real terms[21] for H8 alone, an increase that is unacceptably high and unsustainable.

15. As acknowledged by the CAA, at least part of the high charges is attributable to inefficient capex.

16. Heathrow Reimagined commissioned a study by Oxford Global Projects (**OGP**) to evaluate capex efficiency at Heathrow. OGP, are the world's leading experts on megaproject management with the most-cited scholars on megaprojects worldwide[22], OGP conducted comprehensive international benchmarking using their Reference Class Forecasting (**RCF**) methodology[23] (a methodology endorsed by HM Treasury's Green

[20] https://www.jacobs.com/reports/infrastructure/review-airport-charges-2024
[21] LACC's letter to the CAA RE: Initial Response to HAL H8 Business Plan – Level of Charge
[22] Oxford Global Projects was founded by Professor Bent Flyvbjerg and Alexander Budzier, PhD, they are the world's leading experts on megaproject management with the most-cited scholars on megaprojects worldwide, with over 30 years advising government and business and uses the largest high-quality datasets on project performance in the world to conduct research and advise clients.
[23] The Reference Class Forecasting method is based on theories that won the Nobel Prize in economics (planning fallacy and optimism bias) and Nobel Laureate Daniel Kahneman cites OGP's reference class forecasting tool as "the single most important piece of advice regarding how to increase accuracy in forecasting through improved methods."

Book and used by infrastructure regulators globally) applied to over 100 global airport projects to assess capex efficiency at Heathrow.

17. The OGP report[24] is unequivocal that HAL's capex is inefficient (see Figures 7, 8, 9):

    a. *"Across all asset types, Heathrow projects consistently lie above the international median, and in many cases fall within the upper quartile or even the upper decile of global benchmarks. This pattern is persistent across metrics and asset classes, indicating a systematic cost premium rather than isolated outliers"*

    b. *"Taken together, the benchmarking evidence points to three overarching conclusions:*

        i. *First, a structural cost premium is evident. Heathrow's capital delivery framework consistently yields higher costs than comparable international airports, even after controlling for scope, context, and price level.*

        ii. *Second, scale does not translate into efficiency. Larger projects do not deliver proportional cost savings, indicating that potential economies of scale are not being realised.*

        iii. *Third, consistently high costs across asset types point to governance, procurement, and ex-ante cost assurance as key influences. Design ambition alone does not explain the persistence of Heathrow's cost premium, which appears driven by broader features of project planning and delivery."*

18. IAG's review of select airport company annual reports[25] reflect the same inefficiency on a Net Fixed Asset (**NFA**) productivity basis (see Figure 10). NFA productivity measures the amount of capex invested for each flight operated (Air Traffic Movement of "**ATM**") and the amount of capex invested for each passenger flown. Heathrow has a significantly higher NFA per passenger and per ATM[26] than most peer airports. This illustrates that in order to produce the same passenger output or to support the same number of flights, HAL is spending significantly more on its assets. In other words, HAL has built £29,898 worth of assets to support each flight while Atlanta (the world's largest airport), has only built £7,878 worth of assets to support each flight (Figure 10). This statistic is even more concerning as Heathrow is a "full" airport, has not made any major developments in the last decade, and therefore should be at its peak asset level of productivity, requiring minimal capex for maximum capacity output. We should be observing a low NFA per flight and per passenger for Heathrow.

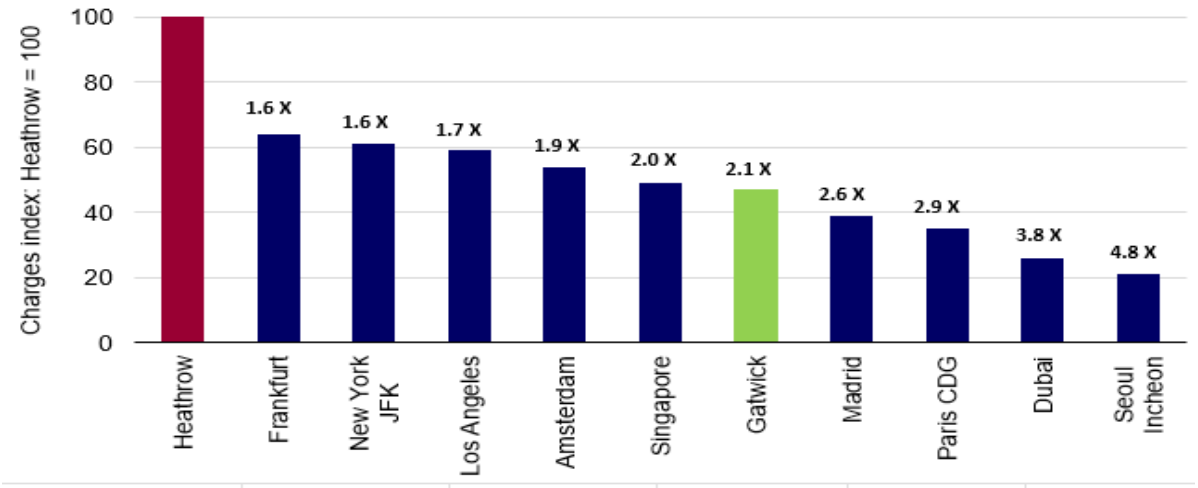
19. Under the plans for H8 and expansion, NFA productivity will decline further, with no headroom to absorb it. Even once capacity is operational it will not return to its current levels, let alone reach the level of peers.

[24] Oxford Global Projects, *Heathrow Benchmark Report,* 2025

[25] IAG reviewed the annual reports covering Heathrow Airport, Atlanta airport (largest airport in the world and hub for Delta Airlines), Dallas airport (hub for American Airlines), Amsterdam (hub for KLM), Singapore airport (hub for Singapore Airlines and widely seen as the world's best airport for customer experience. Also undergoing a significant expansion), Hong-Kong airport (hub for Cathay Pacific and undergoing a 3rd runway and terminal expansion), Tokyo Haneda airport (hub for Japan Airlines). These airports were chosen as they are comparable hub airports to Heathrow, in different world regions and their annual reports provide the required details to compare with HAL's annual report

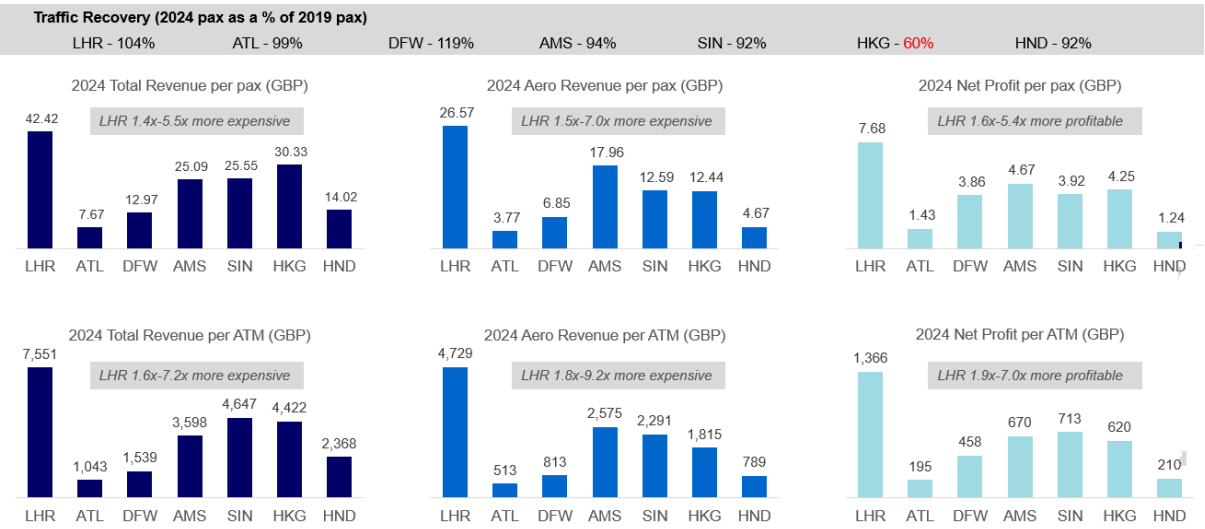
[26] ATM or Air Traffic Movements are flights taking off and landing at a given airport.

Figure 3: Heathrow's charges are significantly higher than those of other major international airports, 2024



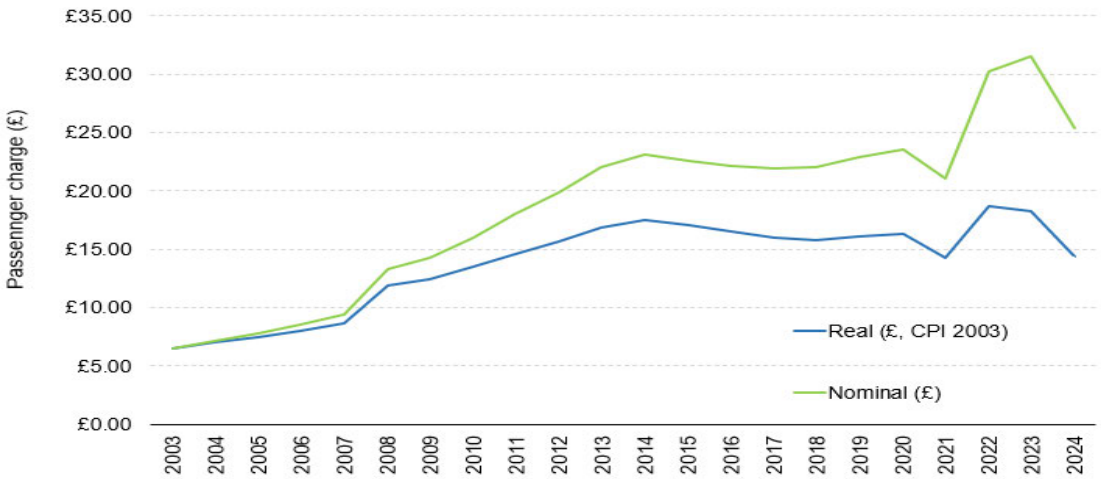
Source: Jacobs, Review of Airport Charges, 2024. Note: multipliers above the bars represent how many times more expensive Heathrow's charges are compared to other airports

Figure 4: Comparison of Revenue and Profitability metrics by airport shows that Heathrow is the most expensive airport in the comparator set



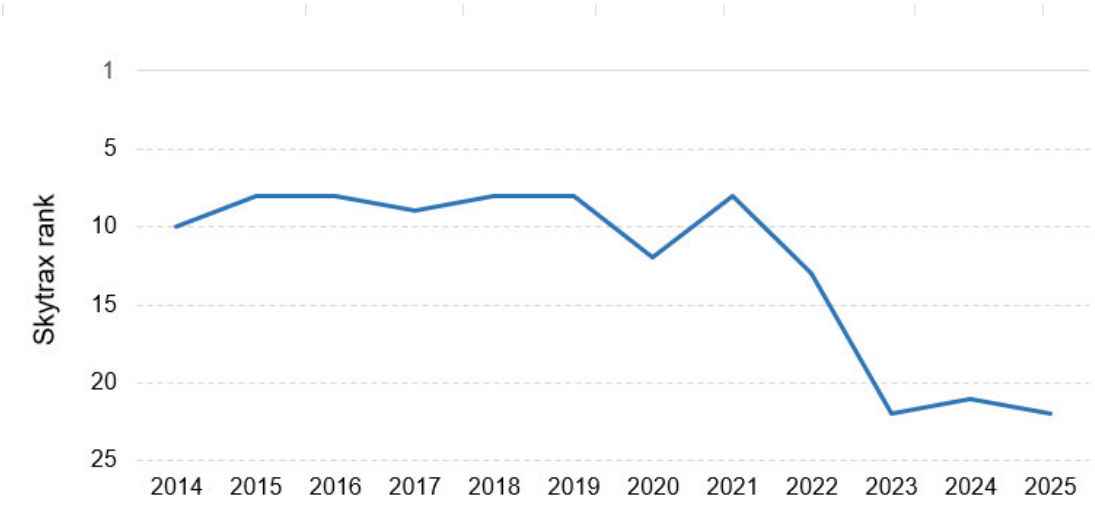
Source: Airport's annual reports

Figure 5: Heathrow's per passenger charges more than trebled in nominal terms (doubled in real terms) across regulatory control periods Q4 and Q5



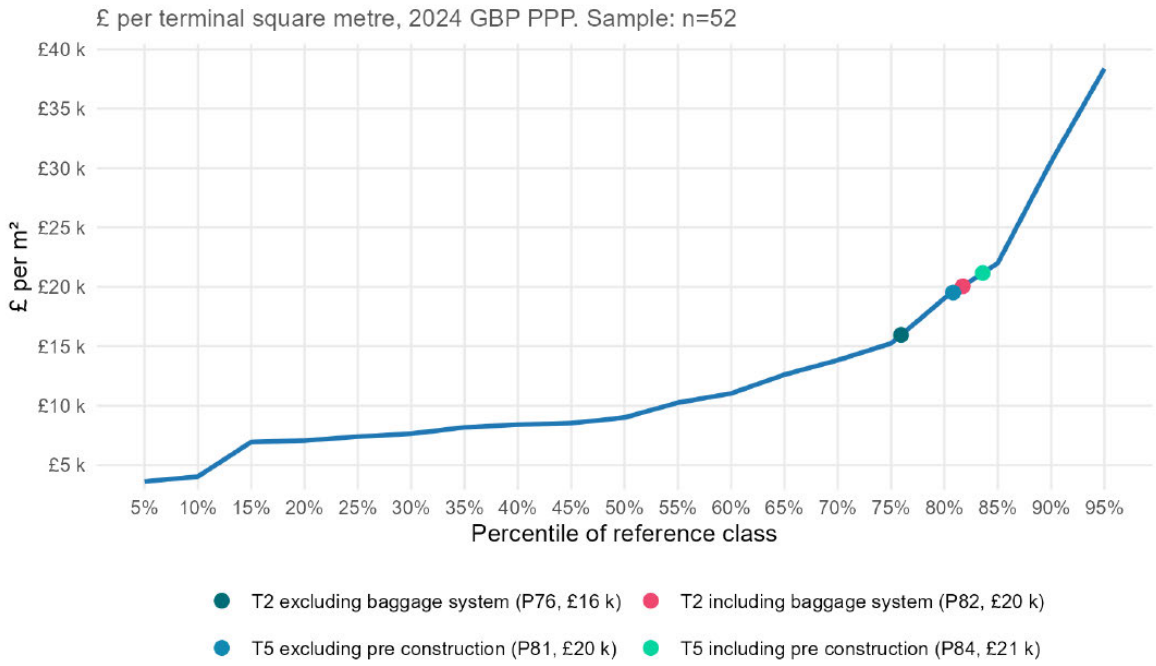
Source: CAA, Economic Regulation of BAA London Airports 2003 - 2008, 2003; CAA, Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013, 2008; A consultation on extending by one year the current price regulation at Heathrow and Gatwick airports, 2011; Heathrow Airport, Airport Charges for 2019 Consultation Document, 2018; CAA, Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications, 2019; CAA, Statement on Heathrow Airport Interim price cap, 2021; CAA, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023, 2022 ; CAA, Regulator proposes changes to Heathrow Airport Limited's airline charges in response to CMA appeal, 2024; ONS, RPI All Items Index, 2024; ONS, CPI All Items Index, 2024

Figure 6: Heathrow's customer satisfaction has been declining over time



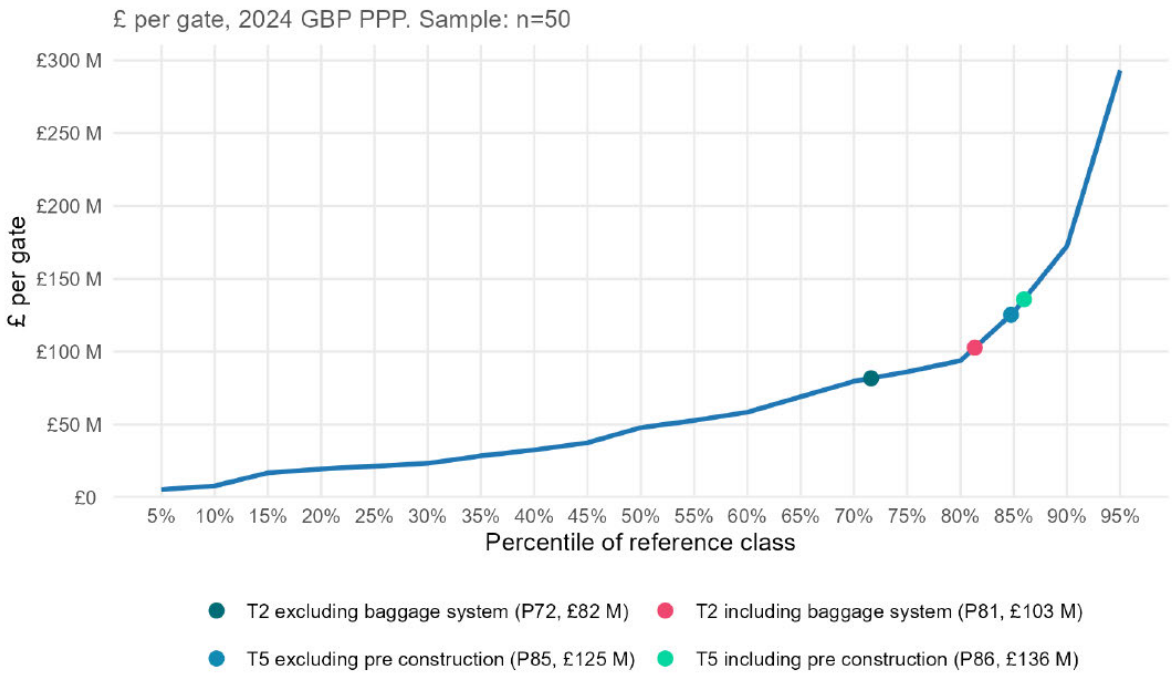
Source: Skytrax, World Airport Awards, 2014-2024

Figure 7: Terminal Cost per m^2 – Reference-Class Distribution (Global Sample)



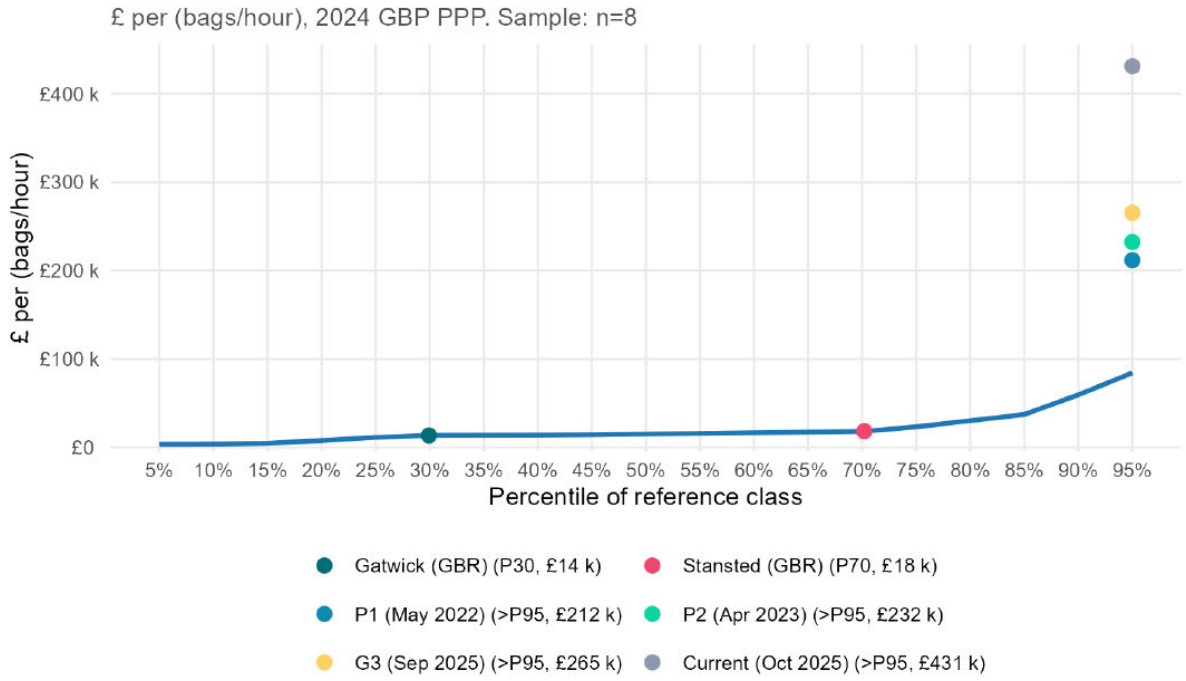
Source: Oxford Global Projects, *Heathrow Benchmark Report,* 2025

Figure 8: Terminal Cost per gate – Reference-Class Distribution (Global Sample)



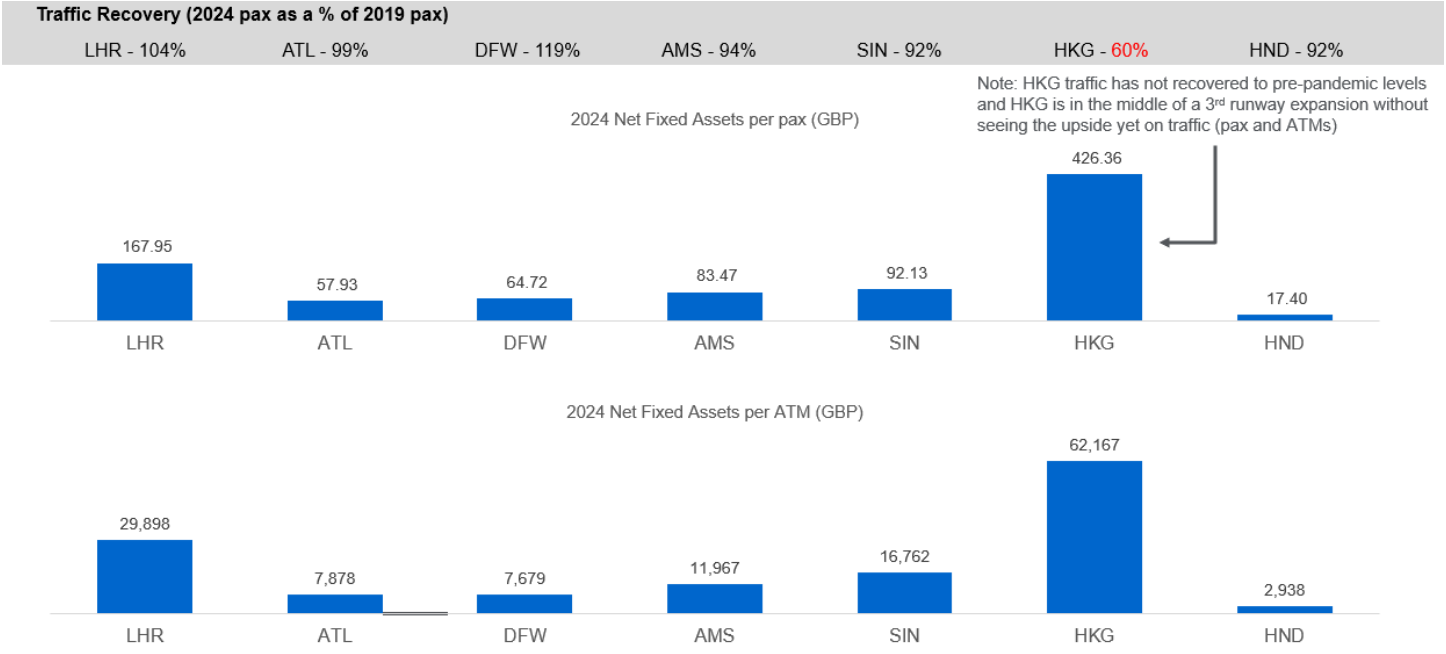
Source: Oxford Global Projects, *Heathrow Benchmark Report,* 2025

Figure 9: Baggage System Costs – Reference-Class Distribution (Global Sample)



Source: Oxford Global Projects, *Heathrow Benchmark Report,* 2025

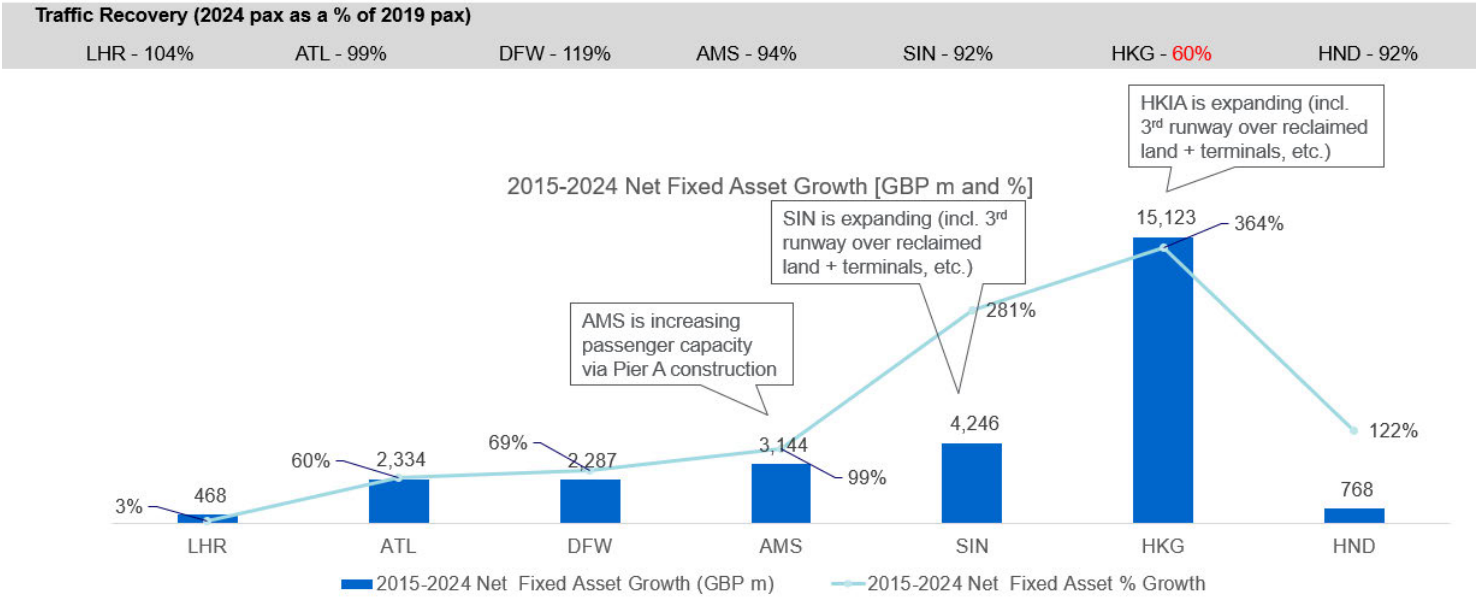
Figure 10: Comparison of Net Fixed Asset per Passenger and Net Fixed Asset per Air Traffic Movement between different airports to assess the capex efficiency (lower NFA per Passenger or per ATM means better Capex efficiency)



Source: Airports' annual reports

[redacted]

Figure 11: Evolution of Net Fixed Asset over the 2015-2024 period to assess which airports are in development phase vs. steady state



Source: Airports' annual reports

[redacted]

2. Question 2: Do you agree with our assessment of how the current regulatory model might perform on a forward-looking basis?

20. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. We add the following additional comments which should be read as supplementary to that response.

21. The CAA assessment does not fully capture how the current regulatory model might perform on a forward-looking basis. Section A of IAG's response sets out the issues in terms of the significant costs, the lack of consideration of airline affordability, incompatibility with the CAA statutory duties, and the actions needed by the CAA and Government.

22. If the expansion and masterplan renewal proceeded on the basis of the current regulatory model and £49 billion plan, we estimate that airlines would have to pay HAL an additional £3 billion per year in real terms for airport charges. In the best-case scenario presented by HAL (which is unrealistic because airlines will not be able to deploy aircraft capacity and therefore passenger numbers would be significantly lower), this would translate into charges more than doubling (see **Annex B** showing IAG and CEPA's analysis of future charges).

23. Realising the benefits of expansion is not simply a construction task. Given the scale of incremental revenues the airport must collect to pay for the construction, Government and Promoter(s) need airlines to deploy significant growth aircraft devoted to Heathrow, while also replacing aging aircraft. Government and Heathrow depend on voluntary, timely and substantial airline investments over many years in fleet (over £45 billion during the ramp up period and £20 billion leading up to the ramp up period), ground infrastructure, people and vast supply chains to efficiently use the new capacity.

24. Affordability therefore matters at every stage. If charges and costs rise materially above current levels, UK based airlines will not be able to afford to commit the scale of capital required and foreign based airlines will deploy their aircraft to markets with far better returns. The benefits to passengers, trade and the wider economy would not be delivered and HAL and LHR-based UK airlines would enter a downward spiral.

[redacted]

3. Question 3: Do you agree with the framework for evaluation we have proposed?

25. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses, including the evaluation elements that must be given primacy in the CAA's assessment, as set out below in Table 3 for ease of reference.

26. We add the following additional comments which should be read as supplementary to that response.

27. The framework for evaluation proposed by the CAA needs to be revised to take into account the realities of airline economics, a critical component to accurately assess the appropriateness of the regulatory model, especially in the context of expansion. Most importantly, it must take account of the limits on affordability for airlines, as explained in Section A of this response. Airlines (not airports) sustain network growth and provide the majority of the capital and jobs in any airline / airport hub system. If Heathrow expansion is not affordable for airlines, they will be unable to deploy the capacity required to deliver new routes, additional trade links, consumer choice, and the associated UK jobs. We elaborate on this in the response to Question 4 below.

Table 3: Which evaluation elements should be given primacy in the CAA's assessment?

Evaluation Element	Should it be given primacy?
A: Appropriate support for capacity expansion	**No** – While expansion can benefit consumers through increased capacity and connectivity, models that prioritise short-term expedience/expansion delivery timelines over comprehensively fixing the current regulatory model (i.e. expansion under a flawed regulatory model) will not, ultimately, further the interests of users and therefore are not consistent with the CAA's statutory duties.
B: Costs	**Yes** – HAL's harmful incentives and the ineffectiveness of the current regulatory regime to prevent it from acting on those incentives that drive inefficiency and high costs, and therefore are key factors contributing to the poor consumer outcomes at Heathrow today. Comprehensively addressing these failings is critical to meeting the CAA's duty to promote economy and efficiency.
C: Finance	**No** – Financeability must focus on ensuring operators can finance efficient investment, not minimise financing costs at consumers' expense. Different models involve different financing trade-offs: RAB models may have lower financing costs but create incentives for capital inefficiency that increase overall costs to consumers. Finance considerations are relevant to detailed implementation, not to choosing between fundamentally different approaches. Any consideration of financeability also needs to recognise that unaffordable expansion is unfinanceable.
D: Practicality	**No** – While reforms need to be practical to develop and apply in a timely manner, practicality considerations should not be used as a reason to prioritise short-term expedience and ease over the longer-term interests of users. Where the CAA does not currently have the necessary powers to implement all aspects of a particular model, Government can confer those powers as part of its wider expansion legislative activities.
E: Promotion of effective competition	**Yes** – Directly aligns with the CAA's statutory duties and forms part of the CAA's primary duty. The current regime exists because HAL holds substantial market power (i.e. is a monopolist); effective competition directly addresses this and resets harmful incentives. Competition is inherently more effective than regulation at aligning operator incentives with consumer interests. The CAA should adopt a presumption in favour of competition.

[redacted]

F: Service quality	**Yes** – Heathrow's service quality is inadequate and has declined, consistent with its harmful incentives and an ineffective regulatory regime. Ensuring that reforms promote an appropriate level of service quality and value for money is a core element of furthering the interests of users and the pursuit of the CAA's statutory duties.
G: Affordability	**Yes** – Ensuring affordable charges is essential to furthering user interests, the CAA's primary duty. Given the scale of planned investment (c.£9.5 billion in H8, at least £49 billion for expansion), the reformed regime must ensure capex efficiency and charge affordability. Without this, airlines cannot invest in connectivity, triggering a self-reinforcing contraction where, capacity underutilisation drives higher charges, further weakening demand and connectivity. The risk of dehubbing that follows would undermine the economic growth case for expansion and harm existing and future passengers.

Source: Heathrow Reimagined response

4. Question 4: Are there additional elements we should consider as part of the analytical framework that would better ensure that the options considered will align with consumers' interests?

28. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. We add the following additional comments which should be read as supplementary to that response.

Airline Economics

29. A key additional element the CAA should consider as part of its analytical framework to ensure the options align with consumer interests is updated modelling on airline economics. As explained below, the models used by the Government to underpin decisions on airports policy and regulation fail to take account of airline economics and the realities of the aviation market. It is essential that the CAA decisions are not made without an assessment of all relevant factors (such as airline economics) as this would be omitting relevant evidence and be procedurally unfair to the airlines. Moreover, because airline economics are central to whether Heathrow expansion succeeds or fails, any regulatory approach that does not take proper account of airline economics and subsequent behavioural responses is unlikely to deliver the projected consumer benefits and risks placing the CAA in breach of its duties to further the interests of consumers and to have regard to HAL's financeability.

4.1 Department for Transport (DfT) modelling

4.1.1 Summary

30. UK aviation policy appraisal relies heavily on demand forecasts produced using the DfT's aviation demand modelling framework. These forecasts, which informed the Airports Commission and subsequent policy decisions on Heathrow, Gatwick and other capacity options, are used within a cost-benefit analysis structure aligned with HM Treasury's Green Book. While formally compliant with Green Book processes, the underlying modelling fails key Green Book principles in substance, notably in respect of behavioural assumptions and treatment of risk and uncertainty and fails to correctly identify the binding constraint (i.e., profitability, not demand).

31. The DfT framework is fundamentally passenger-led. It assumes that if passenger demand exists (or can be stimulated by changes in generalised cost), airline capacity will be supplied endogenously to meet that demand. This implicitly assumes that airline supply is unconstrained by profitability or capital allocation considerations. In reality, airlines deploy aircraft capacity only after making forward-looking, high-risk capital commitments. Capacity deployment therefore requires confidence in achieving a risk-adjusted return that exceeds the airline's hurdle rate. If that condition is not met, demand remains unserved regardless of passengers' theoretical willingness to travel.

32. The omission of this profitability and investment constraint represents a systematic optimism bias in the appraisal of Heathrow expansion, which is particularly acute where new infrastructure is financed through materially higher airport charges. Airport charges cannot be treated as a symmetric marginal cost. For existing capacity, airlines may *partially* mitigate higher charges through efficiency and fleet optimisation over time. For new capacity, however, the higher charge constitutes an entry condition that must be met from day one (before any of the normal mechanisms that improve route economics over time can take effect), fundamentally altering expected net present value (**NPV**), downside risk and investment incentives.

33. In line with Green Book guidance, robust appraisal of airport expansion should therefore:

- Explicitly model airline investment decisions and profitability constraints.
- Distinguish clearly between optimisation of existing capacity and deployment of new capacity.
- Apply explicit optimism bias adjustments or scenario analysis where airline willingness to supply capacity is uncertain.
- Test outcomes under realistic assumptions about airport charging, ramp-up losses and capital allocation behaviour.

34. Without these adjustments, expansion appraisals risk overstating benefits, understating risks, and failing the Green Book test of realistic, evidence-based decision-making.

35. In addition, the Green Book makes clear that transformational projects should be appraised using a holistic, systems-based analytical framework.[27] Annex 7.6 highlights that complex systems contain numerous interacting feedback effects, leverage points (where feedback effects converge and amplify the effects of an intervention), and potential tipping points, where modest interventions can result in the entire system tipping over when a certain point is reached.

36. In the context of the London (and UK) air passenger market, the 'system' extends far beyond any single airport. It is an interdependent airport – airline – passenger – capital markets ecosystem, in which outcomes are highly sensitive to airline network and fleet allocation decisions, route-level economics, passenger mix and behaviour, and competitive dynamics across UK and international hubs. Consistent with the Green Book guidance, the CAA should map the key systems effects, interactions, and tipping / leverage points (particularly those triggered by materially higher airport charges at Heathrow) to ensure that regulatory decisions are consistent with Green Book principles and do not inadvertently create conditions under which demand forecasts, financing assumptions, or utilisation projections collapse. As airlines (not airports) provide the network and the majority of the capital and jobs in the system, an essential part of this analysis must be a detailed mapping of airlines system effects.

4.1.2 How the DfT models aviation demand

37. The DfT aviation demand model is a large-scale econometric and network-style model that forecasts passenger flows based on:

- GDP and income growth;
- Population and demographic trends;
- Fare levels and generalised cost of travel (including time);
- Connectivity and frequency assumptions.

38. At its core, the model treats air travel demand similarly to other transport modes: passengers decide to travel if the generalised cost is acceptable, and the system supplies capacity to meet that demand.

[27] HM Treasury, *Guidance: The Green Book (2022)*, updated 16 May 2024, Annex 7.6, accessible here.

39. Airports appear in the model primarily as cost and capacity constraints, not as commercial entities setting prices that interact with airline profitability. Airlines are implicitly assumed to behave as capacity providers responding elastically to passenger demand signals.

40. Airport charges are incorporated into fares as a component of ticket price. In the DfT appraisal, an increase in airport charges is therefore often treated as an increase of £[x] per passenger, partially passed through to fares, leading to some demand suppression. What is missing, however, is a supply-side investment decision: whether airlines will deploy incremental aircraft capacity at all when faced with a structurally higher unit cost base.

4.1.3 How airlines deploy capacity (Green Book perspective)

41. Airlines cannot serve demand without first committing capital. Capacity deployment involves ordering or leasing aircraft years in advance; allocating scarce aircraft to specific airports and routes a long time in advance; and committing crews, maintenance, ground handling and marketing resources. These decisions are made before a single incremental passenger materialises. The airline therefore bears downside risk if the route or airport underperforms.

42. This reverses the causality assumed in DfT models: the DfT modelling assumes that if passengers appear, airlines will add capacity. However, the airline reality is that if expected profitability is insufficient, capacity is simply not deployed, even if notional passenger demand exists.

43. It is profitability, not demand, that is the binding constraint. For an airline, the relevant decision metric is not passenger demand but expected return on invested capital (ROIC) and cash generation. A route or airport expansion must cover direct operating costs (fuel, crew, maintenance); indirect overheads; aircraft ownership or lease costs; airport and air navigation charges; and risk premiums for demand volatility. If any of these inputs, particularly fixed or quasi-fixed costs such as airport charges, increase materially, the hurdle rate for deploying aircraft rises sharply.

44. The DfT framework does not explicitly model airline capital constraints, fleet availability and competing uses for aircraft, risk-adjusted return requirements or strategic capacity discipline (now central to airline management). As a result, the model implicitly assumes that airlines are willing to deploy capacity at negative returns that don't cover their cost of capital and with no expectation of returns improving.

45. This assumption may have been closer to reality in a regulated or growth-at-all-costs era, but it is increasingly invalid in today's airline industry, which is characterised by tighter capital markets, shareholder pressure for returns, disciplined capacity growth post-Covid and higher structural costs (fuel volatility, SAF mandates, labour).

46. By assuming capacity will appear if demand exists, the DfT model overstates utilisation of new runways and terminals and understates the risk of stranded or under-used capacity. It also overstates consumer and connectivity benefits and understates the importance of airport pricing and risk sharing.

[redacted]

4.1.4 The impact of increased airport charges on existing and new services

47. For existing services, airlines facing an increase in airport charges (e.g. from ~£25 to ~£55 per passenger) have some *partial* mitigating levers, including:

- Re-adjusting its route network
- Upgauging aircraft over time (e.g. A320 → A321, 787-9 → 787-10)
- Improving load factors on already deployed capacity over time
- Introducing more fuel-efficient aircraft to reduce unit costs over time

48. Crucially, these levers are applied to sunk or semi-sunk capacity. The aircraft is already deployed, the route is already in the network, and marginal optimisation can help absorb higher charges over time. Even then, this is challenging and often results in reduced frequencies, loss of marginal routes and pressure on thinner long-haul or leisure services. These points are further elaborated on in **Annex E** where the impact of charges on British Airways' network and Aer Lingus' London strategy is explained.

49. For new routes or new capacity, the economics are fundamentally different from those faced by incumbent services. The challenge is not simply that the airport charge is higher, but that it applies from the outset, before any of the normal mechanisms that improve route economics over time can take effect.

50. Existing routes benefit from sunk or semi-sunk investment, for example, aircraft are already owned or leased; crews, maintenance arrangements and ground handling are already in place; brand awareness and distribution channels already exist; and traffic rights, slots and operational knowledge have already been secured. These sunk investments create flexibility. Airlines can attempt to re-optimise an existing route when charges rise, because withdrawing capacity is costly and politically or strategically undesirable. This gives management an incentive to look for mitigating actions where possible.

51. By contrast, for new routes nothing is sunk. The airline faces a clean-sheet investment decision. If the expected NPV is negative at a defined level of per passenger charge, the rational response is simply not to enter. New routes almost never reach maturity load factors and yield in their first years. They typically experience low initial load factors, discounted fares to stimulate awareness and demand, high marketing and launch costs, and operational inefficiencies during early operations. A high per-passenger airport charge magnifies early-year losses. The airline incurs substantial costs even when aircraft are only partially full, materially increasing cash burn during the ramp-up phase.

52. For existing routes, this ramp-up phase has already occurred. The higher charge is applied to a mature revenue base. For new routes, it applies precisely when revenues are weakest and risks are highest.

53. A material increase in airport charges results in both a higher break-even load factor and a higher minimum viable average yield. For a new route, these thresholds must be met immediately. There is little tolerance for gradual improvement. This sharply reduces the set of markets that can plausibly support service, particularly price-sensitive leisure routes, thinner long-haul markets and routes reliant on connecting traffic.

54. For existing routes, the ones that have consistently low profitability risk being discontinued and the ones that operate comfortably above break-even can be retained through incremental adjustments to absorb higher charges.

55. Aircraft are scarce, agile assets. Airlines continuously allocate them across competing market opportunities worldwide. When evaluating new capacity at Heathrow, airlines evaluate the potential returns against allocating the capacity at other airports, including other hubs with lower charges, point-to-point leisure markets, and growth opportunities in faster-growing regions. A £49 billion plan for expansion and masterplan renewal materially weakens Heathrow's relative attractiveness in this internal capital allocation process. Even if a Heathrow destination route might be marginally viable for a non-based carrier in isolation, it may lose out to alternative uses of the same aircraft to different airport destinations with superior risk-adjusted returns.

56. This opportunity cost is largely invisible in demand-led models, but central to airline decision-making.

4.1.5 Why this matters for Heathrow and UK policy and regulation

57. Much of the Airports Commission case for Heathrow expansion relied on high assumed utilisation of new capacity, strong long-haul growth from the UK, and limited airline resistance to higher charges. If, however, airlines cannot profitably deploy new capacity at Heathrow under a high-charge regime, then traffic forecasts will not materialise, connectivity benefits will be overstated, and regional and consumer welfare gains will fall short of appraisal.

58. The key modelling failure is not a parameter error, but a conceptual omission centred on the absence of an explicit airline investment and profitability constraint. Without incorporating real-world airline decision-making risks, demand-led models systematically bias results in favour of expansion, regardless of the plausibility of the theoretical result.

59. From a Green Book perspective, the issues identified in this report can be summarised as follows:

- **Incorrect identification of the binding constraint:** The DfT framework treats passenger willingness to travel as the binding constraint, whereas in reality the constraint is airline willingness to deploy capital at acceptable risk-adjusted returns.
- **Lack of behavioural realism:** Airlines are implicitly modelled as passive capacity suppliers rather than profit-maximising firms subject to capital rationing, fleet scarcity and competing investment opportunities.
- **Systematic optimism bias:** By assuming capacity will materialise if demand exists, utilisation and benefit forecasts for new infrastructure are biased upwards, while downside risks are understated.
- **Inadequate treatment of risk and uncertainty:** High airport charges amplify early-year losses and downside exposure for new routes, yet this risk asymmetry is not reflected in appraisal outputs.
- **Mischaracterisation of costs:** Treating airport charge increases as marginal fare increments fails to recognise their role as fixed or quasi-fixed entry costs that fundamentally alter project NPV.

60. Whilst the CAA's proposed analytical framework for evaluating regulatory models (**Proposed Evaluation Framework**) purports to assess whether a regulatory model meets the "B. Costs" and "C. Finance" elements, it does not consider the key modelling

failures set out above, notably in relation to airline economics and the realities of the aviation market. In the absence of alternative economic modelling being used, the CAA's Proposed Evaluation Framework cannot properly assess whether a proposed model: (i) promotes efficiency and control of the costs of expansion whilst deriving the benefits of expansion for consumers; or (ii) supports the raising of sufficient finance to enable the delivery of expansion at an efficient price. If expansion is not affordable for airlines, it will not be financeable for HAL or any other promoter.

61. Given that the regulatory model will govern how, and to what extent, costs will be passed through to consumers through airport charges, it is essential that the CAA's Proposed Evaluation Framework takes these key modelling failures into account to achieve its primary duty under the CAA2012 to further the interests of users of air transport (present and future).

62. In line with Green Book guidance, the CAA's Proposed Evaluation Framework should ensure a robust appraisal of airport expansion based on the following actions:

- Explicitly model real-world airline investment decisions and profitability constraints.
- Distinguish clearly between optimisation of existing capacity and deployment of new capacity.
- Apply explicit optimism bias adjustments or scenario analysis where airline willingness to supply capacity is uncertain.
- Test outcomes under realistic assumptions about airport charging, ramp-up losses and capital allocation behaviour.

63. Without these adjustments, expansion appraisals risk overstating benefits, understating risks, and failing the Green Book test of realistic, evidence-based decision-making. They would also prejudice the design of an effective regulatory framework for Heathrow in line with the CAA's statutory objectives and duties under the CAA2012.

4.2 Quality of Evidence

64. A key element of the CAA's evaluation framework and approach to assessment must be that any evidence used or relied on by the CAA is robust and of good quality. Studies, modelling, or methodologies that contain flawed or biased assumptions, data or analysis risk undermining the basis of CAA decision-making on the future regulatory framework for Heathrow and make their decision open to challenge. It is essential therefore that the CAA's decisions are not made on the basis of incorrect assumptions and facts. We want to highlight one such example of this, namely the principal report by Frontier Economics commissioned by HAL in 2019[28] (**Frontier Economics study**) and which has been updated in part in the Heathrow Expansion Cost Benefit Analysis[29]. This study should be treated with caution as we have identified several fundamental flaws with it.

4.2.1 The Frontier Economics theoretical conclusions do not add-up with reality

65. We strongly disagree with the conclusions of the Frontier Economics study which asserts the existence of a material "congestion premium" at Heathrow Airport. The study's central claim that slot scarcity enables airlines to extract excess economic rents from passengers is not supported by observed airline pricing behaviour, airline financial performance, or reliable empirical evidence.

66. The Frontier Economics study concludes that airlines operating at Heathrow earn excess revenues as a result of congestion-driven pricing power.

    a. *"In other words, there is such excess demand at Heathrow, that **airlines are able to raise ticket prices above what we would expect to see in an unconstrained market** – much like what we see in other markets such as tickets for popular music events – and earn around £3.5 billion in additional revenue per annum. If there were spare capacity at Heathrow, competition between airlines would result in incumbent airlines and/or new entrants adding extra capacity on existing routes which would drive prices back down towards the competitive level."*[30]
    --Frontier Economics, Heathrow Expansion Cost Benefit Analysis, 1 August 2025, Page 51

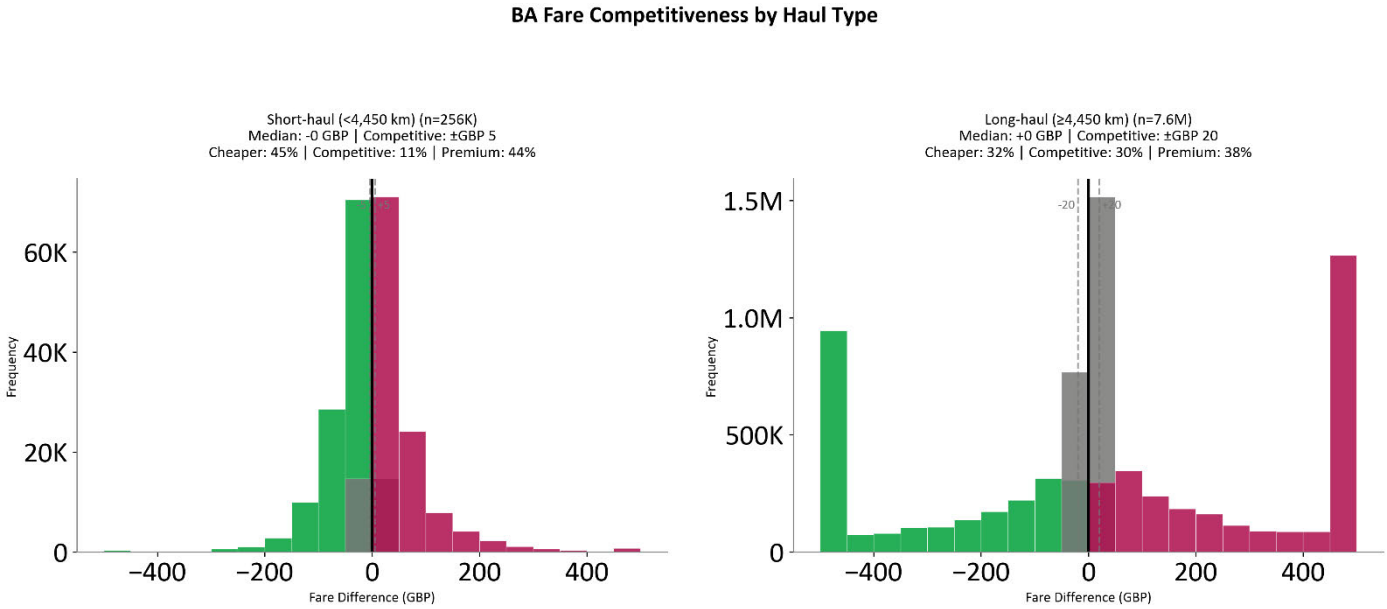
67. The prices consumers pay for airfares, which include the customer's portion of airport charges passed through as well as APD, are strongly governed by the market forces. While individual selling prices for particular itineraries may be above or below competitors' from at any given time for a number of reasons, a large sample of simultaneously available selling prices for an airline and all of its competitors will consistently have a median of difference between the lowest available selling prices for itself and its best priced competitor on a like-for-like product of around zero – as shown in Figure 1a and 1b. These figures represent the price differential analysis of a sample taken over the course of a week for like-for-like prices available on a given day during that week (and copied again below for convenience). Airlines based at Heathrow compete in a global market. Airlines at Heathrow compete among themselves on specific routes, as well as with airlines serving the same destination from other London airports and with airlines serving the same destinations using connections over other hubs such as KLM over Amsterdam, Air France over Paris, Lufthansa over Frankfurt, Turkish

[28] https://www.caa.co.uk/media/dwfgyk53/estimating-the-congestion-premium-at-heathrow.pdf
[29] https://www.frontier-economics.com/media/uelpl53a/heathrow-expansion-cost-benefit-analysis.pdf
[30] https://www.frontier-economics.com/media/uelpl53a/heathrow-expansion-cost-benefit-analysis.pdf

[redacted]

Airlines over Istanbul, etc. Customers have options and, over time, they receive competitive prices. This reflects the commercial reality that airlines cannot sustain their prices being meaningfully above competitors' without losing significant market share.

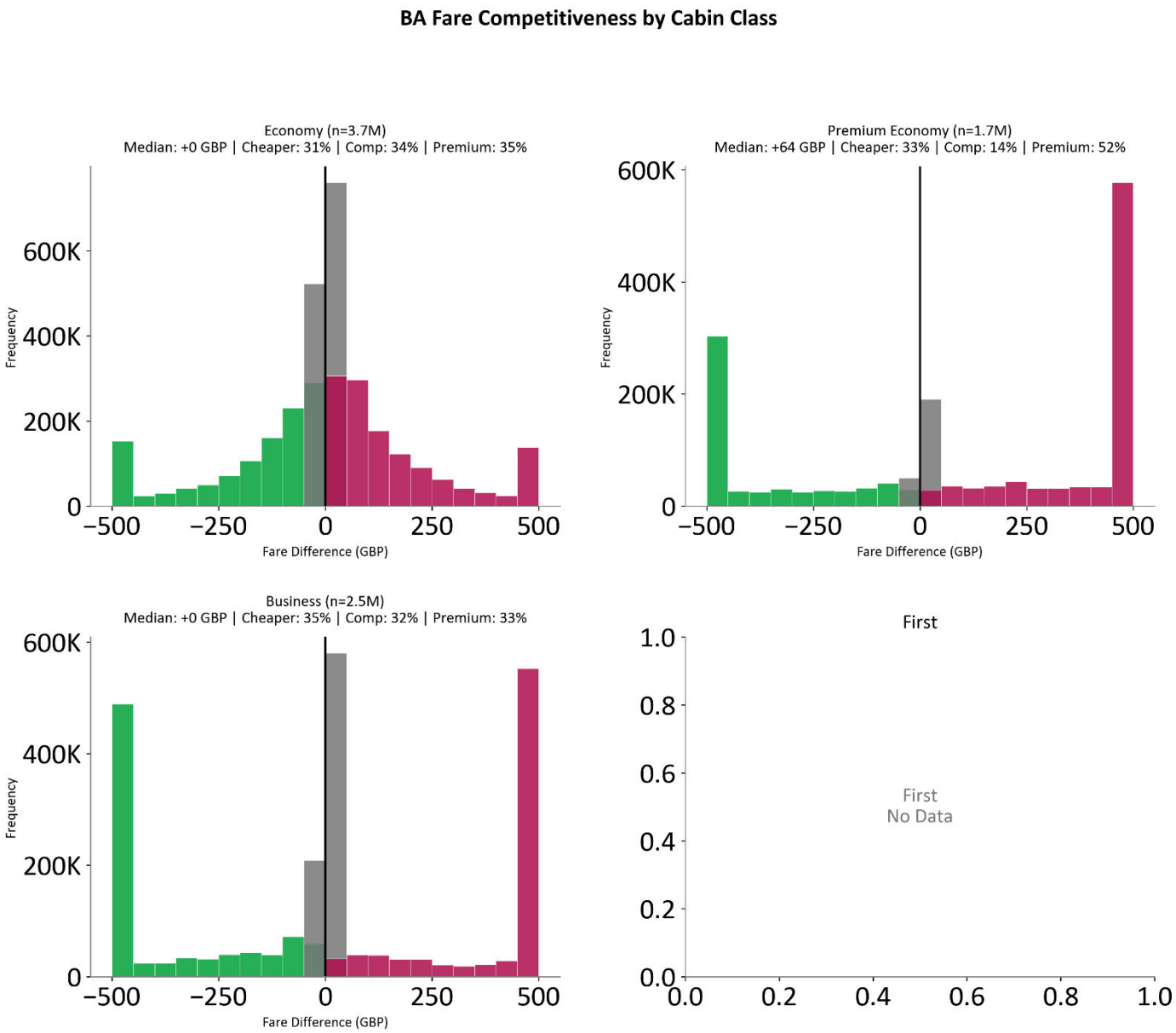
Figure 1a: Comparison of BA's lowest available fare by haul type vs. competitors lowest available fares on a like-for-like travel basis from INFARE[31].



Source: IAG analyses of fares obtained from INFARE
Note: Grey box covers the fares within +/- £5 for short-haul and within +/- £20 for long-haul

[31] Analysis from INFARE data

Figure 1b: Comparison of BA's lowest available fare by cabin type vs. competitors lowest available fares on a like-for-like travel basis from INFARE



Source: IAG analyses of fares obtained from INFARE
Note: Grey box covers the fares within +/- £5 for short-haul and within +/- £20 for long-haul

68. The assertion that airlines earn excess revenues at Heathrow is contradicted by observed financial outcomes. IAG estimates that EBIT margin, a measure of aggregate airline profitability that excludes the interest cost of financing, at Heathrow is approximately 9.6%, equating to around £3.1 billion per annum across all operators[32], and is broadly consistent with the airline industry's long-run cost of capital and the

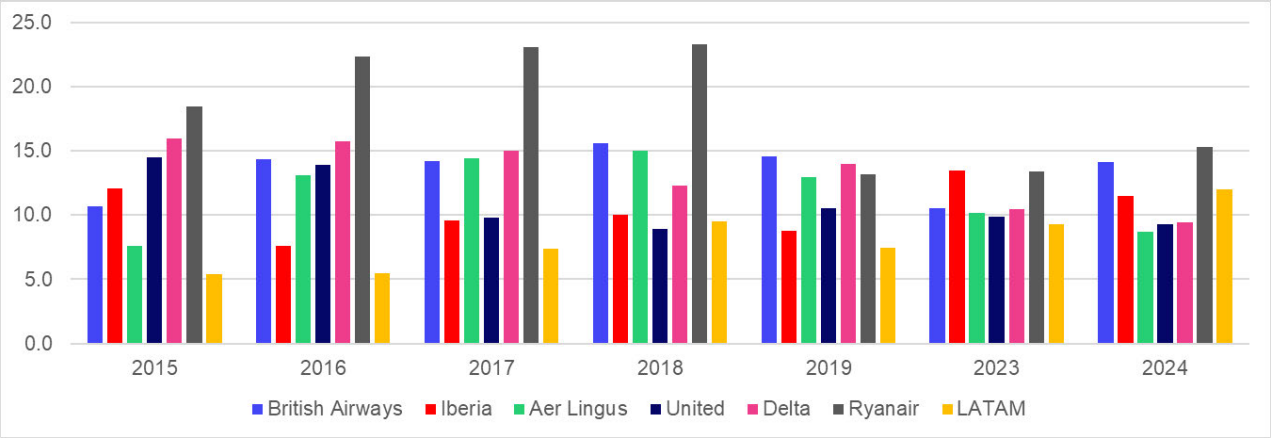
[32] This is based on IAG's preliminary analysis. A study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion. IAG would welcome the opportunity for Oliver Wyman to present its findings to the CAA and Government.

industry's profitability globally (6.6% EBIT globally, ranging from 3.7% in Africa to 13.8% in Latin America with Europe at 6.2% in 2024, according to IATA[33]).

a. IAG airlines (Aer Lingus, British Airways, Iberia, Vueling), which accounted for c. 50% of the seat capacity and c. 55% of the flights to/from LHR in 2024[34], generated c. £2 billion EBIT from their LHR operations in 2024. This was a c. 14% EBIT margin[35].

    i. British Airways' profitability in the last decade is in line with the industry's best performers and is comparable to its peers within IAG, with Iberia (out of Madrid) having similar performance levels post-COVID following a significant transformation and Aer Lingus (out of Dublin) having comparable margins across the last decade.

Figure 12: Comparison of British Airways' profitability with peers



Source: CapIQ and carrier annual reports; global airline average is weighted average of all carriers with publicly reported financial information

b. Virgin Atlantic, which primarily operates to/from Heathrow, and which accounted for 6.2% of seats and 4.7% of flights to/from Heathrow in 2024, has been persistently loss making when accounting for its aircraft financing costs[36].

c. If airlines at Heathrow were to achieve an EBIT margin exactly in line with what other airlines achieve across Europe (6.2% EBIT in 2024), they would be expected to generate a total combined £2.0 billion EBIT.

d. The assertion of Frontier Economics that airlines at Heathrow earn £3.5 billion of excess revenue should translate to airlines at Heathrow generating a total combined EBIT of £5.5 billion. If IAG and Virgin Atlantic account for 56-60% of the activity at Heathrow and generate a combined c. £2.1 billion EBIT, it would imply that the remaining airlines generate c. £3.4 billion EBIT for 40-44% of the activity. This would translate to these airlines achieving a combined EBIT margin of c. 25% on their Heathrow operation. This is clearly unplausible:

    i. *Note: London being the world's largest aviation market by number of passengers and Heathrow being the UK's only hub, a better than average European performance would also be logical (i.e.: EBIT higher*

[33] https://www.iata.org/en/iata-repository/pressroom/fact-sheets/industry-statistics/
[34] Based on OAG data
[35] Based on IAG's internal accounts
[36] https://corporate.virginatlantic.com/content/dam/corporate/Virgin_Atlantic_Annual_Report_2024.pdf

than 6.2%), further increasing the lack of credibility of the claimed £3.5 billion excess revenue when compared with actual airline EBIT performance.

69. Furthermore, Frontier's methodology assumes that connecting fares carry no premiums and that the congestion premium comes entirely from direct markets. Frontier sources its revenue data from IATA. IATA's data products are engineered to give a gauge of average revenue and limit visibility into true selling prices. The IATA methodology systematically randomizes fares when for a specific origin and destination market pair there are three or fewer carriers ticketing, with no single carrier holding more than 75% of the market share and no combination of two carriers exceeding 90% of the market share in the sample period. Most direct markets (globally) have three or fewer carriers serving them and two carriers exceeding 90% of the capacity. For sample weeks in March and June 2025, approximately 90% of routes and 80% of seats out of each Heathrow, Paris CDG, Frankfurt and Munich are in markets that require randomization. In Amsterdam, 90% of routes and more than 70% of seats require randomization. By relying only on direct traffic, (non-connecting data only) the bulk of the data in Frontier's regression analysis has been systematically randomized by the data provider (IATA) to keep individual airlines from knowing what others are actually ticketing. This is unsuitable data for the type of regression analysis they are conducting.

70. Furthermore, connecting traffic and direct traffic compete with each other for space on the same aircraft. They both are for sale simultaneously on every airline offering connecting itineraries, and both products compete for each seat: airline inventory management systems manage this competition via a bid pricing structure. It cannot be true that the direct product is systematically attracting a congestion premium when it competes with a connecting product that has no congestion premium.

71. Heathrow is structurally one of the most expensive airports globally. Any all-in, selling price premiums observed relative to less constrained airports are overwhelmingly absorbed by high aeronautical charges, ground handling and operational costs, inefficiencies associated with operating at near-maximum utilisation (i.e.: delays), and network costs inherent to long-haul hub operations. Furthermore, the configuration of aircraft deployed (e.g.: a larger business class cabin and a smaller economy class cabin) will directly impact the underlying costs for airlines.

72. The Frontier Economics analysis fails to demonstrate that higher fares translate into higher profitability rather than cost recovery. The analysis also fails to explain how a large slot holder can be consistently loss making. In the absence of such evidence, inferring congestion rents from fare differentials alone is analytically flawed.

4.2.2 The Frontier Economics report mischaracterises the Heathrow ATM cap as equivalent to route-level congestion

73. A critical flaw in the study is the treatment of Heathrow's ATM cap as evidence of congestion at the route level. Indeed, passengers travel between cities. Many Heathrow routes are served by multiple daily frequencies from multiple competing carriers, with viable indirect (connecting) alternative itineraries or substitution via other London and UK airports. All of this is evidenced by the RBB study provided at **Annex C** and remains true of routes today in 2026.

74. Airlines continuously re-optimise capacity through aircraft gauge, cabin mix (configuration), scheduling, and network adjustments. The existence of an ATM cap does not imply that airlines are unable to add effective capacity on specific routes where demand warrants it.

4.2.3 The Frontier Economics report ignores the realities of the markets being served

75. Comparing Heathrow's average fares to average fares seen at AMS, BCN, CDG, FCO, FRA, IST, LGW, LTN, MAD, MUC or STN is not a valid test of congestion: it is primarily a comparison of passenger mix (e.g. cabin/class, business/leisure) and booking behaviour (late booking vs advance purchase), which predictably drives very different average fare outcomes.

76. Any comparison that fails to control for booking horizon, travel purpose, and passenger income profile risks attributing differences in fare levels to congestion when they are, in fact, a predictable consequence of fundamentally different markets.

77. The study relies on comparing fare data between airports that serve different origin markets and different destination markets depending on which airport is considered which is another major flaw:

    a. Heathrow is structurally different from the main European comparator airports because its passenger base is unusually concentrated in high-income, time-sensitive travel segments driven by London's role as Europe's leading global financial and professional-services centre. That mix produces a disproportionate share of travellers who book late (to preserve flexibility), prioritise schedule convenience, and purchase higher fare classes and cabins (flexible economy, premium economy, business, first class). The mechanical consequence is a thicker "late-booking tail" in the demand curve and a higher airport-level average fare—even where route-level competition is effective.

    b. By contrast, Frankfurt (FRA), Paris CDG and Amsterdam (AMS), while major hubs, typically exhibit a more balanced mix of corporate, institutional, leisure and connecting traffic. FRA's corporate demand is materially shaped by Germany's industrial and export economy - often more project- and plan-led - supporting a higher share of advance-purchase business travel than Heathrow's finance/professional-services profile. CDG combines hub traffic with substantial leisure and institutional travel associated with Paris's global tourism role and France's administrative landscape, which also tends to increase advance-purchase volumes relative to Heathrow. Amsterdam (AMS) is a strong hub but typically carries a large share of short-haul intra-European and connecting traffic with a more mixed demand profile than Heathrow's premium-skewed long-haul portfolio. This shifts the fare distribution at AMS more towards advance purchase fares and is associated with price comparison across alternatives, reducing the share of high-fare last-minute tickets outside a limited set of trunk business routes.

    c. Madrid (MAD) and Barcelona (BCN) are even more strongly shaped by leisure and Visiting Friends & Relatives (**VFR**) demand (with BCN particularly influenced by low-cost carrier (LCC) dynamics), which results in earlier booking horizons, stronger seasonality, and a fare structure dominated by discounted advance-purchase inventory rather than flexible last-minute fares.

d. Rome Fiumicino (FCO) is more structurally leisure/VFR dominated, with greater seasonality and far fewer high-yielding, last-minute corporate transactions; average fares are therefore lower largely because bookings are made earlier and demand is more price-elastic.

e. Istanbul (IST) differs again: it is a large intercontinental hub with a heavy share of transfer passengers and price-competitive connecting flows. Transfer-heavy itineraries are often more substitutable (multiple routings and stopover options), which pushes a larger portion of demand toward earlier booking and higher price sensitivity than Heathrow's "local corporate" market.

f. Within London, the contrast is stark: Gatwick (LGW), Stansted (STN), and Luton (LTN) are all structurally more weighted towards mass-market leisure and VFR markets and passenger segments, with longer booking horizons and fewer high-yielding corporate tickets. Further, Stansted (STN) and Luton (LTN) are overwhelmingly LCC/price-led airports which do not cater or cater less to the needs of demand segments (including corporate travellers, long-haul travellers) served by airlines at Heathrow.

4.2.4 The Frontier Economics study misclassifies products

78. The fact that Frontier Economics ignores the differences between a premium economy and a business class product and therefore assumes fares between these two very different products should be the same is another major flaw:

    a. *"For the purposes of this analysis, premium economy has been treated as business class"*[37]

4.2.5 Why this matters for Heathrow and UK policy and regulation

79. The congestion premium narrative has been used to suggest that Heathrow expansion would primarily benefit consumers through the redistribution of excess airline revenues via lower fares. This conclusion is not supported by the evidence. Given the absence of demonstrable congestion rents, the primary benefits of expansion should instead be understood as:

    a. Improved operational resilience (via more runway capacity)

    b. Enhanced network connectivity

    c. Long-term capacity for growth and competition

    d. Higher number of UK based jobs

80. Policy decisions should not be based on an assumed pool of excess profits that does not exist in practice. The viability of the expansion business case therefore hinges on airlines being able to sustainably deploy capacity at Heathrow.

81. The Frontier Economics congestion premium analysis is conceptually flawed, empirically unsupported, and inconsistent with observed selling prices and observed airline financial performance at Heathrow. Modest aggregate profitability, the presence of loss-making carriers, the absence of route-level congestion, and significant data limitations collectively undermine the study's conclusions. The CAA should therefore place no weight on this analysis.

[37] https://www.caa.co.uk/media/dwfgyk53/estimating-the-congestion-premium-at-heathrow.pdf

[redacted]

5. Question 5: Do you agree with our description of the regulatory models we have identified, and do you have initial views on the advantages and disadvantages of these models?

82. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. Please refer to the response to Question 7 below for additional comments from IAG.

6. Question 6: Are there additional variants of the current regulatory model that we should consider?

83. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. Please refer to the response to Question 7 below for additional comments from IAG.

7. Question 7: Are there additional alternative regulatory models that we should consider?

84. Please refer to Heathrow Reimagined's response to this question, which IAG has co-authored and endorses. We add the following additional comments which should be read as supplementary to that response in Section C (*The Proposed Solution*) below.

[redacted]

C. The Proposed Solution

1. Overview

1. IAG believes that regulatory reform can only be effective if delivered through a package of models. Our proposed solution is a combination of regulatory models, which collectively will control monopoly power and consumer harming incentives ("Proposed Solution"). The Proposed Solution combines the below elements, which are all required in combination rather than standalone proposals:

    a. **Apply Stringent Controls on Capital Spend**: Control of capital expenditure across campus is essential to reduce consumer harm. This can be achieved through the establishment of a Capital Investment Committee enforcing stringent controls across all campus capital investments via Capital Planning, Capital Approval and Capital Performance Monitoring; and

    b. **Leveraging Competition**: Competition must be leveraged where possible to help maximise capital efficiency; and

    c. **Leveraging the attractiveness of the RAB**: RAB investments are attractive. By establishing a multi-RAB model, competitors can bid to develop infrastructure at Heathrow at value for money, with guaranteed returns and low cost of capital; and

    d. **Aggregating Pricing:** A cross-campus pricing (Maximum Allowable Yield) should be retained to ensure all airline users benefit from capital controls and capital efficiency.

2. The Proposed Solution would address the issues with the current regulatory model (identified in the response to Question 1 above) through removing or reducing the incentive to spend capital inefficiently.

3. The regime should also incorporate a £25-30 billion budget cap for the Heathrow expansion and masterplan renewal, as explained further below.

4. Furthermore, terminal capacity development should be optimised and phased in line with actual traffic growth. There is no economic or operational requirement for all elements of Heathrow's expansion and masterplan renewal to be delivered by 2040, and a more staged approach would materially reduce cost, system-wide risk and pressure on airline affordability.

5. In combination, with clear execution, this should drive down the excesses of monopoly power and capital inefficiency. The Proposed Solution is illustrated in Figure 13 below and summarised in more detail in Table 4.

Figure 13: Overview of the Proposed Solution

1

Capital Investment Committee
- Chaired by the CAA with casting vote
- Other voting members include home based carriers, alliance representatives (1x per Terminal) and airport operators
- Define affordable 15-20year capex envelope
- Agree masterplan priorities, informed by bids/proposed plans
- Approve business cases
- Hold operator(s) accountable for delivery on-time, on-budget
- Has the powers to ultimately freeze dividends and executives' bonuses in case of poor performance

2

Leverage competition
- Bidders/potential promoters put forward their plans for different packages
- Selected bidders/promoters Design/Build/Operate/Own under a RAB model that reflects their asset base on the campus

3

Aggregated Pricing
- Cross campus, aggregated pricing >>> every airline and its passengers benefit from competition regardless of where the airline operate on the campus
- Single till is retained with incentives on commercial revenue contribution
- Promoters bear the risks of construction (overruns, etc.)
- Airlines bear the demand risks (passenger volumes)

4

Cross Campus Maximum Allowable Yield
- CAA continues to define the Regulatory WACC and associated Allowed Returns every 5-years *(Note: the capex envelope is already defined per item 1 and the CIC)*

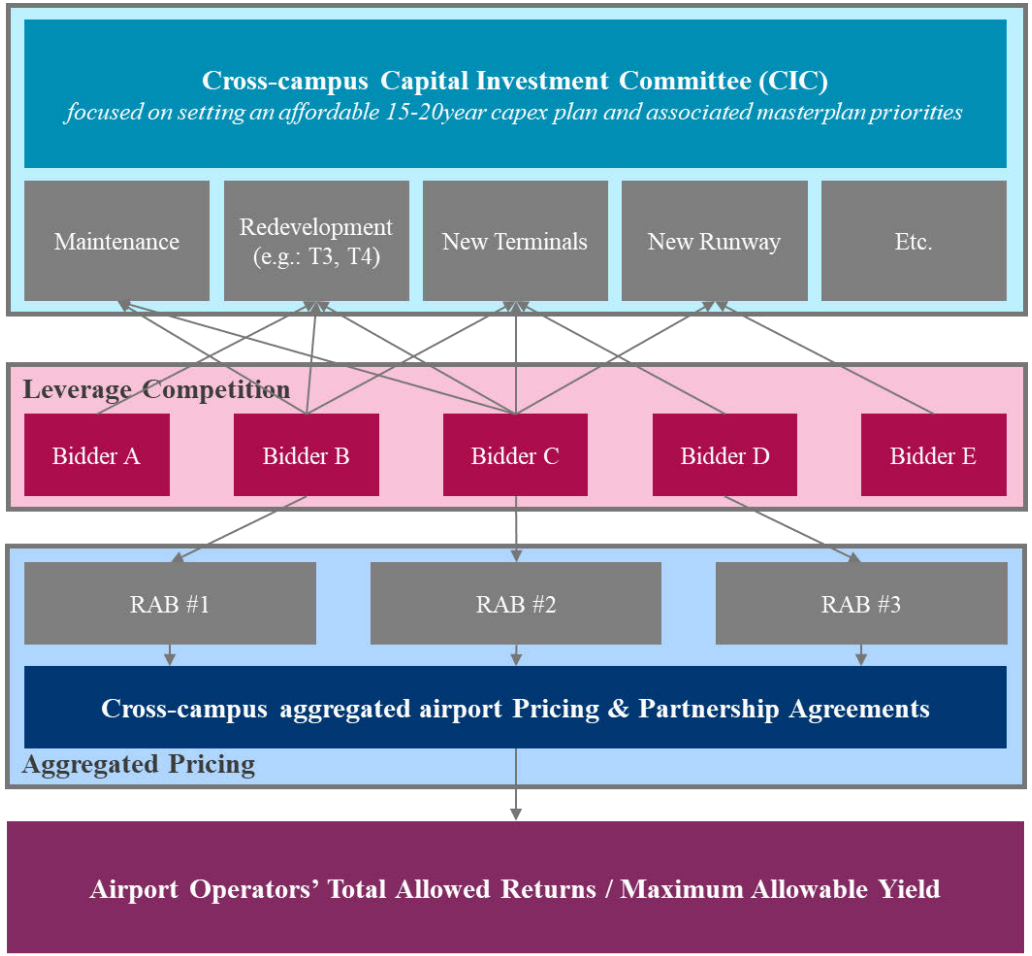


Table 4: Description of the Proposed Solution

Reform Elements	**What does it do?**	**What's new vs. Today's model?**	**Who is involved in the process?**
Apply Stringent Capital Controls (Capital Investment Committee (**CIC**))	Capital Planning - Define long-term affordable capital requirement - Masterplan priorities set in accordance with the defined budget and renewal cycle - Masterplan priorities informed by competing bidders and independent Subject Matter Experts (SME) - Bid parameters set in accordance with priorities and renewal cycle Capital Approval - Robust reviews of individual business case/project plans before approving the individual project budget, scope and outcomes Capital Performance Monitoring - Robust in-delivery and post-delivery evaluation of the results vs. approved business case - Powers to hold the promoter/operator accountable for cost overruns/unmet targets, etc. (including RAB adjustments, freezing dividends and executive bonuses)	Capital Planning: - Full investment portfolio visibility across multiple regulatory periods. Holistic view of renewal cycle. Today, airlines don't have an overall portfolio view nor the ability to prioritise projects. - The Capital Plan is the overarching plan, not an approval. Capital Approval: - The CIC (and its experts) has clear visibility of the detailed project specifications, commitments on benefit realisation and access to ALL required information (in particular, contracting terms and scopes for outsourced activities). - The CIC can also mandate use of competitive process and has extensive access to benchmarks. Capital Performance Monitoring: - The licence holder is held accountable for achieving its business case commitments (e.g. operational expenditure (opex) allowance reduced by the committed improvement following capex programme and maintenance/renewal as forecast) and subject to penalties according to the deviations.	CIC Members: - CAA - Home based carriers - Representative of each Terminal (if not covered by home based carriers) - Airport Licence Holder(s) Supporting bodies and resources: - Subject Matter Experts - AOC/IATA - Other relevant stakeholders as required
Leverage Competition	- Competition for design/build/operate+own packages with parameters set through Capital Planning. - New operators for separable elements of the airport, competing for the rights under the bid packages.	- Capital efficiency through competitive bid and package focus. - Competition through the value chain: design, build, operate+own (see table below).	- CAA - aligned with CAA's duty to promote competition - CIC airline members

Reform Elements	What does it do?	What's new vs. Today's model?	Who is involved in the process?
	- Inform the allocation of the affordable capex renewal cycle across the masterplan priorities. - Critical to make expansion affordable as competition drives all parties including the incumbent to be more efficient.	- Leverage the market and competition to drive down capex costs and drive-up innovation. - New entrants with focus on greater efficiency and better outcomes. - On site comparators and benchmarks.	- Existing Airport Licence Holders and new bidder/promoters
Multi RAB aggregated into a single airport pricing with partnership agreements between operators	- Each airport licence holder has its own RAB for which it receives its allowable returns. - The individual licence holders' RAB are aggregated into an overall airport pricing. - Operators establish partnership agreements to support the single pricing.	- Competition is introduced via a multi-RAB model where different operators/airport licence holders can compete for Design/Build/Operate/Own packages.	- CAA
Cross Campus Maximum Allowable Yield	- The CAA continues to define the regulatory WACC on a 5-year regulatory period basis. - The CAA uses the same methodology as today to translate the RAB into a Maximum Allowable Yield per passenger. - The capex envelope for the regulatory period is aligned with the CIC defined long-term capital plan. - The existing single-till RAB model is retained to determine the Maximum Allowable Yield per pax the Airport Licence Holders can charge to airlines.	- The capital envelope for the regulatory period being set by the long-term capital plan defined by the CIC. - The best performing terminal operators from a commercial revenue standpoint are rewarded for performance.	- CAA

Introducing competition maximises capital efficiency. Competition at Heathrow must be established across the value chain where possible: Design > Build > Own & Operate.

Table 5: This table summarizes where competition brings benefits across the value chain:

Value chain element	Status quo at Heathrow (RAB monopoly)	How competition could be introduced	Impact on capex efficiency	Relevance to affordability
Design	HAL defines scope, standards, and requirements; limited challenge to specification "gold-plating".	- Competitive design tenders for terminals, runways, airfield systems. - Output-based specifications mandated by CAA / CIC. - Independent design authority or reference designs. - Design-to-cost obligations.	Very high – design decisions lock in 70–80% of whole-life cost.	Critical – prevents over-specification that inflates RAB permanently.
Build (construction)	HAL manages EPC procurement; weak incentives to minimise total capex because capex enlarges RAB.	- Competitive EPC / alliancing contracts. - Fixed-price or pain/gain share contracts. - Independent project companies responsible for delivery. - Ring-fenced SPVs for major assets.	Very high – construction is the largest capex driver.	Critical – reduces "build big, build bespoke" bias embedded in the RAB.
Own and Operate	HAL owns all assets; earns regulated return on full RAB regardless of efficiency. Single operator (HAL) runs all assets; operating efficiency is regulated ex post.	- Independent asset owners (e.g. Terminal Co, Runway Co). - Time-limited leases with competitive re-tendering. - Private infrastructure funds owning discrete assets.	Medium/High – ownership structure under a RAB based model should enable competition on the Cost of Capital and different Operators should enable a stronger benchmarking of opex efficiency.	Valuable when combined with competitive design/build.

Table 6: This table sets out how combinations of the value-chain elements secure benefits:

Value chain element	Status quo at Heathrow (RAB monopoly)	How competition could be introduced	Impact on capex efficiency	Relevance to affordability
Design + Build bundled	Controlled by same regulated entity	- Competitive DB tenders or D&B-finance concessions - Multiple infrastructure providers competing for Heathrow capacity expansion	Very high – aligns design choices with build cost	Central to IAG's reform requirements
Design + Build + Own & Operate	Controlled by same regulated entity	- Multiple infrastructure providers competing to provide capacity to airlines	Very high – aligns design choices with build cost and creates benchmarking for the CAA on financing and opex efficiency	Maximum affordability impact

2. A £25-30[38] billion budget cap for expansion

6. An affordable charging profile is one in which aeronautical charges remain broadly flat in real terms. The study we have commissioned from Oliver Wyman will define the affordability threshold for the airline community. We will submit the Oliver Wyman affordability threshold analysis and accompanying budget cap as soon as it is available.

7. Assuming the additional ATM capacity created by the Heathrow expansion will be released over a 10-year period (subject to NATS' capabilities), it implies a growth in supply that is likely to exceed the underlying growth rate of the economy and of passenger demand. Introducing capacity at a pace faster than demand growth weakens airlines' ability to invest in the additional aircraft and networks required to utilise that capacity.

8. Maintaining charges that are flat, or close to flat, in real terms ensures airlines face a consistent inflationary headwind, rather than a compounding increase in costs layered on top of supply-demand imbalance pressures during the ramp-up period.

9. A £25-30 billion capital programme for expansion and masterplan renewal (currently proposed at a minimum of £49 billion), in addition to approximately £25 billion of maintenance capital expenditure over the 2026–2050 price control periods, even before taking in to account substantial fleet investments in the tens of billions, would represent a project of exceptional scale. For investors, a £25-30 billion investment, with a credible business case to increase the capacity of the airport in excess of 50% and renew the airport, would deliver material return potential.

10. Even at £25-30 billion (in 2024 prices), when combined with ongoing maintenance capex, Heathrow expansion would be materially larger than any comparable airport expansion programme globally. Recent large-scale expansion projects at major national and international airports and hubs have been delivered at significantly lower cost. All other London airport expansions are significantly better value for money against a range of metrics. Globally, Hong Kong's Three Runway System is projecting a capital envelope of £13.5 billion, Singapore's runway and terminal expansion will be delivered at approximately £7 billion, Dallas Fort Worth's "DFW Forward" programme at approximately £9 billion, and Atlanta's "ATL Next" programme at approximately £9 billion.

[38] This is based on IAG's preliminary analysis. A study by Oliver Wyman has been commissioned to model in detail the profitability level at Heathrow and the level of charges airlines could afford for expansion. IAG would welcome the opportunity for Oliver Wyman to present its findings to the CAA and Government.

Annex A: Capital Investment Committee (A working draft)

A. Introduction and overview

1. This annex sets out further implementation details on the propsoed Capital Investment Committee (**CIC**) model and how the CIC would operate in practice.
2. The CIC model is a comprehensive, integrated governance structure that addresses the structural failures in the current capex regime. While the CAA's Working Paper discusses elements of improved capital governance under Regulatory Models 1a (enhanced governance processes) and 1b (separation of system planning), neither model fully captures the scope, mechanisms, and control structures that the CIC model would deliver. IAG therefore proposes that the CAA consider the CIC as a distinct regulatory model – one that integrates and operationalises elements from Regulatory Models 1a, 1b, 2 (Direct Procurement for Customers), 4 (price benchmarking), and 5b (competitive procurement) within a unified governance framework.
3. The CIC model differs from the CAA's proposed models in three critical respects:
    - **Comprehensive capex lifecycle coverage**: The CIC ensures oversight across all three stages of the capex lifecycle: capital planning (long-term portfolio oversight and affordability), capital approval (project-by-project scrutiny), and capital monitoring (accountability for delivery and outcomes); the CAA's models focus primarily on approval processes.
    - **Fundamental shift in control**: The CIC shifts control over the governance process from the Airport Licence Holder (ALH, currently HAL) to a committee chaired by the CAA with airline representation.
    - **Meaningful enforcement powers**: The CIC provides the CAA with enhanced enforcement powers ensuring the ALH faces genuine accountability for underperformance.
4. The CIC model is designed to apply to all material capital expenditure at Heathrow, including both business-as-usual investment during regulatory periods (such as H8) and major capacity expansion projects (such as the third runway). While governance mechanisms would be consistent across both contexts, the CIC could establish separate workstreams or tailored processes to reflect the distinct scales, complexities, and risk profiles of projects.
5. For expansion specifically, the CIC would provide the long-term oversight and affordability controls essential to ensuring that expansion delivers value for consumers and does not result in charges becoming unaffordable. The CIC would provide a mechanism to ensure that expansion plans are developed within an affordable envelope, with clear prioritisation of projects that deliver the greatest value for consumers, and delivered efficiently, without the cost overruns and delivery failures that have characterised past investment at Heathrow.
6. Effective capital governance requires the existing Constructive Engagement and Gateway 3 Approval processes, as well as the Independent Fund Surveyor and the Delivery Obligations Framework, to be superseded by an adequately resourced and empowered CIC, together with enhanced CAA enforcement and sanction powers when an ALH materially underperforms on CIC-approved capital expenditure projects.

7. The remainder of this annex is structured as follows:
    - Section B details the three pillars of capital governance (planning, approval, monitoring);
    - Section C explains how the CIC integrates competitive processes and benchmarking;
    - Section D sets out the CIC's audit powers;
    - Section E covers the obligations on the ALH;
    - Section F details CIC composition and governance principles;
    - Section G outlines enhanced CAA enforcement powers; and
    - Section H concludes on deliverability and implementation.

B. The CIC model

8. Effective capital governance requires comprehensive oversight across three distinct but interconnected stages of the capex lifecycle: capital planning, capital approval, and capital monitoring and accountability, for all material capex regardless of provider. Under the CIC model, the CAA and airline stakeholders would have meaningful visibility of, and influence over, each stage. The CIC, chaired by the CAA, would direct the governance process. This section outlines how the CIC would operate across the three pillars.

Capital planning

9. Capital planning is the process through which the ALH – with input from airport stakeholders – would develop a long-term view (10-15 years) of the infrastructure investments required to sustain asset integrity, meet regulatory obligations, serve user needs, and support growth. The CIC would review, scrutinise, and challenge the ALH's long-term capital plan before it is finalised. The review would not constitute approval of specific projects – individual projects would still require separate approval through the capital approval process – but it would ensure that the overall long-term investment strategy is transparent, properly prioritised, and fits within an affordable envelope.
10. The CIC would set a planned capex ceiling for each planning period, guided by affordability analysis that considers the implications of different capital envelopes for future charge trajectories. In setting the ceiling, the CIC would use price benchmarking to test whether the ALH's proposed investment levels are consistent with maintaining charges at levels appropriately comparable to peer airports. This ensures that long-term capital planning is disciplined by affordability considerations from the outset, rather than allowing unconstrained investment plans to drive charges to unsustainable levels.
11. The capital plan would provide early visibility of future capital approval requests, enabling the CIC to anticipate major investment decisions and ensure that appropriate expert resources and scrutiny processes are planned in advance.[39] The ALH would be required to update the capital plan regularly (at least annually), with material changes requiring CIC review and potential adjustment of the capex ceiling.

[39] For Heathrow expansion specifically, capital planning oversight by the CIC would be essential. Expansion represents a multi-decade, multi-billion-pound investment program. HAL's current masterplan envisages spending approximately £49 billion on expansion infrastructure. The CIC would provide a mechanism to ensure that expansion plans are developed within an affordable envelope, with clear prioritisation of projects that deliver the greatest value for consumers, and with long-term charge trajectories modelled transparently to test affordability against peer airport benchmarks. This long-term oversight would be critical to protecting the business case for expansion and ensuring it delivers its intended economic benefits.

12. Airlines would have the ability through the CIC to propose alternative investment priorities and challenge the ALH's proposed portfolio, rather than merely reacting to HAL's preferred plans.

Capital approval

13. Capital approval is the formal gateway through which the CIC would authorise individual projects to proceed. The ALH must submit a robust business case for each project exceeding a specified threshold (to be determined through consultation). The business case must detail: purpose, scope, and strategic alignment with the long-term capital plan; delivery schedule and key milestones; cost estimate with transparent breakdown and justification of contingencies; benefits-realisation timeline with quantified outcomes (e.g. capacity improvements, service quality enhancements, operational efficiency gains); Net Present Value (NPV) and Internal Rate of Return (IRR); identified risks and mitigations; credible 'do-nothing' or lower-cost alternatives that were considered; and clear executive accountability for delivery.
14. The CIC would assess each business case, questioning the ALH on its assumptions, cost estimates, risk assessments, delivery schedules, and benefit projections. The CIC would have powers to request additional information, commission independent expert review, and require the ALH to consider alternative approaches or refine its proposals. Crucially, the CIC would have access to all information needed to effectively scrutinise proposals, including details of procurement strategies, contracting terms and scopes for outsourced activities, contingency allowances, benchmarking data, and the detailed basis for cost estimates.
15. Where the CIC deems appropriate, it could mandate the use of competitive procurement processes to test cost estimates, drive innovation, and ensure value for money.[40] The decision on what level of competitive process is appropriate would be made by the CIC on a project-by-project basis, taking account of factors such as the project's scale, complexity, separability, and the extent to which competition is likely to deliver material benefits.
16. Once satisfied that a business case is robust and demonstrates value for money, the CIC would authorise the project to proceed. Funding would typically be allocated in phased tranches linked to milestone-based deliverables, providing ongoing control and the ability to halt funding if the project encounters serious difficulties. The approved business case would establish the baseline against which subsequent performance is monitored.
17. Any proposed changes to approved scope, cost, or schedule would require CIC approval through a defined change control process. The CIC would scrutinise proposed changes to assess whether they result from factors genuinely outside the ALH's control or from inadequate planning, and would approve changes only where justified.[41]

Capital performance monitoring and accountability

18. Capital performance monitoring is the ongoing governance cycle that safeguards value once a project is approved. The ALH must track and report to the CIC on whether work remains on time and within the authorised budget, using earned-value metrics, schedule

[40] This could include, for example, requiring design-build-operate competitions for major new separable infrastructure, competitive tendering with independent review of bids, or other competitive mechanisms tailored to the specific project.
[41] This provides discipline that is currently lacking, where the ALH can re-baseline projects through change control without effective oversight.

performance indicators, risk registers, and benefit realisation tracking. Regular reporting (at least quarterly for major projects, with frequency tailored to project scale and risk) ensures that issues are identified early and corrective action can be taken promptly.

19. The CIC has powers to scrutinise proposed cost overruns and either approve or reject them from being added to the RAB (subject to the CAA's final determination in accordance with its statutory duties). Where cost overruns or schedule slippage occur, the burden of proof rests with the ALH to demonstrate that overruns result from factors genuinely beyond its control. The CIC would scrutinise the ALH's explanation and proposed remedial actions, and would determine whether the overrun should be approved for inclusion in the RAB. Overruns that result from factors within the ALH's control, or that could have been avoided through prudent management action, would not be approved – meaning the ALH would need to absorb the additional costs rather than passing them to consumers through the RAB.[42]
20. Post-completion, the ALH must report on actual benefits delivered compared to the original business case targets. The CIC would conduct post-implementation reviews to assess whether projects have delivered the outcomes that justified the investment. These reviews would not be limited to the immediate post-completion period but would include periodic reviews to ensure that benefits are sustained over the asset's life.
21. Where projects fail to deliver expected outcomes,[43] the CIC would implement remedial measures to protect consumers' return on investment. This could include: requiring the ALH to take corrective action (e.g. system modifications, enhanced maintenance regimes, operational changes); adjusting future operational expenditure allowances to reflect the failure to achieve planned efficiency benefits; adjusting future service quality targets to reflect enhanced capabilities that were funded through the investment; or recommending financial penalties or other enforcement action where failures are material or repeated.

C. Integrating competitive processes and benchmarking

22. The CIC model provides the governance structure within which other regulatory mechanisms can be effectively deployed. Specifically, the CIC would integrate competitive processes (CAA Regulatory Models 4b and 5b) and price benchmarking (CAA Regulatory Model 9a) at appropriate stages of the capital lifecycle:

- At the capital planning stage, the CIC would use price benchmarking to test whether the ALH's proposed long-term investment levels are consistent with maintaining affordable charges relative to peer airports. This benchmarking analysis would inform the setting of the overall capex ceiling within which individual projects must fit.
- At the capital approval stage, the CIC would have the power to mandate competitive procurement processes for specific projects where this would be effective in revealing efficient costs, driving innovation, and ensuring value for money.
- At the capital monitoring stage, the CIC would use benchmarking data (where available) to assess whether outturn costs are reasonable compared to similar projects delivered by peer airports or in other sectors.

[42] This approach mirrors the model used in the Thames Tideway Tunnel project, where Ofwat had the power to approve overruns only if they were 'appropriate, economic, efficient and reasonable in the circumstances'. The CIC approach would provide similar discipline at Heathrow, incentivising the ALH to deliver efficiently within approved budgets.
[43] For example, where a new system does not achieve the throughput improvements or reliability targets that justified its cost, or where asset availability is below committed levels

23. Competitive processes mandated by the CIC could take different forms depending on the nature of the project:

- For major new separable infrastructure (e.g. a new terminal building, major baggage system), the CIC could mandate design-build-operate (DBO), design-build-finance-operate (DBFO), or design-build-operate-own (DBOO) competitions.[44] Under DBOO arrangements, ownership of the new infrastructure would remain with the third-party rather than transferring to HAL, detaching ownership from HAL's harmful incentives under the RAB-based model.[45]
- For other projects, the CIC could require competitive tendering for design and construction, with detailed independent review of bids to test cost efficiency.
- For enabling works or site preparation, the CIC could mandate that these be procured separately through competitive processes rather than bundled into larger packages where competition may be less effective.

24. The key point is that the CIC would have the authority to determine – on a project-by-project basis – what level of competitive process is appropriate, rather than leaving this entirely to the ALH's discretion.[46] This case-by-case approach ensures that competition is used where it can be most effective in protecting consumers' interests, consistent with the CAA's statutory duty to promote competition in the provision of AOS where appropriate.

D. CIC audit powers

25. The CIC will establish a Capital Audit and Assurance Function (CAAF) to provide independent, risk-based assurance across the full investment lifecycle. The CAAF would supersede the current IFS role, addressing structural weaknesses in the current arrangements.
26. The CAAF will have full access to the ALH's internal audit team and its associated resources, reports, databases, and audit findings, to enable effective scrutiny through comprehensive information access. The CAAF will audit capex projects according to its own schedule, with the frequency and depth of audit tailored to the scale, complexity, and risk profile of each project.
27. The CAAF will be genuinely independent of the ALH, and not contracted and funded by it (as it is today). Rather than being contracted and funded by the ALH (as is currently the case with the IFS).[47] This means that the CAAF's appointment, terms of reference, and remuneration would be controlled by the CIC (and ultimately the CAA as chair of the CIC), not by the ALH.
28. The CAAF will report to the CIC and provide copies of its findings to the CAA. Reports would cover matters including: the robustness of the ALH's cost estimates and

[44] i.e. where third parties compete to deliver and potentially operate the asset under a long-term contract.
[45] This approach could drive further benefits for consumers, particularly where there are concerns about the CIC's ability to counter HAL's incentives to prioritise and specify individual capital projects effectively. This approach is consistent with CAA Regulatory Model 5b (DBO) and Model 7b (third-party ownership retained).
[46] The CIC's decisions would be guided by assessment of factors including: the project's scale and complexity; the extent to which the project is separable from other airport operations; the degree of market interest in competing for the project; and the extent to which competition is likely to deliver material benefits relative to the costs and complexity of running a competitive process.
[47] This could be done through: an internal CAA function, staffed by CAA employees or contractors appointed by the CAA; or an external auditor appointed through a competitive tender conducted under the CIC's supervision, with contract terms, remuneration, and governance structured to safeguard independence from the ALH.

scheduling; the adequacy of risk identification and mitigation; the effectiveness of the ALH's project management and controls; compliance with approved business cases; and any emerging issues that warrant CIC attention. Where CAAF audits reveal material non-compliance, cost inflation, poor project management, or other concerns, the CIC may recommend enforcement actions to the CAA, as well as inform decisions on whether to approve project changes and cost overruns for inclusion in the RAB.

E. Obligations on the ALH

29. The CIC has an oversight role representing users' interests, but it does not take over the airport operator's duties. The ALH retains full responsibility for operating the airport, planning capital investments, managing projects, and delivering outcomes. However, the ALH would have mandatory obligations to engage with the CIC throughout the capex lifecycle, with non-compliance giving rise to enforcement action by the CAA.

30. These mandatory obligations include:

- **Submit long-term capital plan**: The ALH must submit its long-term capital plan to the CIC for review, demonstrating that the plan fits within an affordable capex envelope as agreed with the CIC. The plan must be updated at least annually and whenever material changes occur.
- **Submit robust business cases**: When seeking approval for individual projects, the ALH must submit a robust business case (as above in paragraph 14), sufficiently detailed to enable effective scrutiny by the CIC and its expert advisors.
- **Provide complete information**: The ALH must provide all information necessary to enable the CIC to effectively scrutinise business cases and monitor delivery.[48] Information provision must be timely, enabling adequate scrutiny before decisions are required.
- **Consider competitive procurement**: The ALH must provide evidence that it has considered competitive procurement options for all major projects.[49] Where the CIC mandates competitive procurement for a specific project, the ALH must implement the competitive process in accordance with the CIC's requirements.
- **Report on delivery**: During project delivery, the ALH must report regularly to the CIC on whether projects are meeting their business case timelines, budget requirements, and interim milestones.[50] Reporting frequency must be commensurate with project scale and risk.
- **Report on outcomes**: Post-completion, the ALH must report to the CIC on actual benefits delivered compared to original business case targets, and must participate in post-implementation reviews conducted by the CIC. Where benefits are not being realised as expected, the ALH must propose and implement remedial action.
- **Cooperate with audit**: The ALH must supply all information requested by the CAAF to fulfil its audit functions, and must provide the CAAF with full access to project documentation, systems, and personnel as necessary to enable effective audit.

[48] This includes full transparency on: underlying cost estimates and assumptions; contingency allowances and their justification; procurement strategies and competitive processes used; contracting terms and scopes for outsourced activities; risk assessments and mitigation plans; and any other information the CIC or CAAF reasonably requests.
[49] This could include assessment of market interest and the potential for competition to deliver value for money.
[50] This may involve using metrics/measures, such as earned-value, schedule, risk, and benefit realisation metrics.

- **Implement CIC directions**: Where the CIC approves corrective actions or recommends changes to project plans, the ALH must implement these in a timely manner; failure to do so may result in enforcement action by the CAA.

F. CIC composition and governance principles

31. The CIC would be chaired by the CAA, with ALH and airline participation.[51] The CAA would retain ultimate authority to make determinations in accordance with its statutory duties under CAA2012. This structure ensures that the CIC is consistent with the CAA's regulatory independence while providing stakeholders with meaningful influence over capital governance. The CAA Chair would have the authority to make final decisions where consensus cannot be reached.
32. All representatives appointed to the CIC must have the necessary seniority, skills, knowledge and experience to fulfil the CIC's duties, including, for example, corporate finance, airline operations, airport operations, large infrastructure programme developments, accounting, auditing and risk management.
33. Appropriate governance rules would cover matters such as: appointment and removal of representatives, voting, meetings and quorum, appointment of experts, independence, conflicts, reporting duties, performance evaluation, and training.
34. A mechanism for appropriate CIC funding will be required. The CIC's budget would be funded through the regulatory price control and recovered from the ALH through airport charges. The CAA would have oversight of the CIC's budget to ensure that it is proportionate and delivers value for money. The availability of dedicated expert resources (through the CAAF and external advisors as needed) would be essential to ensure that the CIC has the capacity to effectively scrutinise the ALH's proposals, particularly for complex or high-value projects.

G. Enhanced CAA enforcement powers

35. For the CIC model to be effective, the CAA must have meaningful enforcement powers to sanction the ALH where it materially or repeatedly fails to comply with CIC-approved business cases, fails to deliver committed outcomes, or demonstrates poor capex performance.
36. The CIC would have the power to recommend that the CAA take enforcement action where the ALH materially or repeatedly fails to deliver on its commitments. However, the final decision on whether to impose enforcement measures would rest with the CAA, exercising its judgment in accordance with its statutory duties. The CAA's decision on enforcement would be guided by factors including the severity and persistence of the ALH's underperformance, whether the underperformance results from factors within or outside the ALH's reasonable control, the impact on consumers, and the proportionality of the proposed enforcement measure. The CAA would be expected to issue a statement of reasons for enforcement decisions (positive or negative) in any case.
37. Enforcement measures could be applied in a graduated manner[52] where appropriate and within the CAA's existing powers, ensuring that enforcement is proportionate and

[51] Airline participation could take the form of, for example: representatives of each of the home-based carriers (currently IAG/BA and VAA); and to the extent not covered by these carriers, a representative for the airlines at each Heathrow terminal. The CIC could also look to draw upon supporting bodies and resources, including an expert panel and airline industry bodies (Heathrow AOC and IATA).
[52] For example, with less severe measures (such as capex freezes or bonus restrictions) applied initially, and more severe measures (such as dividend restrictions or partial revocation) reserved for cases of persistent or egregious failure. This

provides the ALH with opportunities to improve performance. The specific enforcement tools deployed would depend on the nature and severity of the failure and the CAA's assessment of what measures are both effective and within its statutory authority.

38. These existing powers provide the foundation for effective CIC enforcement. The CAA would use its powers proportionately, with enforcement action targeting material or repeated failures that harm consumers. The existence of credible enforcement powers, even if rarely used, creates the appropriate incentives for the ALH to deliver efficiently and in accordance with CIC-approved plans.

H. Deliverability and implementation

39. The CIC could be readily implemented by the CAA using its existing powers under CAA2012. The CAA has powers to impose licence conditions, set price controls (including what expenditure is allowed into the RAB), and require information provision. These powers are sufficient to establish and operationalise the CIC model without requiring primary legislation.

40. The CIC model is suitable for implementation for both business-as-usual capital investment during regulatory periods (such as H8) and major capacity expansion projects.
    - For H8, the CIC could be established through the licence modification process as part of the CAA's price control determination, immediately improving capital governance.
    - For expansion, the CIC would provide the long-term strategic oversight essential to ensuring the expansion program is delivered efficiently and affordably.
    - The CIC's governance mechanisms would be consistent across both contexts, though the CIC could establish separate workstreams or tailored processes reflecting the different scale and complexity of H8 investment versus expansion, while maintaining an integrated view of the overall capital portfolio to ensure that the combined program remains affordable.

* * *

graduated approach ensures that enforcement is proportionate and provides the ALH with opportunities to improve performance before more severe consequences are imposed.

Annex B: CEPA – Analysis of charge profile in expansion

See attached

Annex C: RBB report on Frontier Economics

See attached

Annex D: Oxford Global Projects report on HAL capital efficiency

See attached

[redacted]

See attached