

HEATHROW AIRPORT LIMITED
REGULATORY ACCOUNTS
FOR THE YEAR ENDED 31 MARCH 2008

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Performance Report

		Actual	CAA Forecast
		'000s	'000s
Terminal passengers	1	67,951	70,700
		£m	£m
Revenue			
Net revenue from airport charges	2	639.7	671.7
Other revenue	3	638.5	624.7
Total revenue		1,278.2	1,296.4
Expenditure			
Operating costs	4	772.7	541.5
Assumed Ordinary Depreciation	5	218.5	218.5
Total expenditure		991.2	760.0
Regulatory operating profit	6	287.0	536.4
Capital expenditure	1,8	894.0	975.8
Opening Basic RAB	8	8,834.2	8,130.0
Closing Basic RAB	8,9	9,776.3	9,776.3
Weighted average Basic RAB		9,296.5	8,937.8
Return on weighted average Basic RAB		3.1%	6.0%

The notes on pages 2 to 10 form part of these regulatory accounts.

These regulatory accounts were approved by the Board of Directors on 5th September 2008 and signed on behalf of the Board.

Notes to the performance report

1. BASIS OF PREPARATION

Heathrow Airport Limited (“the Company”) is required to prepare Regulatory Accounts by the Airports Act 1986. The primary purpose of these accounts is to serve the process of regulation by the Civil Aviation Authority (“CAA”).

The CAA has determined that the Regulatory Accounts shall comprise a report in the format shown on pages 1 to 10 of this report. This in turn comprises the Performance Report which sets out actual performance for the year under review compared with the forecasts underlying the determination of the price cap for Heathrow Airport Limited. These forecasts are set out in the CAA’s document entitled ‘Economic Regulation of BAA London Airports (Heathrow, Gatwick and Stansted) 2003-2008, CAA Decision, February 2003’, (“the 2003 Decision”), following its quinquennial review. The Performance Report includes notes as agreed with the CAA which describe the derivation of key regulatory results, and, where relevant, adjustments to the statutory and management accounts of the Company.

In March 2008 the CAA published its Decision on the maximum price caps for Heathrow and Gatwick airports for the period 1 April 2008 to 31 March 2013, entitled ‘Airport Regulation, Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013, CAA Decision, 11 March 2008’ (“the 2008 Decision”).

The following explains the key underlying assumptions in the preparation of this report:

(a) **Data sources**

The principal sources of data used in the preparation of these accounts are the audited financial statements for the year ended 31 December 2007, unaudited interim financial statements for the three month periods ending 31 March 2008 and 31 March 2007 formally approved by the Directors, and unaudited management accounts for the year ended 31 December 2007 and for the three month period ended 31 March 2008. Together, these are referred to in these Regulatory Accounts as ‘the underlying accounts’.

(b) **Terminal passengers**

Terminal passenger numbers represent those passengers on commercial flights who physically pass through the airport’s passenger terminal facilities. This is consistent with the CAA’s definition in Annex 5 of its 2003 Decision. It excludes transit passengers. It also excludes passenger numbers for the following flight categories, which are included in the certificate of revenues from passenger flights provided annually to the CAA: air ambulance, government charter (troops and cargo), air taxi, general aviation, diplomatic and military.

(c) **The Regulatory Asset Base (“RAB”)**

The CAA, in Annex 6 of its 2003 Decision, determined how the value of the RAB at 31 March 2003 should be calculated, and this is shown in Note 7. The CAA further determined in Annex 6 how the value of the RAB should be rolled forward annually thereafter.

Capital expenditure in the year has been uplifted by the increase in RPI in accordance with Annex 6 of the 2003 Decision. Forecast capital expenditure has likewise been uplifted by the increase in RPI, from average 2000/01 prices (as in the 2003 Decision) to average 2007/08 prices, in accordance with CAA guidance. Indexing the forecasts in this way does

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1. BASIS OF PREPARATION (contd.)

not fully take into account actual variations in the Construction Output Price Index ("COPI") from the Company's original 2002/03 forecast, which in the Company's view is a more appropriate basis for comparison with actual expenditure. Note 8 shows the effect of using COPI on capital expenditure forecasts and on the forecast closing Basic RAB value at 31 March 2008.

The depreciation allowance has been set for each of the five years. This is referred to in Annex 6 of the 2003 Decision and in this report as 'Assumed Ordinary Depreciation';

Comparisons with the 2003 Decision have been made with the CAA 'Basic RAB' forecasts. In that Decision the CAA adjusted the Basic RAB by including a profiling adjustment to arrive at a Closing RAB at each year end. The Company's view is that, as this profiling adjustment does not form part of actual movements in net investment in the year, inclusion of the adjustment would only serve to complicate a true comparison of performance. The CAA's rationale for profiling is included in its 2003 Decision.

The Weighted Average Basic RAB is calculated using the weighting formula adopted in the 2003 Decision. This equates to the sum of the closing balance multiplied by a factor of 0.49067 and the opening balance multiplied by a factor of 0.50933.

(d) Operating revenues and costs

Operating revenues and costs are taken from the underlying accounts and underlying accounting records of the Company. Adjustments have been made to align the presentation of actual results to that in the 2003 Decision. The principal adjustments are:

- retail costs, principally car park management fees, are netted off against income;
- operational facilities income, principally aviation fuel rents and check in/baggage rents income are re-categorised to 'Other revenue' from 'Property and operational facilities';
- intercompany income is netted off against costs, and the intercompany management fee charge from Heathrow Express Operating Company is excluded from operating costs;
- service quality rebates are excluded from operating costs; and
- gains or losses on asset disposals are excluded from operating costs.

(e) Indexation

The CAA forecasts have been derived by indexing forward the forecasts to 2007/08 in accordance with the 2003 Decision. The appropriate RPI indices are shown in Note 11. Profit and loss items have been indexed forward to 2007/08 using the average RPI for 2007/08, and the RAB using the RPI at 31 March 2008.

(f) Prior year accounts

The Regulatory Accounts for the year ended 31 March 2007 reflected the unaudited management accounts for the three month period to 31 March 2007. The Regulatory Accounts, for the year ended 31 March 2008, reflect corrections to the three month period to 31 March 2007 arising from the preparation of the unaudited interim accounts for the three month period to 31 March 2008, and associated comparative information .

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2. AIRPORT CHARGES

	Actual 2008 £m	CAA Forecast 2008 £m
Gross and net revenue from passenger flights	636.9	669.3
Net revenue from non passenger flights	2.8	2.4
	<u>639.7</u>	<u>671.7</u>
Net revenue from airport charges	<u>639.7</u>	<u>671.7</u>

3. OTHER REVENUE

	Actual 2008 £m	CAA Forecast 2008 £m
Other traffic charges	10.1	7.2
Retail	310.4	285.9
Property	152.6	133.8
Rail	80.3	81.0
Other	85.1	116.8
	<u>638.5</u>	<u>624.7</u>
Other revenue	<u>638.5</u>	<u>624.7</u>

Reconciliation to the underlying accounts

Other revenue	638.5
Airport charges	639.7
Retail costs netted off against revenue	14.3
Intercompany income netted off against costs	50.4
	<u>50.4</u>
Revenue per the underlying accounts	<u>1,342.9</u>

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4. OPERATING COSTS

	Actual 2008 £m	CAA Forecast 2008 £m
Operating costs	<u>772.7</u>	<u>541.5</u>
Reconciliation to the underlying accounts		
Adjusted operating costs	772.7	
Service quality rebates	1.0	
Statutory depreciation	291.3	
Loss on disposals of tangible fixed assets	0.3	
Retail costs netted off against revenue	14.3	
Intercompany adjustments	<u>55.3</u>	
Operating costs per the underlying accounts including exceptional costs	<u>1,134.9</u>	

Intercompany adjustments of £55.3 million comprise £50.4 million of intercompany income netted against costs and £4.9 million relating to the management charge from Heathrow Express Operating Company Limited ("HEOC") to Heathrow Airport Limited. In the forecasts underlying the 2003 Decision this charge was fully offset against the income to HEOC and therefore excluded from the underlying intercompany cost forecasts.

5. ASSUMED ORDINARY DEPRECIATION

The depreciation allowance was determined by the CAA in the 2003 Decision. This has been indexed to current year values in accordance with the methodology specified in Annex 6 of that document.

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6. REGULATORY OPERATING PROFIT

Reconciliation of operating profit between the underlying accounts and the Regulatory Accounts

	2008
	£m
Operating profit per the underlying accounts	208.0
Statutory depreciation	291.3
Assumed Ordinary Depreciation per CAA (indexed)	(218.5)
Loss on disposals of tangible fixed assets	0.3
Service quality rebates	1.0
HEOC management charge	4.9
	<hr/>
Regulatory operating profit	<u><u>287.0</u></u>

7. OPENING REGULATORY ASSET BASE AT 31 MARCH 2003

	£m	Increase in RPI to 31 March 2003	Adjusted RAB at 31 March 2003
			£m
Forecast RAB at 31 March 2003 in 2003 Decision (at average 2000/01 prices)	4,025.7	5.0%	4,227.8
Actual capital expenditure 2002/03	(a) 648.3	1.3%	657.0
Assumed capital expenditure for 2002/03 (at average 2000/01 prices)	(545.2)	5.0%	(572.6)
Actual proceeds from disposal in 2002/03	-	1.3%	-
			<hr/>
Adjusted opening RAB at 31 March 2003			<u><u>4,312.2</u></u>

- (a) This excludes the provision for the present value of future payments for the acquisition of land for Terminal 5 amounting to £186.5 million included in the airport's capital expenditure additions total of £834.8 million.

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8. CLOSING REGULATORY ASSET BASE AT 31 MARCH 2008

		Actual 2008 £m	CAA Forecast 2008 £m
Opening Basic RAB at 1 April 2007		8,834.2	8,130.0
Additions in year	(a,b)	894.0	975.8
Proceeds from disposal	(c)	(1.9)	0.0
Assumed Ordinary Depreciation		(218.5)	(218.5)
Indexation to 31 March 2008		344.1	319.0
		<u>9,851.9</u>	<u>9,206.3</u>
Closing Basic RAB at 31 March 2008 before CAA adjustments			
Closing Basic RAB at 31 March 2008 after CAA adjustments	(d)	9,776.3	9,776.3
Cumulative profiling adjustment as determined by the CAA	(d)	(543.7)	(543.7)
Closing RAB at 31 March 2008 after CAA adjustments	Note 9	<u>9,232.6</u>	<u>9,232.6</u>

This includes payments of £1.3 million in respect of the acquisition of land for Terminal 5. The net present value of estimated future payments is included in the statutory accounts net book value of fixed assets, but not in the RAB value. Payments are capitalised into the RAB as incurred.

Forecast additions in the year, £975.8 million, have been calculated by indexing forward the forecasts in the 2003 Decision by RPI (Note 1). The Company believes that a more appropriate comparison would be achieved by using the actual increase in COPI and the original forecasts produced in 2002/03 prices. COPI indices used are those published quarterly by the Office of National Statistics ("ONS"). At the time of preparation of these accounts, the ONS index for the final quarter of 2007/08 was not available, and has been estimated at the same level as the previous quarter for the purposes of establishing the annual average. On this basis the forecast additions in the year would be £1,026.9 million. The forecast Closing Basic RAB at 31 March 2008, based on published COPI indices for the five years of the current quinquennium, would be £9,448.0 million.

Proceeds from disposal comprise amounts from the sale of operating assets.

Following the CAA quinquennial regulatory review, which concluded with the publication of the 2008 Decision in March 2008, the opening Regulatory Asset Base for Q5, commencing on 1 April 2008, has been set for both Basic RAB and Profiling Adjustment, as described in note 9. These revised RAB values before profiling adjustment have been used in these regulatory accounts to assess the airport's regulatory returns for the year under review.

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9. OPENING REGULATORY ASSET BASE AT 1 APRIL 2008

	£m	Increase in RPI to 31 March 2008	Adjusted RAB at 1 April 2008 £m
Forecast Basic RAB at 31 March 2008 in 2008 Decision (at average 2006/07 prices)	9,242.2	5.89%	9,786.7
Actual capital expenditure 2007/08	894.0	1.68%	909.0
Assumed capital expenditure for 2007/08 (at average 2006/07 prices)	866.4	5.89%	(917.5)
Actual proceeds from disposal in 2007/08	(1.9)	1.68%	(1.9)
Adjusted opening Basic RAB at 1 April 2008			9,776.3
Profiling adjustment (at average 2006/07 prices)	(513.5)	5.89%	(543.7)
Adjusted opening RAB at 1 April 2008			9,232.6

**10. RECONCILIATION OF FIXED ASSETS IN THE UNDERLYING ACCOUNTS TO THE
CLOSING BASIC RAB AT 31 MARCH 2008**

		£m
Net fixed assets per the underlying accounts at 31 March 2008		9,615.6
Difference between net fixed assets and RAB at 31 March 2003	(a)	(197.8)
Payments for land purchase obligation	(b)	116.3
Interest capitalised disallowed	(c)	(789.7)
Difference between net book value of disposals and proceeds	(d)	4.6
Revaluation in the underlying accounts	(e)	(123.9)
Indexation of RAB	(e)	1,197.2
Difference between depreciation in the underlying accounts and Assumed Ordinary Depreciation	(f)	29.6
Closing Basic RAB at 31 March 2008		9,851.9
CAA adjustments at 31 March 2008	(g)	(75.6)
Closing Basic RAB after CAA adjustments		9,776.3

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10 RECONCILIATION OF FIXED ASSETS IN THE UNDERLYING ACCOUNTS TO THE CLOSING BASIC RAB AT 31 MARCH 2008 (contd.)

These reconciling items are explained as follows:

- (a) This reflects the difference between the net fixed asset value in the statutory accounts of £4,510.0 million and the assessed value of the RAB at 31 March 2003 of £4,312.2 million (Note 7). This comprises:
- (i) a reduction of £186.5 million in respect of obligations for the acquisitions of land for the construction of Terminal 5. Provision has been made in the statutory accounts for the present value of future estimated payments to the vendor. Costs are capitalised in the RAB as incurred;
 - (ii) a reduction of £204.0 million in respect of interest capitalised from 1 April 1995 to 31 March 2003 in statutory fixed assets valuations but excluded from the RAB calculation;
 - (iii) an addition of £231.3 million in respect of the difference between the value of asset revaluations in the statutory accounts and the indexation uplifts provided in the regulatory accounts to 31 March 2003; and
 - (iv) a reduction of £38.6 million in respect of other valuation differences.
- (b) Capital costs for the acquisition of land for the construction of Terminal 5 during the year ended 31 March 2008 amounted to £1.3 million (2003 - 2007 - £115.0 million);
- (c) Interest costs amounting to £318.4 million (2003 - 2007 - £471.3 million) were capitalised in the year. The roll forward calculation for the RAB specified in Annex 6 of the 2003 Decision excludes capitalised interest;
- (d) Statutory asset valuations are derived after deducting the net book value of assets disposed of during the year. The RAB value specified in Annex 6 of the 2003 Decision is derived by deducting the proceeds of asset disposals;
- (e) Investment properties and land held for development are subject to annual revaluation in the statutory accounts. Remaining assets are held at depreciated historic cost. The RAB is revalued annually by reference to the Retail Prices Index ("RPI") as specified in Annex 6 of the 2003 Decision;
- (f) This reflects the difference between the amount charged as depreciation in the underlying accounts and the Assumed Ordinary Depreciation allowed in the 2003 Decision and specified in Annex 6 of that Decision.
- (g) This reconciles the opening RAB at 31 March 2008, calculated as in Note 9 in accordance with the roll forward calculation set out in Annex F of the 2008 Decision, with the RAB roll forward based on the methodology set out in the 2003 Decision. The adjustment derives from RAB reductions determined by the CAA, as set out in Table 9.2 of the 2008 Decision, and differences between forecast and actual indexation to 31 March 2008.

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11. INDEXATION

The following indices have been used for revaluing forecasts;

Average RPI index for the year ended 31 March 2001	171.3
Average index for the year ended 31 March 2003	177.5
Average index for the year ended 31 March 2008	208.6
RPI index at 31 March 2003	179.9
RPI index at 31 March 2008	212.1
Increase from average 2000/01 to 31 March 2003	5.02%
Increase from average 2002/03 to 31 March 2003	1.35%
Increase from average 2000/01 to 31 March 2008	23.81%
Increase from average 2007/08 to 31 March 2008	1.68%
Increase from average 2000/01 to average 2007/08	21.76%
Increase from average 2006/07 to 31 March 2008	5.89%