Heathrow Finance plc

Annual report and financial statements for the year ended 31 December 2017

Company registration number: 06458635

Heathrow Finance plc

Contents

Heathrow Finance plc

Officers and professional advisers

Directors
Javier Echave
Andrew Efiong
Nicholas Golding

Company secretary
Patrick Dawe-Lane

Registered office
The Compass Centre
Nelson Road
Hounslow
Middlesex
TW6 2GW

Independent auditor
Deloitte LLP
Statutory Auditor
2 New Street Square
London
United Kingdom
EC4A 3BZ

Bankers
Lloyds Bank plc
1st Floor
10 Gresham Street
London
EC2V 7AE

Heathrow Finance plc

Strategic report

Heathrow Finance plc (the 'Company' or 'Heathrow Finance') is the holding company of Heathrow (SP) Limited ('Heathrow (SP)') which itself is the holding company of a group of companies that owns Heathrow airport ('Heathrow') and operates the Heathrow Express rail service. Heathrow Finance plc is an indirect subsidiary of the Heathrow Airport Holdings Limited group (the 'HAH Group').

The consolidated financial statements of Heathrow Finance and its subsidiaries (together 'Heathrow Finance' or the 'Group') are prepared in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the European Union ('EU'). The accounting policies have been applied consistently in dealing with items which are considered material in relation to the financial statements.

This Strategic report is presented in five sections:

Business overview – an overview of the business model and strategy of the Group;

Management review – overview of the year ended 31 December 2017, along with the key factors likely to impact the Group in 2018;

Financial review – presentation and explanation of the key drivers behind the financial performance reported for the year ended 31 December 2017 and analysis of the financial position of the Group as at that date. The Group's accounting and reporting policies and procedures are also considered;

Leadership and governance – description of the Board of Directors (the 'Board') of Heathrow Airport Holdings Limited and Committees of the Board which provide overall leadership to the HAH Group; and

Internal controls and risk management – outline of the HAH Group's internal controls, approach to risk management, sources of assurance and highlights of the key business risks identified by the HAH Group Executive Committee and Board.

Business overview

Heathrow's business model

Heathrow is one of the best connected hub airports in the world, with 81 global airlines operating regular scheduled flights to 204 destinations. Heathrow is the primary airport in London, which is the world's largest origin and destination aviation market with over 160 million passengers travelling to and from London annually. With 78.0 million passengers in 2017, Heathrow is Europe's busiest airport and the world's seventh busiest airport.

Heathrow provides service to a range of market segments, including business and leisure travellers, direct and transfer passengers on long and short-haul routes, operated by a diversified range of major airlines. As well as earning income from services to airlines, Heathrow also generates revenue from a variety of sources, including concession fees from retail operators, income from car parks, advertising revenue, the rental of airport premises, the provision of facilities and services and the Heathrow Express rail service.

Heathrow has maintained a strong focus over recent years on operational performance, improving the passenger experience and investing in new and upgraded facilities. Heathrow has invested over £10 billion transforming the airport over the last decade. The focus and investment has resulted in Heathrow being named 'Best Airport in Western Europe' by Skytrax for the third consecutive year in 2017 and achieving top ranking among major European hub airport in terms of overall passenger satisfaction for thirteen successive quarters.

Heathrow is subject to economic regulation by the Civil Aviation Authority ('CAA'), which sets caps on the amount that Heathrow can charge airlines for using its facilities. This price setting mechanism provides significant cash flow predictability within each regulatory period which usually lasts five years and may be extended. The current regulatory period was initially set to last from 1 April 2014 to December 2018. In 2016, the CAA formally extended the current regulatory period by one additional year to the end of December 2019 rolling forward the existing price control. In 2017, the regulator's latest consultation stated that a further extension of the current regulatory period to at least the end of 2020 is expected to be needed. The CAA is expected to provide further clarity on the price control that will apply to the latest further extension in 2018.

Heathrow's strategy

Heathrow's strategy is focused on developing the airport's position from one of the best airports in Europe to one of the best in the world. Heathrow's vision is to give passengers the best airport service in the world.

To support and develop Heathrow airport's role as a hub, the Group will continue enabling the success of the major network airlines operating at Heathrow by investing in further capacity, operational flexibility and resilience at sustainable charges for airline customers.

Strategic report *continued*

Business overview *continued*

Heathrow's strategy continued

For both local and transfer passengers, Heathrow is working continuously to make every journey better through improved service standards to ensure it remains passengers' preferred airport. Improving the passenger experience is supported by on-going investment in modern airport facilities and operating processes.

Heathrow's priorities

Heathrow's vision is to deliver the best airport service in the world and is underpinned by four strategic priorities:

Mojo

To be a great place to work, Heathrow will help its people fulfil their potential and work together to lead change across Heathrow with energy and pride.

Transform customer service

To deliver the world's best passenger experience, Heathrow will work with the Heathrow community to transform the service it gives to passengers and airlines, improving punctuality and resilience.

Beat the plan

Aiming to beat the business plan for the current regulatory period and deliver a competitive return to shareholders by growing revenue, reducing costs and delivering investments efficiently.

Sustainable growth

To operate and grow Heathrow airport sustainably, now and in the future.

Infrastructure

The Group has invested over £10 billion transforming Heathrow's infrastructure over the last decade including £687 million invested in 2017 alone (2016: £674 million).

Runways

Heathrow airport has two parallel runways. These generally operate in 'segregated mode', with arriving aircraft allocated to one runway and departing aircraft to the other. The airport is permitted to schedule up to 480,000 air transport movements per year and in 2017, it operated at 98.8% (2016: 98.6%) of this limit.

Terminals

Each of Heathrow's four operational terminals is either new or recently refurbished. The busiest terminals are Terminal 2 and 5. Terminal 2, which opened in June 2014, handled 17.8 million passengers in 2017 (2016: 16.5 million) and complements the award winning Terminal 5 which handled 32.3 million passengers in 2017 (2016: 31.9 million).

Heathrow airport's terminal capacity is currently estimated to be 85 million passengers per year.

Baggage systems

In parallel with the work on Heathrow's terminals, significant investment was made in Heathrow's baggage infrastructure including the underground automated baggage system between Terminal 3 and Terminal 5 and the Terminal 3 integrated baggage system which became fully operational in April 2016.

Cargo and mail carriers

Cargo and mail carriers are responsible for handling merchandise and packages at Heathrow airport, including delivery to cargo warehouses, customs procedures and clearance, aircraft loading and unloading, sorting and transport to the final destination. The bulk of cargo and mail at the airport is carried in the cargo holds of passenger flights rather than by dedicated cargo flights.

Certain cargo sheds at the airport are owned by third parties who lease space to cargo service providers. Heathrow also provides cargo sheds and other accommodation and facilities which are leased, or separately billed on a use basis, to cargo-service providers.

Expansion of Heathrow

Heathrow has been operating close to its permitted limit on annual flights for a number of years and is the busiest airport in the world with two or fewer runways, based on its mode and hours of operations. As a result, for a significant period of time, it has been considering ways to deliver sustainable growth, by expanding its runway capacity in order to deliver even greater benefits as the country's only hub airport, whilst mitigating the effects of expansion particularly on local communities.

The UK government established the Airports Commission in 2012 to identify and recommend options to maintain the UK's position as Europe's most important aviation hub. In July 2015, the airports Commission recommended the expansion of Heathrow airport through the construction of a new runway immediately to the north west of the existing airport, together with associated infrastructure such as new terminal capacity and taxiway systems. In October 2016, the UK government announced its decision to support the expansion of Heathrow airport. The proposed expansion of Heathrow airport is

Strategic report *continued*

Business overview *continued*
Expansion of Heathrow *continued*
expected to deliver at least 260,000 additional flights per annum which could result in annual passenger numbers increasing to approximately 130 million over time, compared to 78.0 million in 2017.

A broad range of workstreams involving various stakeholders is now underway initially aimed at Heathrow obtaining the necessary formal policy support from the UK government and consents to enable Heathrow to proceed with the required construction programme.

Heathrow's regulatory environment
Heathrow is subject to economic regulation by the Civil Aviation Authority ('CAA'), which is the independent aviation regulator in the UK, responsible for economic regulation, airspace policy, safety and consumer protection.

The CAA sets the maximum level of airport charges for Heathrow, generally for five-year regulatory periods using a per passenger price cap mechanism known as RPI +/- X, which incorporates an allowed return on the Regulatory Asset Base ('RAB'). Heathrow's current regulatory period ('Q6') initially ran from 1 April 2014 to 31 December 2018. On 21 December 2016, the CAA issued a formal notice under section 22(6) of the Civil Aviation Act 2012 to modify the licence issued to Heathrow, by extending Heathrow's current regulatory period by one year so that it will end on 31 December 2019 and rolling over the current price control of RPI-1.5% for the additional year.

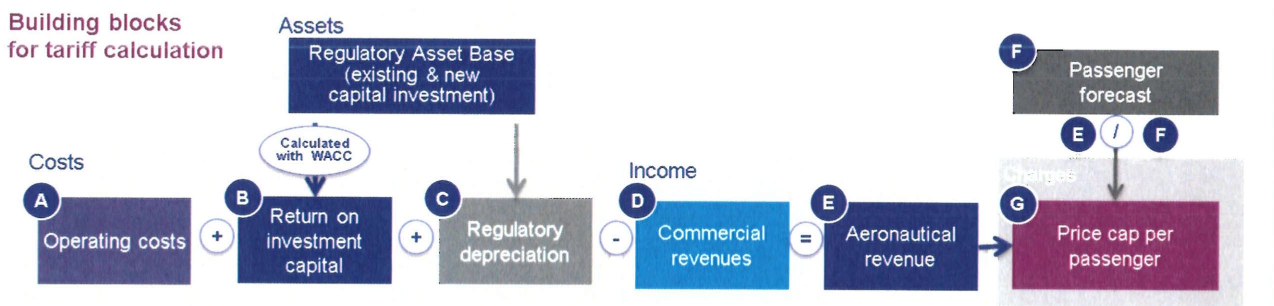
In June 2017, the CAA published a consultation document entitled "Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow". This consultation included a decision by the CAA to further extend the Q6 regulatory period by at least a year to 31 December 2020 with an option to extend the Q6 regulatory period further depending on the overall timeline for the expansion of Heathrow Airport. In a further consultation document published by the CAA in December 2017, it indicated that its preferred approach to the price control that will apply during 2020 and beyond is to combine a headline RPI-0.0% tariff. The CAA expects to make a final decision on the price control for the extended Q6 period and whether the duration should be 12-months or longer as soon as is practicable in 2018 with appropriate licence modifications implemented in 2019.

Heathrow's regulation is consistent with the economic regulation of other UK regulated industries (such as telecoms and the energy sector). This form of economic regulation is also sometimes referred to as incentive regulation, in that Heathrow has an incentive to outperform the price control by means of attracting more passengers, reducing operating costs or delivering higher commercial revenues than forecast. If the opposite is the case, then Heathrow has to absorb the cost or lower revenue. There is no adjustment for shortfalls in passenger numbers or additional costs (with the primary exception of where Heathrow incurs additional security costs, above an established threshold, when implementing new security directives imposed by the EU or the UK Government).

The Price Cap
The price cap for Heathrow is based on a RAB methodology using a "single till" building block approach. The single till takes into account revenue and costs from both aeronautical and non-aeronautical activities when setting the price caps for a regulatory period.

In setting the price cap, the CAA determines the regulated revenue requirement. This is calculated as the sum of forecast operating expenditure less other revenue plus the required return (using the cost of capital determined by the CAA) on the forecast RAB taking into account forecast capital expenditure, plus regulatory depreciation and plus or minus any profiling adjustment. The profiling adjustment is a mechanism used to smooth changes in charges that might otherwise occur as a result of major investments. The resulting aeronautical revenue requirement effectively amounts to the total income from airport charges.

This methodology for deriving the aeronautical revenue requirement can be represented by the following simplified diagram:



Strategic report *continued*

Business overview *continued*

Heathrow's regulatory environment *continued*

Since the start of the current regulatory period, the maximum allowable yield (the amount of income generated from regulated airport charges on a per passenger basis) changes from 1 January each year by RPI minus 1.5%, based on RPI from the previous April.

In setting the price cap the CAA takes its own view of the scope for future efficiency savings, the appropriate level of capital expenditure and the rate of growth in demand for airport services.

While the price cap places a limit on the increase in the airport charges yield, Heathrow has the discretion on whether to price to the maximum permitted level. Therefore, Heathrow can choose to price charges below the cap. For example, if there is unused capacity, Heathrow could choose to set prices below the cap in order to stimulate demand.

The price cap takes certain elements into account in the maximum allowable yield. These include an adjustment for additional or reduced security costs as a result of new UK or European security directives; reductions where capital expenditure project milestones are not delivered; a 2017 business rates revaluation factor and a service quality rebate scheme. In addition there is a mechanism known as the "K factor" which is designed to correct for any under recovery (dilution) or over recovery (concentration) in airport charges compared to the annual maximum allowable yield per passenger. Under or over recoveries generally arise due to changes in passenger mix or average load factors compared to those forecast at the time prices were prospectively set for the relevant year.

Heathrow's income

Heathrow generates two primary types of income: aeronautical income, which is generated from fees charged to airlines for use of the airport's facilities, including passenger fees, landing charges and aircraft parking charges, and non-aeronautical income from a variety of sources, including concession fees from retail operators, direct income from car parks and advertising and income from other services supplied by Heathrow.

Aeronautical income

Aeronautical income reflects the charges levied by Heathrow on the airport's airline customers. These charges (tariffs) cannot exceed the regulated maximum allowable yield per passenger. The tariff structure through which the aeronautical income is recovered from airlines includes three key elements:

Passenger fees

- Fees per passenger are based on the number of passengers on board an aircraft and are levied in respect of all departing passengers. There is no charge in respect of crew members working on flights.

- Three levels of charge based on route area: European, domestic and rest of world. Transfer and transit passengers benefit from a discount.

Landing charges

- Landing charges are levied for substantially all aircraft (with certain diplomatic and other flights being exempted). These are calculated in accordance with the certified maximum take-off weight of the aircraft and are banded into categories for aircraft weighing less than and those weighing more than sixteen tonnes, which includes nearly all commercial aircraft. These charges are adjusted, where applicable, in accordance with each aircraft's noise-rating, its emissions and the time of day, with landing charges being higher during peak traffic times than off-peak traffic times.

Parking charges

- Aircraft parking charges are levied for each 15 minute slot after 30 minutes (for narrow-bodied aircraft) and 90 minutes (for wide-bodied aircraft).

Non-aeronautical income

Heathrow generates non-aeronautical income from a variety of sources. These include concession fees from retail operators; direct income from car parks, advertising revenue and VIP products; the rental of airport premises such as aircraft hangars, warehouses, cargo storage facilities, maintenance facilities, offices and airline lounges; the provision of facilities such as baggage handling and passenger check-in; and fare revenue from the operation of the Heathrow Express rail service.

Strategic report *continued*

Management review

Review of the year
2017 was a record year at Heathrow during which we made excellent progress toward delivering our vision: to give passengers the best airport service in the world. We maintained strong momentum across the four priorities underpinning our vision: making Heathrow a great place to work, transforming our service to passengers and airlines, beating the business plan over the current regulatory period and operating and growing Heathrow sustainably today and in the future.

The success of our vision is bound to attracting, retaining and developing high quality talent. This is why making Heathrow a great place to work and creating careers where people can fulfil their potential is at the very heart of our strategic priorities. In 2017, 74% of our colleagues (2016: 78%) rated themselves engaged: a particularly strong outcome as the company-wide survey was run as an industrial action ballot was taking place. Heathrow was also voted one of The Sunday Times' Top 30 Best Big Companies to Work For. We took great pride in becoming the UK's first airport to be a fully accredited London Living Wage employer. We rolled out our Digital Workplace to our central functions as we continue evolving toward a more agile responsive organisation, further empowering our colleagues.

We delivered an outstanding service to our passengers during our busiest year on record. We achieved an excellent 4.18 out of 5.0 score in the global Airport Service Quality survey in Q4 2017 while we achieved record levels of baggage connections and departures punctuality. Passengers voted Heathrow 'Best Airport in Western Europe' for the third year running and 'Best Airport for Shopping' globally for the eighth consecutive year at the 2017 Skytrax World Airport Awards. Lastly, we were named the world's best airport for security in the inaugural awards from International Airport Review.

In 2017, a record 78.0 million passengers chose to travel through Heathrow, up 3.1% on 2016 - the single best endorsement of our strategy. This was our seventh successive annual record and was enabled by record load factors. Passengers benefitted from an even greater choice in terms of destinations with new long haul services to Barbados, New Orleans, Portland, Qingdao and Santiago. Heathrow also delivered for the UK, supporting British trade with a significant increase in cargo volumes, up 10.2% on last year.

2017 was also about continuing to beat the plan on both revenues and costs as we remain well on track to deliver £900 million of revenue and cost improvements over the current regulatory period to the end of 2018. Our strong focus on operating efficiencies continued with headline operating costs down marginally despite welcoming an additional 2.3 million passengers and a significant pick up in inflation. On the revenue side, we are seeing more passengers participating in our retail offering and each of them is spending more. As a result of all these dynamics, revenues were up 2.7% to £2.9 billion. We raised over £1.0 billion in debt financing paving the way to simpler debt financing arrangements and enhancing our resilience ahead of expansion.

Heathrow's expansion really moved into delivery mode in 2017 following the Government's backing for our plans in late 2016. We are already making good progress toward delivering this once-in-a-generation boost for Britain's economy, one that will help secure the country's economic future as an outward looking nation. The government considers Heathrow expansion as strategically important for the UK and intends to submit its Airports National Policy Statement, the key legislative enabler for expansion, to a vote in Parliament in the first half of 2018. We continue engaging with our regulator and airline stakeholders to define the regulatory framework that will enable expansion that is affordable, sustainable and financeable. Finally, in January 2018, we launched our first planning consultation. The consultation outlines our emerging proposals and options to deliver an expanded Heathrow while keeping our commitments to local communities and meeting strict environmental tests. It is the opportunity for our local community and the broader public to help us shape Heathrow's future.

Key business developments

Mojo

We are committed to making Heathrow a great place to work and our efforts are showing results. In 2017 our colleagues voted us one of The Sunday Times' Top 30 Best Big Companies to Work For.

Our commitment to personal development saw 211 colleagues promoted internally, demonstrating that our focus on retaining and developing talent is working, with a further 3,191 taking part in training and personal growth programmes. We also launched five diversity networks, so colleagues can be their best by being themselves.

Our new Digital Workplace rolled out, helping those who work here to connect – on any device, anywhere, at any time, and we launched a salary sacrifice scheme for green cars, giving colleagues big discounts on sustainable travel.

Our commitment to giving something back saw 932 colleagues and Team Heathrow partners take part in events to raise over £350,000 for our charity partners. These events included our annual midnight marathon on our northern runway and 'race the plane', where 351 participants from Team Heathrow raced an Air Canada flight to Toronto on exercise bikes, raising £101,000 in the process.

Transform customer service

In 2017, we continued to deliver a world-class passenger service achieving a record annual average score of 4.16 out of 5.0 and an excellent 4.18 out of 5.0 score in the fourth quarter in the global Airport Service Quality ('ASQ') survey. Heathrow has been ranked first among major European hub airports for service quality in this survey for thirteen successive quarters. In addition, 82% of passengers surveyed rated their Heathrow experience 'Excellent' or 'Very Good' (2016: 84%).

Heathrow received other recognitions for its high service standards, being named the 'Best Airport in Western Europe' for the third consecutive year at the Skytrax World Airport Awards. The award, voted for globally by passengers, came in addition to Heathrow being voted 'Best Airport for Shopping' for the eighth consecutive time.

Improving passengers' journeys through the airport remains one of our key priorities. Passengers continue to enjoy efficient queuing to pass through security, passing through central security within the five minute period prescribed under the Service Quality Rebate ('SQR') scheme 97.3% of the time (2016: 97.0%) compared with a 95% service standard. The service quality regime penalty threshold was not triggered in 2017 in respect of any performance standard and for the first time in the current regulatory period, we earned a modest level of bonuses under the SQR scheme.

Punctuality improved with a record 80.2% of flights departing within 15 minutes of schedule (2016: 78.8%). Baggage performance improved significantly with the misconnect rate down to 10 bags per 1,000 passengers (2016: 14), reflecting our enhanced operational resilience. Heathrow achieved its best ever monthly baggage performances of 7 bags per 1,000 passengers in February 2017 and 8 bags per 1,000 passengers in 3 other separate months, beating the previous record of 9 bags per 1,000 passengers set in October 2016.

Over a million passengers with reduced mobility travelled through Heathrow in 2017. Last summer, we agreed new service levels with our supplier that took effect in January 2018; they will enhance our performance and transform these passengers' experience. In September 2017, we also launched an improvement plan which includes steps we are now taking to better monitor and report our performance, conduct accredited disability awareness training and engage with disability groups going forward.

Beat the plan

Q6 business plan

Our business plan for the current regulatory period ('Q6') is intended to improve customer service, strengthen operational resilience and deliver an ambitious programme of cost efficiencies and revenue growth.

We are on track to substantially deliver the cost efficiencies and additional commercial revenues built into our plan. As a result, by the end of 2018, we will have secured £900 million of incremental EBITDA over the period.

Strategic report *continued*

Management review *continued*
Key business developments *continued*
Beat the plan continued

Passenger traffic
Heathrow's passenger traffic by geographic segment for the year ended 31 December 2017:

Passengers by geographic segment (millions)	**Year ended 31 December 2017**	Year ended 31 December 2016	Change[1] %
UK	**4.8**	4.6	3.3
Europe	**32.4**	31.7	2.4
North America	**17.4**	17.2	1.1
Asia Pacific	**11.3**	10.8	4.5
Middle East	**7.6**	7.0	9.5
Africa	**3.2**	3.2	0.2
Latin America	**1.3**	1.2	5.5
Total passengers[1]	**78.0**	75.7	3.1

[1] These figures have been calculated using un-rounded passenger numbers.

In the year ended 31 December 2017, we welcomed a record breaking 78.0 million passengers (2016: 75.7 million), a rise of 3.1% on prior year on a total of 471,082 passenger flights (2016: 470,764). Our traffic growth was primarily enabled by average load factor increasing by 2 percentage points to 78.0% (2016: 76.0%) partly driven by an increase in UK inbound demand, influenced by the depreciation of sterling, particularly from the Middle East and Asia Pacific. The average number of seats per passenger aircraft rose 0.4% to 212.3 (2016: 211.5). The increase in the number of flights reflects the immediate benefit of a scheme we launched in the fourth quarter of 2017 to boost utilisation of our limited spare capacity which drove a net increase in the final quarter of over 1,300 flights.

Passengers benefitted from an even greater choice in 2017 with new domestic services operated by Flybe, new international destinations including Barbados, New Orleans, Portland, Qingdao and Santiago and more services and additional seats per flight to the Middle East and Asia.

Intercontinental traffic was the key geographic driver of our traffic growth, increasing 3.6%, with load factors improving significantly. Intercontinental traffic growth was particularly robust on routes serving the Middle East where passenger numbers increased 9.5% supported by flights and larger aircraft, including additional A380 services from Emirates, Etihad and Qatar Airways, and more flights, including additional services from Oman Air. The 4.5% rise in Asia Pacific traffic was driven by substantial growth in load factor on existing routes serving Malaysia and new or increased services to Thailand, Philippines and Vietnam. North American traffic rose 1.1% mainly benefitting from increased load factors. Latin American traffic grew 5.5%, due to more flights and fuller aircraft serving the region.

European traffic increased by 2.4% due to fuller, larger planes with notable growth on routes to Italy, Russia, Belgium, Denmark, Netherlands and Portugal with over 70,000 extra passengers in each market. Flybe's new Scottish services contributed to the 3.3% growth in domestic traffic. In January 2018, Heathrow announced a £15 discount on airport charges for domestic flights, a 50% increase in the discount put in place in 2017. The new initiative will provide even better value to our passengers and support our plans to enhance domestic connectivity by making domestic routes more commercially viable for our airlines.

Over 30% of the UK's non-EU exports by value pass through Heathrow today. In the twelve months ended 31 December 2017, cargo volumes were up 10.2% to 1.7 million tonnes, one of the strongest periods in the last 5 years in terms of year on year growth, with notable increases on North America and the Middle East.

Investing in Heathrow
We invested £687 million in 2017 on a variety of programmes to improve the passenger experience, airport resilience and work through a broad asset replacement programme. We also continued to develop our plans for expanding Heathrow for which investments amounted to approximately £80 million in 2017. We expect expansion-related capital investment to increase to around £150 million to £175 million in 2018.

Management review *continued*

Key business developments *continued*

Investing in Heathrow continued

Passengers have benefited from improvements delivered in Terminal 4 including increased space in the immigration hall to ease congestion and the opening of a new Gucci store marking the completion of the luxury retail redevelopment. In Terminal 5, premium passengers are enjoying the new 'First Wing' offering a fast track route with dedicated security lanes to British Airways' lounge. In Terminal 5 as well, the final self-boarding gate of the first tranche of works was completed and won the 'Best Gate Initiative' at the 2017 Future Travel Experience Global Conference. The self-boarding gates will help reduce boarding times as we continue extending automation across the passenger journey and further enhance efficiency for airlines. New combined body-scanner/metal detectors were also installed in Terminal 5 to enhance the transfer security experience. Airfield improvements continued to meet increased A380 operations with additional taxiway widening and stand modifications now substantially completed. The upgrade of the hold baggage screening machines, which is our largest single investment of the current regulatory period, continues to be delivered across all terminals with a portion of bags in Terminal 5 already being screened through the new security machines. Lastly, in relation to expansion, our key investment was into finalising a review of all the components and options that will underpin the expanded infrastructure. This work informed the preparation of our first planning consultation launched in January 2018.

Sustainable growth

Heathrow 2.0

In 2017, we launched our sustainability leadership plan 'Heathrow 2.0' which aspires to make the airport a centre of excellence in sustainable aviation. Our strategy sets out ambitious goals to reduce the airport's and the industry's environmental impacts while maximising economic opportunities across the UK.

We want Heathrow to be a great place to work and to create careers, not just jobs, so that the people who work here can fulfil their potential. One of our flagship goals is to facilitate 10,000 apprenticeships by 2030 to help people develop skilled and sustainable careers. Since 2004, the Heathrow Academy has helped over 3,600 local residents find work, 5,800 advance into further training and over 1,500 into apprenticeships.

We want Heathrow to be a great place to live and to work better with our neighbours to improve their quality of life, particularly relating to noise and air quality. One of our key goals is to encourage the use of the quietest aircraft available, operated with the least noise impact practicable within an agreed noise envelope. Over the past 30 years, Heathrow's passenger numbers have more than doubled, while its noise footprint has decreased to its smallest levels yet. Independent analysis showed that in 2017, 15% fewer households were impacted by noise than in 2006. From 1 January 2018, Heathrow increased environmental charges by 7%, incentivising airlines to deploy their cleaner and quieter aircraft at Heathrow. In 2017, we also made progress in reducing the number of late runners with a decrease of 29% to 235 flights operating after 11:30pm (2016: 330 flights).

We want Heathrow to be part of a thriving, sustainable economy and to create opportunities for sustainable businesses to deliver a stronger future for the UK. In November 2017, Heathrow became a fully accredited Living Wage Employer, recognised by the Living Wage Foundation. This will see 3,200 airport workers receive the living wage by the end of 2020. Heathrow is also committed to exceed the criteria for accreditation by encouraging other businesses based at the airport to take a similar stance.

Finally, we want Heathrow to play a role in ensuring that we have a world worth travelling and to deliver fair and sustainable air travel for future generations to enjoy. Our aspiration is to make growth from our new runway carbon neutral and we will publish a Carbon Neutral Roadmap in 2018. We also have a goal that no illegal wildlife or animal products should pass through Heathrow. As the only airport signatory to the Buckingham Palace Declaration, we want to encourage others to sign up and raise awareness with passengers, colleagues, the cargo community and the global community about the impact of trade in endangered wildlife. In 2017, we worked with UK Border Force and IAG Cargo to support United for Wildlife's 'United for Elephants' campaign and raise awareness of critically endangered species with passengers.

Management review *continued*

Expansion

Key Heathrow developments

Our expansion plans remain on track to deliver a once-in-a-generation boost for Britain's economy in a way that is affordable, financeable and sustainable.

On 17 January 2018, Heathrow launched a 10-week consultation on options for expansion which will run until 28 March. The consultation is a major milestone in the delivery of an expanded Heathrow and is expected to be one of the largest consultations ever in the UK – including 40 events across areas close to Heathrow. The consultation is composed of two parts – the first relating to the physical options needed to deliver and operate an expanded Heathrow and the second on the design principles for the new airspace required to operate an expanded Heathrow. It is an opportunity for the public to help shape at an early stage how the future expanded airport will look and operate. The feedback from this consultation will help Heathrow determine a preferred masterplan which will be presented to the public for a second, statutory consultation in 2019 after which Heathrow will prepare a final planning application known as a Development Consent Order which is expected to be submitted to the Planning Inspectorate in 2020.

Heathrow confirmed in December 2017 that it could deliver an expanded airport for £2.5 billion less than the plans submitted to the Airports Commission – bringing the total cost of the project down to £14 billion and contributing to meeting the government's challenge to expand whilst keeping airport charges close to current levels. The physical options related to this emerging scheme are among those included in the consultation referenced above.

Work continues to develop an efficient, affordable and sustainable expansion supply chain. In 2017, Heathrow kicked off its search for four logistics hubs which will ultimately help manufacture and assemble components of an expanded Heathrow. Over 120 sites applied and after an initial review, Heathrow long-listed 65 sites for further consideration in 2018. The final locations will pioneer offsite manufacturing, helping to reduce local disruption and environmental impacts whilst spreading jobs created from expanding Heathrow across the UK.

Heathrow's successful Business Summits programme continued to grow in 2017 with seven events taking place across the UK offering small and medium businesses the chance to meet face-to-face with Heathrow's top suppliers and become part of the airport's multi-billion-pound supply chain. The Business Summits programme is set to grow even further in 2018, with 10 events scheduled across the UK.

Governmental developments

In 2017, the government confirmed expanding Heathrow as strategically important for the UK. The Department for Transport launched two public consultations on a draft Airports National Policy Statement ('NPS') which will set the policy framework for expansion. The first consultation ran from February to May with the second following between October and December after updated evidence on aviation demand forecasts and the government's final air quality plan became available.

The government is currently reviewing this feedback and has committed to submitting the final NPS to a vote in Parliament in the first half of 2018. In parallel, the Transport Select Committee launched its own inquiry into the revised NPS in October. It is expected to provide its final recommendation on the revised draft NPS to the Department for Transport this spring following input from a series of public evidence sessions.

Expanding Heathrow remains widely supported, particularly in Parliament, with the latest polling showing that over 70% of MPs back the project. In addition, both the Scottish and Welsh Governments, the DUP, major business groups including the CBI, BCC and FSB, union bodies including Unite, GMB and the TUC and airlines like easyJet and Flybe continue to support expanding Heathrow.

CAA consultation

During 2017, the CAA has further developed its thinking regarding the next regulatory period (H7) which would comprise a significant proportion of the expansion investment phase. The CAA launched two consultations, one in June 2017 'Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow' and the other in December 2017 'Economic regulation of capacity expansion at Heathrow – policy update and consultation'. Responses to the second consultation are due by 2 March 2018.

The CAA's fundamental objective in developing the H7 regulatory framework is to ensure that it appropriately balances affordability and financeability considerations.

In both consultations, the CAA is clear that the regulatory framework for expansion should build on the strengths which have evolved through thirty years of regulation, including continued use of the regulatory asset base ('RAB') as the cornerstone of the regulatory framework and a single till approach to determine tariffs.

Strategic report *continued*

Management review *continued*
Expansion continued
CAA consultation continued
The consultation states that a further extension of Q6 to at least the end of 2020 is expected to be needed, with the CAA emphasising the need for flexibility, in particular the potential need to further extend Q6 to better align the start of H7 with commencement of the expansion construction programme. In terms of economics beyond 2019, in its latest consultation the CAA expresses a preference for a headline price of RPI-0% while various options are being considered to reflect performance on building blocks such as passenger volumes, operating costs, commercial revenues and potentially the cost of debt component of the weighted average cost of capital ('WACC'). Heathrow is considering its response to this area.

The consultations have addressed many aspects of Heathrow's regulation through expansion including various issues related to financeability and financial resilience such as preliminary views on cost of capital, inflation and debt indexation, minimum creditworthiness, gearing caps and strengthened liquidity requirements.

The current consultation includes preliminary work by PwC on defining Heathrow's allowed WACC in H7 although the CAA specified this analysis does not represent its own views. PwC suggests a real 'vanilla' (pre-tax debt and post-tax equity) WACC range of 2.8-4.6% in a 3-runway scenario, estimated to be equivalent to 3.3-5.3% on a consistent basis with the 5.35% applicable in Q6. The preliminary cost of capital for H7 versus Q6 largely reflects two opposing factors, lower cost of debt and equity (driven by market parameters) offset by a risk premium related to expansion. The CAA acknowledges that given expansion's incremental risks the scale of the premium in Heathrow's allowed cost of capital will be subject to significant further work over the coming years. As it stands, PwC's preliminary analysis presents various methodological flaws and erroneous assumptions which Heathrow will address in its response.

In terms of defining the cost of debt allowance included in the WACC, the CAA's initial view is to introduce indexation to a relevant benchmark for just new debt while the cost of embedded debt would continue to be determined as a fixed allowance.

With regards to inflation indexation, the CAA has confirmed a gradual transition to consumer price index ('CPI') rather than retail price index ('RPI') based regulation. Its initial policy for H7 is to continue to use RPI to calculate both the WACC and RAB but it leaves open whether RPI or CPI is used to calibrate the H7 price control, for example, the tariff formula.

Away from financeability matters, the CAA provides further details on the definition and information requirements applying for early category C costs (costs related to land acquisition, detailed surveying or design or very early construction) that may be incurred before planning consent is granted. Heathrow expects these costs to amount to several hundred million pounds between 2018 and 2020.

The CAA plans to provide additional clarity on the regulatory framework in April 2018 and September 2018 when it publishes its next consultation papers.

Brexit
We are encouraged by the progress made by the government in its Brexit negotiations toward agreeing a transitional period with its European counterparts. As the UK charts its new path outside the European Union as an outward looking nation, it remains particularly important that the country secures continued access to the single European aviation market with around 35% of Heathrow's traffic to and from European Union member countries. In addition, Heathrow will continue to advocate a deal that maintains efficient flows of both people and goods that will ensure continued access to skills and efficient immigration and cargo processing.

Key management changes
On 22 January 2018, Heathrow announced that Chris Garton will be joining the company as Chief Operating Officer ('COO') in the spring. He held a similar position for nine years at Dubai Airport until late 2016. He was most recently Director of Asset Management at Associated British Ports. During his career, Chris has also held a number of roles in engineering and change management at Gatwick Airport, Ineos and ICI.

Chris's imminent arrival at Heathrow follows the appointment of Derek Provan, who has been interim COO since October 2017, as Chief Executive Officer of AGS Airports.

Strategic report *continued*

Financial review

Introduction

The following financial review, based on the consolidated financial statements of the Group, provides commentary on the performance of the Group's operations.

Basis of presentation of financial results

Heathrow Finance consolidated financial statements are prepared under International Financial Reporting Standards ('IFRSs').

The presentation of retail revenue has been changed to more closely reflect the way in which the retail activities are managed. Retail revenues are now presented under five categories: retail concessions, catering, other retail, car parking and other services. Airside specialist shops and duty and tax-free activities drive most of retail concessions revenues. Other retail revenues include advertising and bureau de change while other services income comes primarily from VIP and fast track services and car rental. Recategorised historical values for the new categories are outlined in Appendix 2 and are also available in excel format on the Heathrow investor centre website.

Summary performance

In the year ended 31 December 2017, the Group's operating profit before certain re-measurements was £1,066 million (2016: £1,009 million) and its profit after tax was £503 million (2016: £127 million loss).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Excluding certain re-measurements		
Revenue	**2,884**	2,807
Operating costs before depreciation and amortisation	**(1,124)**	(1,125)
Adjusted EBITDA[1]	**1,760**	1,682
Depreciation and amortisation	**(694)**	(673)
Adjusted operating profit[2]	**1,066**	1,009
Net finance costs	**(825)**	(738)
Adjusted profit before tax[3]	**241**	271
Tax charge on profit before certain re- measurements	**(54)**	(60)
Including certain re-measurements		
Fair value gain on investment properties	**149**	44
Fair value gain/(loss) on financial instruments	**215**	(522)
Tax (charge)/credit on certain re-measurements	**(48)**	84
Tax credit relating to change in tax rate	**-**	56
Profit/(loss) after tax	**503**	(127)

[1] Adjusted EBITDA is earnings before interest, tax, depreciation and amortisation and certain re-measurements.
[2] Adjusted operating profit is adjusted EBITDA inclduing depreciation and amortisation.
[3] Adjusted profit before tax is adjusted operating profit after deducting net finance costs

For the year ended 31 December 2017, Adjusted EBITDA was £1,760 million (2016: £1,682 million) and EBITDA was £1,909 million (2016: £1,726 million) after adjusting for fair value gain/(loss) on investment properties.

Management uses Adjusted EBITDA to monitor performance of the segments as it believes it more appropriately reflects the underlying financial performance of the Group's operations. On a monthly basis management review results, paying particular attention to the airport operations over which it exercises control on a day-to-day basis.

Certain re-measurements comprise fair value movements on investment properties, which are mainly market-driven and over which management has little influence; fair value gains and losses on financial instruments which are subject to external financial market fluctuations; tax associated with these items and the effects of changes in tax rates, which are set by statute.

By isolating certain re-measurements, management believes the underlying results provide the reader with a clearer understanding of the performance of the Group, by concentrating on the matters over which it exerts influence, whilst recognising that information on these additional items is available within the financial statements, should the reader wish to refer to them.

Financial review *continued*

Revenue

In the year ended 31 December 2017, revenue increased 2.7% to £2,884 million (2016: £2,807 million).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Aeronautical	**1,716**	1,699	1.0
Retail	**659**	612	7.7
Other	**509**	496	2.6
Total revenue	**2,884**	2,807	2.7

Aeronautical

In the year ended 31 December 2017, aeronautical revenue increased 1.0% to £1,716 million (2016: £1,699 million). Heathrow delivered better value for passengers and airlines with lower charges as average aeronautical revenue per passenger declined 2.0% to £22.00 (2016: £22.45).

Traffic growth of 3.1% generated £51 million incremental revenue. This was offset by a lower price due to the regulatory RPI-1.5% pricing formula and adjustments to reflect lower capital expenditure than forecast in the original regulatory settlement. Yield dilution in the period compounded by concentration in the prior year resulted in £20 million lower revenue.

Retail

In the year ended 31 December 2017, retail revenue increased 7.7% to £659 million (2016: £612 million). Retail revenue per passenger rose 4.5% to £8.45 (2016: £8.09).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Retail concessions	**304**	275	10.5
Catering	**56**	49	14.3
Other retail	**109**	110	(0.9)
Car parking	**120**	114	5.3
Other services	**70**	64	9.4
Total retail revenue	**659**	612	7.7

Growth in retail income reflected primarily the increased passenger traffic in the period combined with greater airside participation (up 2 percentage points versus 2016) as well as increased retail spend per participating passenger. Retail concessions grew by 10.5% reflecting the benefit, particularly in duty and tax-free and airside specialist shops, from depreciation of sterling since June 2016, although, as expected, this trend has moderated since the anniversary of the depreciation. The redevelopment of Terminal 4's luxury retail offering, completed in late 2016, also contributed to this growth.

Catering also saw strong growth from increased passenger traffic, the redevelopment of Terminal 5 catering outlets and more passengers choosing to buy food from terminals before boarding their flights. In other retail activities, growth in advertising revenues was offset by some underperformance in bureau de change as a result of increasing competition. Car parking rose 5.3% driven by increased passenger numbers and a more dynamic pricing strategy. Higher car rental revenue from a change in arriving passenger mix and increased volumes in VIP services drove other services income up 9.4%.

Other

In the year ended 31 December 2017, other revenue rose 2.6% to £509 million (2016: £496 million).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Other regulated charges	**240**	232	3.4
Heathrow Express	**127**	120*	5.8
Property and other	**142**	144*	(1.4)
Total other revenue	**509**	496	2.6

* Segment revenue for both Heathrow and Heathrow Express has been re-stated by £14 million as the revenue from Transport for London (allowing the Piccadilly line to run to Heathrow) was included in the Heathrow Express revenue. The restatement reflects a more accurate performance of the underlying Heathrow Express business and presents segmental revenue on a basis consistent with Adjusted EBITDA reported for Heathrow Express. There was no effect on total revenue as a result of this restatement.

Strategic report *continued*

Financial review *continued*

Other *continued*

Other regulated charges reflect a pass through to airlines of Heathrow's costs in areas such as baggage system operations and maintenance and utilities. The year on year performance reflects increased baggage income from higher traffic volumes, income from under recovery of 2016 costs, offset by lower consumption of utilities at reduced prices. Performance elsewhere in other revenue reflects strong traffic growth at Heathrow Express, driven by the introduction of a more sophisticated pricing strategy and 7% growth in passenger numbers versus 2016.

Operating costs

In the year ended 31 December 2017, operating costs excluding depreciation, amortisation and exceptional items decreased 0.1% to £1,124 million (2016: £1,125 million) as cost efficiencies across a range of areas offset the impacts of higher passenger numbers and inflation. Operating costs before depreciation and amortisation were 3.1% lower on a per passenger basis at £14.41 (2016: £14.88).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Employment	**374**	373	0.3
Operational	**252**	265	(4.9)
Maintenance	**176**	176	-
Business rates	**126**	128	(1.6)
Utilities	**86**	74	16.2
Other	**110**	109	0.9
Operating costs before depreciation and amortisation	**1,124**	1,125	(0.1)
Depreciation and amortisation	**694**	673	3.7
Total operating costs	**1,818**	1,798	1.3

The non-repeat of 2016 organisational change costs and benefits of cost efficiencies in people-related areas was offset by managing higher passenger numbers whilst maintaining service and resilience, a pay rise coming into effect in July 2017 and the costs of voluntary severance schemes across a range of operational areas to enable future efficiencies. A combination of benefits from the renegotiated NATS contract, efficiencies from other third party suppliers and lower insurance costs in the year drove operational costs down.

Higher utility costs are due to the non-recurrence of a one-off credit in 2016 following the renegotiation of a contract for the provision of electricity distribution infrastructure services. The recurrent benefits from this renegotiation and focus on energy demand management continued to drive underlying savings year on year.

Other costs were in line with 2016, with higher costs of winter resilience offset by various efficiencies and the fact that in relation to expansion, following the UK Government's decision in late 2016 to support Heathrow expansion, costs have started to be capitalised rather than being expensed.

Operating profit

For the year ended 31 December 2017, the Group recorded an operating profit of £1,215 million (2016: £1,053 million).

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Adjusted EBITDA	**1,760**	1,682	4.6
Depreciation and amortisation	**(694)**	(673)	3.1
Operating profit before certain re-measurements	**1,066**	1,009	5.6
Fair value gain on investment properties	**149**	44	238.6
Operating profit	**1,215**	1,053	15.4

In the year ended 31 December 2017, Adjusted EBITDA increased 4.6% to £1,760 million (2016: £1,682 million), resulting in an Adjusted EBITDA margin of 61.0% (2016: 59.9%). Depreciation and amortisation increased to £694 million (2016: £673 million), driven by a number of new assets coming into operational use during the year as the Q6 programme of capital projects nears completion. Fair value gain on investment properties, which are mainly market driven and over which management has little influence, increased to £149 million (2016: £44 million). Investment properties were valued at fair value at 31 December 2017 by CBRE Limited, Chartered Surveyors (2016: CBRE Limited, Chartered Surveyors). Also, during the year ended 31 December 2017, operating profit increased by 15.4% to £1,215 million (2016: £1,053 million), resulting in an operating profit margin of 42.1% (2016: 36.5%).

Financial review *continued*

Taxation

All Heathrow group companies operate not only within the UK's tax laws, but also within the spirit of them and do not structure transactions in a way which gives a tax result contrary to the intentions of Parliament. All Heathrow group company profits are subject to UK corporation tax.

The total tax charge recognised for the year ended 31 December 2017 was £102 million (2016: £80 million credit). Based on a profit before tax for the year of £605 million (2016: £207 million loss), this results in an effective tax rate of 16.9% (2016: 38.6%).

The total tax charge before certain re-measurements for the year ended 31 December 2017 was £54 million (2016: £60 million) which includes a £13 million prior year deferred tax credit adjustment (2016: £2 million prior year deferred tax debit adjustment) relating primarily to accelerated capital allowances. Based on a profit before tax and certain re-measurements of £241 million (2016: £271 million), this results in an effective tax rate of 22.4% (2016: 22.1%). The tax charge is more (2016: more) than implied by the statutory rate of 19.25% (2016: 20%) primarily due to non-deductible expenses and because a substantial proportion of Heathrow's capital expenditure does not qualify for tax relief.

In addition, there was a £48 million tax charge (2016: £84 million tax credit) reflecting the tax impact arising from fair value gains on investment property revaluations and fair value gains/losses on financial instruments, along with any associated prior year adjustments.

Further details supporting these amounts are shown in Note 4 to the financial statements.

The Finance (No 2) Act 2015 enacted reductions in the main rate of UK corporation tax from 20% to 19% from 1 April 2017 and from 19% to 18% from 1 April 2020. The Finance Act 2016 enacted a further reduction in the main rate of corporation tax to 17% from 1 April 2020. The effects of these rate reductions were reflected in the deferred tax balances in the 2016 financial statements.

In November 2017 the Finance (No.2) Act 2017 received Royal Assent, giving effect to a new interest deductibility regime. This regime is in response to the Organisation for Economic Co-operation and Development (OECD) reports on base erosion and profit shifting (BEPS). As a result of the new legislation, from 1 April 2017, interest deductions are limited to 30% of tax based EBITDA, with the ability to apply a group ratio rule (GRR) and a public infrastructure exemption (PIE). Heathrow will be protected from the 30% of tax based EBITDA cap as a result of applying either the PIE or GRR therefore no interest disallowance has been reflected in the 2017 tax charge (2016: nil).

As a business, Heathrow has high infrastructure costs and of these a significant proportion now attracts no tax deduction. For those that do attract a tax deduction there is a timing difference between the accounting depreciation of these assets (the asset cost is charged to the income statement over the useful life of the asset as depreciation on a straight line basis, which is not deductible for tax purposes) and the tax relief available for capital expenditure (capital allowances, being tax relief provided in law, spread over a number of years), which generates significant deferred tax liabilities within the Group, reflecting future tax payable as these assets depreciate.

Profit/(loss) for the year

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m	Change %
Operating profit	**1,215**	1,053	15.4
Net finance costs	**(825)**	(738)	11.7
Fair value gain/(loss) on financial instruments	**215**	(522)	(141.2)
Profit/(loss) before tax	**605**	(207)	(392.3)
Tax (charge)/credit	**(102)**	80	(227.5)
Profit/(loss) for the year	**503**	(127)	(496.1)

In the year ended 31 December 2017, the Group recorded an operating profit of £1,215 million (2016: £1,053 million).

In the year ended 31 December 2017, the Group recorded a profit before tax of £605 million (2016: £207 million loss). The movement of £812 million from a loss to a profit reflects an increase in operating profit of £162 million, partly offset by net finance cost being £87 million higher (reflecting higher index linked accretion due to higher inflation index rate in period). In addition, fair value gains on financial instruments reflect a favourable movement of £737 million, driven primarily by a decrease in the long term GBP RPI curve and an increase in the long term LIBOR curve, compared to the previous year.

Financial review *continued*

Summary cash flow

For the year ended 31 December 2017, there was an increase of £237 million in cash and cash equivalents compared with a increase of £108 million in 2016.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Cash generated from operations	**1,732**	1,654
Taxation:		
Corporation tax paid	**(53)**	(45)
Group relief paid	**(7)**	(12)
Net cash from operating activities	**1,672**	1,597
Purchase of property, plant and equipment and other assets	**(687)**	(674)
Decrease in term deposits	**368**	170
Decrease/(increase) in group deposits	**(495)**	65
Interest received	**3**	7
Net cash used in investing activities	**(811)**	(432)
Dividends paid to Heathrow (DSH) Limited	**(335)**	(616)
Proceeds from issuance of bonds, term notes and other financing	**1,436**	1,119
Repayment of bonds and facilities and other financing items	**(1,163)**	(807)
Swap restructuring	**-**	20
Settlement of accretion on index-linked swaps	**(10)**	(188)
Interest paid	**(552)**	(585)
Net cash used in financing activities	**(624)**	(1,057)
Net increase in cash and cash equivalents	**237**	108

At 31 December 2017, the Group had £535 million (2016: £666 million) of cash, cash equivalents and term deposits of which, cash and cash equivalents comprised £523 million (2016: £286 million).

Cash generated from operations

In the year ended 31 December 2017, cash generated from operations increased 4.7% to £1,732 million (2016: £1,654 million). The following table reconciles Adjusted EBITDA to cash generated from operations.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Adjusted EBITDA	**1,760**	1,682
Increase in receivables and inventories[1]	**(7)**	(18)
Increase/ in payables	**8**	14
(Decrease)/increase in provisions	**(7)**	7
Difference between pension charge and cash contributions	**(22)**	(31)
Cash generated from operations	**1,732**	1,654

[1] Excludes movement in group deposits

Dividends

In the year ended 31 December 2017, Heathrow's ultimate shareholders received £525 million in dividends (2016: £325 million) reflecting the continued strong performance achieved by the business including delivering better value for airlines and passengers and significantly improving service. This made up a substantial proportion of the total controlled payments paid from Heathrow Finance plc in the year which amounted to £524 million net or £616 million gross. Other than payments to fund dividends to ultimate shareholders, net controlled payments related principally to making funds available to repay £195 million of loan facilities at ADI Finance 2 Limited ('ADIF2') and to meet £11 million (2016: £29 million) of interest payments at ADIF2.

The financing arrangements of the Group control certain payments unless specified conditions are satisfied. These controlled payments include, among other things, payments of dividends, distributions and other returns on share capital, any redemptions or repurchases of share capital, and payments of fees, interest or principal on any intercompany loans.

Strategic report *continued*

Financial review *continued*

Pension scheme

Heathrow operates a defined benefit pension scheme, the BAA Pension Scheme, which closed to new members in June 2008. At 31 December 2017, the defined benefit pension scheme, as measured under IAS 19, was funded at 97.1% (2016: 98.1%). This translated into a deficit of £124 million (2016: £79 million deficit). The £45 million increase in deficit in the year is primarily due to net actuarial losses of £65 million. In 2017, Heathrow contributed £49 million (2016: £59 million) into the defined benefit pension scheme including £23 million (2016: £25 million) in deficit repair contributions.

The deterioration in the scheme actuarial position was driven by a fall in the net discount rate, derived from corporate bond yields, of 0.15% and returns on scheme assets being lower than allowed for in the income statement.

Recent financing activity

Heathrow continues to focus on maintaining a strong liquidity position and optimising its long-term cost of debt whilst ensuring duration, diversification and resilience in its debt financing. Heathrow's debt financing strategy for the remainder of its current regulatory period is expected to have a strong focus on ensuring its relatively limited funding requirements are targeted at maintaining its presence in existing public markets whilst capitalising selectively on private placement opportunities.

During 2017, Heathrow raised over £1.0 billion of debt financing globally comprising just over £700 million in Class A debt, a £275 million bond issued by Heathrow Finance and a £75 million term loan facility initially held at ADIF2 which will migrate to Heathrow Finance by 2019. Completion of the Heathrow Finance and the ADIF2 financing will enable Heathrow to simplify its debt financing from four layers to three no later than 2019.

In terms of Class A debt, the highlight of the year was the issue in June 2017 of a €500 million, 15 year public bond with a fixed rate coupon of 1.875% which further strengthened Heathrow's presence in this market. Also in June 2017, a £100 million private placement from non-sterling sources which was signed in March 2017 was drawn and will mature in 2033 and 2037. In March 2017, Heathrow drew in full a £418 million term loan initially signed with a group of banks in June 2016 and increased by £68 million in early 2017. Finally, in July 2017 Heathrow entered into a £100 million 7 year term loan facility that is expected to be drawn later in 2018.

In May 2017, Heathrow Finance returned to the bond market for the first time since October 2014, raising £275 million in a highly successful 10 year public bond with a fixed rate coupon of 3.875%. In June 2017, the last undrawn £75 million of Heathrow Finance term loans agreed in 2016 was drawn. In December 2017, Heathrow drew £275 million in loan facilities that were temporarily repaid in June 2017 in order to optimise interest costs in 2017.

During 2017, Heathrow repaid €700 million (£584 million) and CHF400 million (£272 million) Class A bonds in January 2017 and February 2017 respectively. In March 2017, Heathrow Finance repaid a £265 million bond. Finally, £310 million of loan facilities at ADIF2 were repaid in July 2017. Since the start of 2018, Heathrow has repaid a €750 million (£510 million) Class A bond earlier in February 2018.

Looking ahead, Heathrow's 2018 debt financing targets are expected to be similar in scale to 2017.

Net debt and liquidity

At 31 December 2017, the Group's external nominal net debt increased 5.1% to £13,673 million at 31 December 2017 (2016: £13,005 million) and comprised £12,372 million in bonds, £1,445 million in term debt and £391 million in index-linked derivative accretion offset by £535 million cash at bank and term deposits. Nominal net debt comprised £10,625 million in senior net debt, £1,746 million in junior debt at the Company's subsidiaries and £1,302 million at the Company itself.

The average cost of the Group's nominal gross debt at 31 December 2017 was 3.92% (2016: 4.19%). This includes interest rate, cross-currency and index-linked hedge impacts and excludes index-linked accretion. Including index-linked accretion, the Group's average cost of debt at 31 December 2017 was 5.62% (2016: 5.24%). The reduction in the average cost of debt excluding index-linked accretion since the end of 2016 is mainly due to the replacement in 2017 of relatively high cost maturing legacy debt with newer lower cost debt. The increase in the average cost of debt including index-linked accretion since the end of 2016 has been driven by recent increases in inflation with the annual rate of retail price index ('RPI') inflation increasing from a low of 0.9% in March 2016 to 4.1% in December 2017. The average life of the Group's gross debt as at 31 December 2017, was 11.4 years.

Nominal debt excludes any restricted cash and intra-group borrowings. It includes all the components used in calculating gearing ratios under the Group's financing agreements including index-linked accretion.

The accounting value of the Group's net debt was £13,597 million at 31 December 2017 (2016: £13,268 million). This includes £523 million of cash and cash equivalents and £12 million of term deposits, as reflected in the statement of financial position, and excludes accrued interest. A reconciliation of total borrowings as per the statement of financial position to the Group's measure of net debt is shown in Note 25.

Financial review *continued*

Net debt and liquidity *continued*

Heathrow expects to have sufficient liquidity to meet all its obligations in full until September 2019.The obligations include forecast capital investment (including expected investment over the period related to potential expansion), debt service costs, debt maturities and distributions. This liquidity position takes into account £1.8 billion in undrawn loan facilities and term debt as well as cash resources at 31 December 2017 together with expected operating cash flow over the period.

Net finance costs and net interest paid

In the year ended 31 December 2017, the Group's net finance costs before certain re-measurements, from operations, were £825 million (2016: £748 million) and net interest paid was £549 million (2016: £578 million). Reconciliation from net finance costs on the income statement to net interest paid on the cash flow statement is provided below.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Net finance costs before certain re-measurements	**825**	738
Amortisation of financing fees and other items	**(33)**	(33)
Borrowing costs capitalised	**46**	35
Underlying net finance costs	**838**	742
Non-cash accretion on index-linked instruments	**(270)**	(139)
Other movements	**(19)**	(25)
Net interest paid	**549**	578

Underlying net finance costs were £838 million (2016: £742 million) after adjusting for capitalised borrowing costs of £46 million (2016: £35 million) and non-cash amortisation of financing fees, discounts and fair value adjustments of debt of £33 million (2016: £31 million). The increase in underlying net finance costs reflects higher index-linked accretion due to higher inflation in the period.

Net interest paid in the period was £549 million (2016: £578 million) of which £495 million (2016: £521 million) was paid by the Company's subsidiaries and £54 million (2016: £57 million) was paid by the Company. The reduction in interest paid primarily reflects the ongoing process of new lower cost financing replacing more expensive legacy debt.

Included within certain re-measurements is a £213 million fair value gain on financial instruments (2016: £522 million loss) driven primarily by a decrease in long term market inflation expectations, together with an increase in long term sterling swap rates, compared to the prior year which was driven by a combination of lower rates and higher inflation expectations following the outcome of the UK's referendum on membership of the European Union.

Net interest paid is lower than underlying net finance costs primarily due to a £270 million (2016: £139 million) non-cash charge relating to accretion on index-linked instruments

Financial ratios

The Group continues to operate comfortably within required financial ratios.

Gearing ratios under the Group's financing agreements are calculated by dividing using consolidated nominal net debt to Heathrow's Regulatory Asset Base ('RAB') value. At 31 December 2017, Heathrow's RAB was £15,786 million (2016: £15,237 million).

At 31 December 2017, the Group's senior (Class A) and junior (Class B) gearing ratios were 67.3% and 78.4% respectively (2016: 66.7% and 78.2% respectively) compared with trigger levels of 70.0% and 85.0% under its financing agreements. Heathrow Finance's gearing ratio was 86.6% (2016: 85.4%) compared to a covenant level of 90.0% under its financing agreements.

In the year ended 31 December 2017, the Group's senior and junior interest cover ratios (the ratio of cash flow from operations (excluding cash exceptional items) less tax paid less 2% of RAB to interest paid) were 3.55x and 2.81x respectively (2016: 3.12x and 2.50x respectively) compared to trigger levels of 1.40x and 1.20x under its financing agreements. Heathrow Finance's interest cover ratio was 2.52x (2016: 2.25x) compared to a covenant level of 1.00x under its financing agreements.

Strategic report *continued*

Financial review *continued*

Outlook

Traffic trends in the early weeks of 2018 have been consistent with expectations and forecast Adjusted EBITDA for 2018 remains consistent with the guidance set out in the investor report published in December 2017 of £1,830 million.

2018 will also see a number of developments in relation to Heathrow's expansion including the conclusion of Heathrow's first planning consultation in March, further regulatory updates starting in April and the Parliament vote on the final National Policy Statement by the end of June.

Leadership and governance

The discussion in this section is extracted from the financial statements of Heathrow Airport Holdings Limited, since the functions of the Board and Board Committees of Heathrow Airport Holdings Limited are applied equally to this Company.

Board of Directors of Heathrow Airport Holdings Limited
The Board consists of the Chief Executive Officer, the Chief Financial Officer and Non-Executive Directors. Board Meetings are attended also by the Company Secretary. More than half of the board are Non-Executive Directors. The majority of the Non-Executive Directors are shareholder representatives. The remaining minority are independent Non-Executive Directors.

The Board determines the Heathrow Airport Holdings Group's long-term strategy, to ensure that the Group acts ethically and has the necessary resources to meet its objectives, to monitor performance and to ensure the Group meets its responsibilities as a leading airport company.

Board Committees

Audit Committee
The Audit Committee members include a chairman appointed by the Board of Directors and three shareholder Non-Executive Directors, who also attend the Board.

Of the four members of the Audit Committee all, including the Chair, are non-executive directors. Together they have appropriate competence in accounting and auditing.

The Audit Committee is a sub-committee of the Board and its responsibilities include:

- considering the appointment of the external auditor, taking into account relevant ethical guidance and assessing the independence of the external auditor ensuring that key audit personnel are rotated at appropriate intervals (including overseeing the process for selecting the external auditor and making recommendations to the Board);
- recommending the audit fee to the Board for approval and pre-approving any fees in respect of non-audit services provided by the external auditor and ensuring that the provision of non-audit services does not impair the external auditor's independence or objectivity;
- discussing with the external auditor the nature and the scope of the audit and reviewing the auditor's quality control procedures and steps taken by the auditor to respond to changes in regulatory and other requirements;
- reviewing reports on the effectiveness of systems for internal financial control, financial reporting and risk management;
- monitoring the integrity of the financial statements of the Group and reviewing, and challenging where necessary, the actions and judgements of management, in relation to the interim and annual financial statements and any press release related to those statements;
- reviewing Internal Audit reports to the Audit Committee on the effectiveness of the Heathrow Airport Holdings Group's systems for internal control, financial reporting and risk management;
- reviewing the external auditor's management letter and management's responses;
- considering management's response to any major external or internal Audit recommendations;
- approving the appointment and dismissal of the Director of Internal Audit, Risk and Assurance;
- reviewing Heathrow's procedures for handling allegations from whistle-blowers;
- reviewing the ethics policy and monitoring its application throughout the business, considering any ethical issues which arise as a result of audit findings;
- overseeing all press releases relating to external financial results; and
- reviewing Heathrow's tax policy and insurance strategy and arrangements.

Nomination Committee
The Nomination Committee members include the Chairman of the Board, an independent Non-Executive Director and four shareholder Non-Executive Directors who attend the Board.

The Nomination Committee is a sub-committee of the Board and its responsibilities include:

- identifying and recommending for the consideration of the Board all new appointments of independent Non-Executive directors; and
- ensuring a formal, rigorous and transparent procedure is followed for the appointment of new independent Non-Executive directors to the Board.

Remuneration Committee
The Remuneration Committee members include a chairman appointed by the Board, three shareholder Non-Executive Directors who attend the Board and one independent Non-Executive Director.

The Remuneration Committee is a sub-committee of the Board and its responsibilities include approvals of:

Strategic report *continued*

Leadership and governance *continued*
Board Committees *continued*
Remuneration committee *continued*
- the remuneration policy of the members of the Executive Committee and Senior Managers;
- the compensation packages of the members of the Executive Committee (other than the Chief Executive Officer) including salary, bonus, pensions and other incentive compensation;
- the contractual terms for the members of the Executive Committee and independent Non-Executive Directors;
- the design and terms of bonus plans including approval of off-cycle bonus payments outside bonus guidelines including sign on, retention and guaranteed bonuses;
- the design and terms of long term incentive plans; and
- succession planning for the members of the Executive Committee.

Finance Committee
The Finance Committee members include a chairman appointed by the largest shareholder of FGP Topco Limited, the Chief Executive Officer, the Chief Financial Officer and a Non-Executive Director representing each shareholder entitled to appoint a director to the Board.

The Finance Committee is a sub-committee of the Board and also acts as a forum for obtaining consents required from the shareholders of FGP Topco Limited.

The Finance Committee is responsible for approving various matters relating to the Group's debt financing arrangements prior to their implementation including approval for:
- any prospectus or other listing document required in relation to the issuance of any capital markets instruments or any formal information memorandum in relation to borrowing by any member of the Group;
- the borrowing of any money or the assumption of any indebtedness by any member of the Group (including by way of the issue of securities) in excess of certain financial thresholds;
- the refinancing of any existing indebtedness in respect of any member of the Group in excess of certain financial thresholds;
- the making of any repayments of principal in addition to scheduled principal payments on any debt that may be owing by any member of the Group; and
- other than as required by the financing arrangements of any member of the Group, the making of any material loan or advance or giving of any guarantee, indemnity or provision of any credit, in each case in excess of certain financial thresholds.

Executive Committee
The Executive Committee consists of the Chief Executive Officer, the Chief Financial Officer, the Chief Operating Officer, the Chief Information Officer, the Chief of Staff and Group General Counsel, the Chief People Officer, Expansion Director, Chief Commercial Officer and Chief Strategy Officer.

The Executive Committee is the management committee of the Chief Executive and is responsible for, among other things, developing, reviewing and refreshing medium and long term Group business strategies, policies and development plans for Board approval, agreeing short-term tactics and action plans to ensure their delivery and reviewing the principal risks and the risk management framework.

Executive Risk Committee
The Risk Committee is chaired by the Chief of Staff and Group General Counsel and consists of the Chief Financial Officer, the Chief Operating Officer, the Director of Expansion and the Strategy Director. It is responsible for reviewing the effectiveness of the risk management strategy and framework and for reviewing the principal risks. The Risk Committee is a sub-committee of the Executive Committee.

Sustainability and Operational Risk Committee
The Sustainability and Operational Risk Committee (formerly the Responsible Heathrow and Operational Risk Committee) is chaired by an independent Non-Executive Director and its members include the Chief Executive Officer and three shareholder Non-Executive Directors who attend the Board.

The Sustainability and Operational Risk Committee is a sub-committee of the Board and its responsibilities include:
- reviewing Heathrow's policies, conduct, performance and risk management approach against sustainability goals and operational activities;
- reviewing and challenging the performance and conduct of the Group relating to operational risks and delivery of sustainability goals;
- monitoring and challenging management over the effectiveness of the relevant internal control systems and having access to any audit or assurance report it considers relevant;
- reviewing and assessing management's response to significant operational incidents and having access to any accident and investigation report it considers relevant; and
- monitoring and challenging the appropriateness of Sustainability and operational risk assurance strategies and plans, the execution and results of such plans, and relevant communications.

Strategic report *continued*

Internal controls and risk management

Internal controls and risk management are key elements of the Group's corporate operations. Risk is centrally managed within the Group as part of Corporate Services provided under the Shared Services Agreement ('SSA') by a fully dedicated senior team. The Corporate risk management function, sets the strategy for risk management to provide the necessary framework to ensure that key risks are managed and embeds a sustainable risk management culture that views the execution of risk management processes and practices across Heathrow as a key enabler to Heathrow achieving its business objectives.

Internal controls

The directors are responsible for the system of internal controls designed to mitigate the risks faced by the Group and for reviewing the effectiveness of the system. This is implemented by applying the Group internal control procedures, supported by a Code of Professional Conduct Policy, appropriate segregation of duties controls, organisational design and documented procedures. These internal controls and processes are designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against material misstatements or loss.

The key features of the Group's internal control and risk management systems in relation to the financial reporting process include:

- a group-wide comprehensive system of financial reporting and financial planning and analysis;
- documented procedures and policies;
- defined and documented levels of delegated financial authority;
- an organisational structure with clearly defined and delegated authority thresholds and segregation of duties;
- a formal risk management process that includes the identification of financial risks;
- detailed reviews by the Executive Committee and the Board of monthly management accounts measuring actual performance against both budgets and forecasts on key metrics;
- Audit Committee review of press releases and key interim and annual financial statements, before submission to the Board, scrutinising amongst other items;
  - compliance with accounting, legal, regulatory and lending requirements
  - critical accounting policies and the going concern assumption
  - significant areas of judgement and estimates;
  - key financial statement risk areas as reported further below in the report
- independent review of controls by the Internal Audit function, reporting to the AC; and
- a confidential whistleblowing process.

Risk management

Our aim is to gain a deep understanding of the principal risks we face at all levels of the business and to focus management attention on effective mitigation of these risks as well as a review of over-the-horizon emerging risks which may impact the business and strategy of Heathrow.

We continue to roll out a risk improvement plan which is focussed on improving accountability for end-to-end risk management at all levels and drive improvements in our risk culture. The risk improvement plan covers all the key elements of an effective risk management framework including risk leadership, informed risk decision making, competency and risk skills, governance including timeliness and transparency of risk information and clarity of accountability for managing risks. We assess and monitor our risk maturity across all key areas and drive improvements where required.

Principal risks

Our principal risks are aligned to our 4 strategic priorities as follows:

- to be a great place to work, we will help our people fulfil their potential and work together to lead change across Heathrow with energy and pride;
- to give passengers the best airport service in the world we'll work with the Heathrow community to transform the service we give to passengers and airlines, improving punctuality and resilience;
- to secure future investment we will beat the Q6 business plan and deliver a competitive return to our shareholders by growing our revenue, reducing costs and delivering investments more efficiently; and
- to grow and operate our airport sustainably, now and in the future.

Strategic report *continued*

Internal controls and risk management *continued*
Risk management *continued*
Prinicpal risk *continued*
The principal risks identified by the Executive Committee are:

Business resilience
Business resilience risks can relate to Heathrow's assets, infrastructure, human or electronic processes or systems, the failure of which, by accident or deliberate act, could result in prolonged periods of interruption to critical services/operations and passenger experience. There are a number of circumstances that can pose short-term risks to the normal operations at the airport such as shocks to the macroeconomic environment, terrorism, wars, airline bankruptcies, human health scares, weather conditions and natural disasters whose cause may be remote from Heathrow's location. These conditions can have a particularly significant impact where, due to operating close to full capacity, there is negligible spare capacity to utilise in recovering from some of the above conditions.

Where possible the Group seeks to anticipate the effects of these events on its operations and also maintains contingency plans to minimise disruption and passenger inconvenience working as necessary with those parties who have direct contractual responsibility. Through a series of programmes the Group seeks to keep a competent, flexible and motivated workforce that can respond to a changing business and operating environment. By driving engagement in its people the Group will achieve its goals and give excellent passenger service, avoid safety and security incidents, protect resilience and deliver successful change.

People
Heathrow employs around 6,500 colleagues and, in a complex business such as Heathrow's, there are risks associated with recruiting, screening, motivating, developing and training employees on a large scale, as well as rewarding appropriately and retaining critical talent and ensuring succession plans are in place.

Heathrow has a transparent recruitment process and is committed to recruiting diverse talented individuals from all sectors of the community. Heathrow has committed to reflecting local diversity at all levels in the company by 2025. At all stages of the recruitment and selection process, interviewing and selection will always be carried out without regard to gender, sexual orientation, disability, marital status, colour, race, ethnic origins, religion or religious belief or age. Any candidate with a disability will not be excluded unless it is clear that the candidate is unable to perform a duty which is intrinsic to the role, having taken into account any reasonable adjustments. Reasonable adjustments to the recruitment process will be made to ensure an applicant is not disadvantaged due to his/her disability. All successful external candidates are subject to a criminal records check and the appropriate security clearance as required by the role.

Heathrow has strategies and policies in place to engage and motivate its colleagues so they are excited and challenged by their work environment, accountable and compliant with internal governance, policies and procedures. Heathrow provides great career opportunities, development and training, retaining talent and knowledge and preventing single points of failure.

Anti-corruption and anti-bribery matters
Heathrow takes a zero-tolerance approach to bribery and corruption, and is committed to conducting its business in an honest and ethical manner, in compliance with the Bribery Act 2010 (the "Bribery Act") and applicable anti-bribery and anti-corruption laws. Breach of anti-bribery provisions by Heathrow employees, paid or voluntary agents, consultants or suppliers could result in Heathrow breaching the Bribery Act by failing to prevent an act of bribery being committed. If Heathrow is found guilty of such an offence, Heathrow could face an unlimited fine, exclusion from tendering for public companies, as well as significant reputational damage. As such, Heathrow embeds and maintains robust Anti-Bribery, Gifts & Hospitality Policy and Guidance (the "Anti-Bribery Policy") and other effective systems and controls to prevent bribery and corruption at Heathrow. All employees and third parties associated with Heathrow are required to conduct themselves according to the standards set out in the Anti-Bribery Policy. Any breach of the Anti-Bribery Policy will result in disciplinary action, and, if appropriate, in instant dismissal and referral to the relevant law enforcement authorities. In addition, our Whistleblowing Policy encourages individuals to report any wrong-doing which extends to bribery and corruption matters. All whistleblowing reports are treated in the strictest confidence and are investigated fully with appropriate actions taken.

Corporate social responsibility
Heathrow understands the importance to its business of the communities in which it operates, and through consultation and engagement seeks to ensure that their concerns are taken into account in the operation and planning of Heathrow. It may restrict opportunities to grow and threaten Heathrow's social license to operate if local communities do not believe the airport is managed responsibly or that its economic benefits are optimised without prioritising profits over the long- term interests of local communities.

Environmental risk has the potential to impact negatively upon Heathrow's reputation and jeopardise its licence to operate and to grow.

The Group undertakes procurement responsibly and encourages trade and employment opportunities for local communities. Progressive influencing of third parties, stakeholder engagement and community relations programmes are also established.

Strategic report *continued*

Internal controls and risk management *continued*

Risk management ***continued***

Principal risks continued

Corporate social ***responsibility continued***

Proactive environmental management systems and employee training programmes are embedded within operations through clear environmental strategies and resource conservation initiatives. The Group works closely with a range of stakeholders to ensure that it reacts effectively to the challenges posed by the environmental agenda.

Operational risks to the delivery of Responsible Heathrow goals are reviewed and monitored by a separate committee of the Board.

Stakeholders

Poor interactions and relationships with key stakeholders including partners, suppliers and airlines could negatively impact passenger experience, airport operations, financial performance and Heathrow's reputation.

Heathrow aims to manage its contracts effectively and share with airport partners the information it may hold about their service providers. This is underpinned by robust and responsible procurement practices which consider the resilience and sustainability of suppliers before contracts are commenced with them, as well as frequent monitoring of their operational performance once they commence business with the airport.

Legal, regulation and compliance

Operations at Heathrow airport are currently subject to economic regulatory review by the CAA normally every five years. Its principal risks relate to changes in economic regulations, non-compliance with these and other regulations, licence conditions, financing covenants, contractual requirements and penalties for failing to comply with competition and relevant EU law. Failure to comply with laws and regulations can have far reaching consequences, including loss of licence, penalties, claims and litigation, reputational damage and loss of stakeholder confidence.

The risk of an adverse outcome from economic regulatory reviews is mitigated as far as possible by a dedicated project team which ensures full compliance with regulatory requirements, establishes a sound relationship with the regulator and advises the Executive Committee and Board on regulatory matters. Clear policy direction, which includes compulsory awareness training and close support from the internal legal department, reduces the risk of Heathrow breaching laws, regulations and contractual requirements.

Health and safety

Heathrow has a statutory and moral responsibility to ensure that it safeguards the welfare and safety of its people, business partners and the public who may be affected by its activities. Heathrow recognises that a failure to exercise this responsibility effectively also risks operational disruption, inconvenience to passengers and long-term damage to its reputation.

Heathrow's Safety Management System includes risk assessment processes for all activities entailing significant risk and proportionate control measures employed to safeguard everyone impacted by the airport's business. Heathrow also operates robust asset management processes to ensure property and equipment remains safe. Governance, led by the airport's senior management teams, and assurance processes are used to ensure that controls around health and safety risks remain effective and continuous improvement is encouraged.

Security

Heathrow is responsible for ensuring that its assets, infrastructure, human and electronic systems and processes meet the minimum statutory requirements to protect aviation security, deliver high security standards and build confidence with regulators, airlines and passengers. It also needs to ensure that its assets, infrastructure, human and electronic systems are protected from theft, damage or intrusion.

Security risks, including cyber security, terrorism risks, and information security are mitigated by adopting and enforcing rigorous policies and procedures supported by professional training and by investment in leading edge security technology. Heathrow works closely with airlines and government agencies including the police building a framework to establish joint accountabilities for airport security and shared ownership of risk, thus ensuring security measures remain both flexible and proportionate to the prevailing threat environment.

Strategic direction and management of change

Heathrow airport is operating its runways at close to full capacity and failure to secure the necessary Development Consent Order, following a robust consultation process, for the third runway, for which Heathrow is the preferred choice of the UK Government, could lead to increased congestion, passenger delay and lack of opportunity for the UK.

Monitoring developments in the global aviation market and the levels of passenger satisfaction with different airports around the world provides input to the on-going relevance of the Group's strategy. The Group also needs to influence the pace and direction of changes to regulations, legislation, government policy, aviation and the wider economy and ensure that it does not lose airlines' support for expansion.

Strategic report *continued*

Internal controls and risk management *continued*
Risk management *continued*
Strategic direction and management of change continued
Heathrow recognises that failure to control key development costs and delivery could damage its financial standing and reputation. There are risks that projects fail to deliver to the agreed quality, specification, time and budget as well as risks that the benefits of change are not realised, return on investments not realised and transformation not delivered.

The planning process for all major national infrastructure projects in the UK sets out a number of steps that The Group needs to go through to obtain development consent to expand Heathrow: a National Policy Statement, a Development Consent Order and public consultation before a final decision is taken by the UK Government for the third runway. The Group's planning process is well underway and it is building an organisation and expertise to ensure this process runs smoothly. Heathrow will undertake extensive consultations with community groups and authorities at a local level and is an active participant in government consultations and other advisory groups.

The risk of unanticipated long-term changes in passenger demand for air travel could lead to a shortfall in revenue and misaligned operational capacity within Heathrow. Since it is not possible to identify the timing or period of such an effect, the Group carries out evaluations through a series of scenario planning exercises. Risks associated with the uncertainties arising from the current Brexit negotiations are monitored and managed as far as possible including putting in place contingency plans.

The regulatory framework requires formal engagement with airline customers. Helping manage the risk of adverse airline relations, all airlines are invited to be represented on engagement fora – e.g. joint steering groups. When feedback is sought or processes are measured, robust steps have been put in place to ensure confidentiality and neutrality of interpretation. In addition, key stakeholders are engaged on a joint planning basis which provides airlines with the opportunity to air views and share plans, thereby ensuring their ongoing requirements are articulated and understood.

Heathrow mitigates project risks through adherence to a robust project process and by a system of assurance, consisting of project and programme reviews before approval and during construction. The process is continually improved incorporating lessons learnt and "best practice" distilled from knowledge sharing with other client programmes, expertise within its supply chain and guidance from professional bodies.

Financial stability
The Board approves prudent treasury policies and delegates certain responsibilities including changes to treasury policies, the approval of funding and the implementation of funding and risk strategy to the Heathrow Finance Committee. Senior management directly control day-to-day treasury operations on a centralised basis.

The treasury function is not permitted to speculate in financial instruments. Its purpose is to identify, mitigate and hedge treasury-related financial risks inherent in the Group's business operations and funding. To achieve this, the Group enters into interest rate swaps, index-linked swaps, cross-currency swaps and foreign exchange contracts to protect against interest rate, inflation and currency risks.

The primary treasury-related financial risks faced by the Group are:

(a) Interest rates
The Group maintains a mix of fixed and floating rate debt. As at 31 December 2017, fixed rate debt after hedging with derivatives represented 97% of the Group's total external nominal debt.

(b) Inflation
The Group mitigates the risk of mismatch between Heathrow's aeronautical income and regulatory asset base, which are directly linked to changes in the retail prices index, and nominal debt and interest payments, by the issuance of index-linked instruments.

(c) Foreign currency
The Group uses cross-currency swaps to hedge all interest and principal payments on its foreign currency debt. The Group uses foreign exchange contracts to hedge material capital expenditure in foreign currencies once a project is certain to proceed.

(d) Funding and liquidity
The Group has established both investment grade (at the Heathrow (SP) level) and sub-investment grade (at the Heathrow Finance level) financing platforms for Heathrow. The Heathrow (SP) platform supports term loans, various revolving loan facilities including revolving credit facilities, working capital facilities and liquidity facilities, and Sterling and foreign currency capital markets issuance. All debt is secured and can be issued in either senior (A-/A-) or junior (BBB/BBB) format. The Heathrow Finance platform is rated BB+/Ba3 and supports both loan and bond debt. Covenants are standardised wherever possible and are monitored on an on-going basis with formal testing reported to the Audit Committee, the Board and Executive Committee.

Strategic report *continued*

Internal controls and risk management *continued*
Risk management *continued*
Financial stability *continued*

Although there can be no certainty that financing markets will remain open for issuance at all times, debt maturities are spread over a range of dates, thereby ensuring that the Group is not exposed to excessive refinancing risk in any one year.

Heathrow Finance has positive cash flows after capital expenditure and interest and expects to have sufficient liquidity to meet all its obligations in full, including capital investment, debt service costs, debt maturities and distributions, up to December 2018. As at 31 December 2017, the Group had cash and cash equivalents and term deposits of £535 million, undrawn headroom under revolving credit facilities of £1,150 million, committed term debt financing to be drawn after 31 December 2017 of £100 million and undrawn headroom under liquidity facilities of £600 million.

(e) Counterparty credit
The Group's exposure to credit related losses, in the event of non-performance by counterparties to financial instruments, is mitigated by limiting exposure to any one party or instrument.

The Group maintains a prudent split of cash and cash equivalents across a range of market counterparties in order to mitigate counterparty credit risk. Board approved investment policies and relevant debt facility agreements provide counterparty investment limits, based on short and long-term credit ratings. Investment activity is reviewed on a regular basis and generally no cash or cash equivalents are placed with counterparties with short-term credit ratings lower than A-2 (S&P)/F1(Fitch). The Group monitors the credit rating of derivative counterparties on a daily basis and ensures no positions are entered into with counterparties with a long-term credit rating below BBB+ (S&P)/BBB+ (Fitch).

Financial statements risk
The Audit Committee reviewed critical accounting judgements and key sources of estimation uncertainty outlined in the "Accounting policies" section of the financial statements. Based on the discussion with the management, work and recommendation of the Group finance function and input from external auditor, the Committee considered that the most significant financial statements risk matters are as follows:

(i) Classification of costs between operating expenditure and capital expenditure

The Group has a substantial Q6 capital programme which has been agreed with the regulator (the Civil Aviation Authority) and therefore incurs significant expenditure investing in assets to improve operational performance, airport resilience and passenger experience. Since October 2016, the Group has also begun investing in Expansion.

Only those costs which satisfy the requirements of IAS16 *'Property, Plant and Equipment'* should be capitalised, which in some cases requires management judgement. Controls and processes related to capital expenditure are directed by the Fixed Asset Steering Group (chaired by the CFO), which reports regularly to the Audit Committee through formal Committee papers and provides them with the opportunity to scrutinize and challenge the judgement made.

The Group has a Property, plant and equipment ("PP&E") Accounting Policy, which outlines the requirements for costs to be eligible for capitalisation and a separate Capitalised Interest Policy which applies to interest costs incurred whilst a project is under construction. Both the PP&E Accounting Policy and the Capitalised Interest Policy are formally published on and communicated to management and employees via the Group's intranet site. These policies are applied and their application is monitored on a regular basis to ensure that all costs eligible for capitalisation and interest costs incurred whilst a project is under construction are correctly capitalised. The PP&E Accounting Policy has been updated to ensure clarity around the treatment of costs relating to Expansion.

Each capital project follows a defined project governance process. This includes a Financial Assurance Review by the Heathrow Finance department which concludes on the appropriate accounting treatment in accordance with the Group's capitalisation policy for the expenditure to be incurred on the project. The project governance process also includes each project being reviewed and approved by the relevant Governance Groups, including the Heathrow Investment Committee for significant projects.

The spend on the project is reviewed and approved by appropriate delegated financial authorities ensuring the correct classification of cost. The Programme Management Office (PMO) is responsible for tracking and monitoring spend against the project cost plan, and when the project is completed a final review of costs incurred is carried out by Finance before transferring the capital cost of the project to the Fixed Asset Register.

Strategic report *continued*

Internal controls and risk management *continued*
Risk management *continued*
Financial statements risk *continued*
Heathrow is currently in the process of obtaining a Development Consent Order (DCO) for Expansion. Particular emphasis is being placed on ensuring that capitalised costs will deliver future economic benefit and are directly attributable to obtaining DCO, through regular reviews and senior leadership involvement. The CAA and independent consultants have also been engaged in reviewing planned and actual capitalised costs (*ex ante* and *ex post)* to ensure that they are efficient, incremental, and directly attributable to obtaining DCO.During the year ended 31 December 2017 the Group recorded £83 million of such expansion related costs in assets in the course of construction (2016: £9 million).

(ii) Hedge accounting

The Group designates certain derivative financial instruments as cash flow hedges where they hedge exposure to variability in cash flows of existing liability or forecast transaction. Significant changes in the expected quantum of future Sterling refinancing may lead to insufficient Sterling borrowings to support components of the cash flow hedge reserve, requiring the recycling of the cash flow hedge reserves through income statement.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for cash flow hedge accounting, any cumulative gain or loss in equity remains in equity and is recycled on a straight line basis as the forecast transaction is recognised in the income statement. When or if a forecast transaction is no longer expected to occur, the cumulative gain or loss in equity is immediately recycled through the income statement.

The Group documents as follows:
- at inception of the transaction, the relationship between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedging transactions;
- both at inception and on an on-going basis, its assessment of whether the derivative financial instruments used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

On a quarterly basis, management:
- compares existing and historic hedging arrangements against expectations of future refinancing of Sterling denominated borrowings;
- reviews floating Sterling debt supporting the existing Cash Flow Hedge Reserve ('CFHR') to ensure the debt is greater than swap notional, which supports the existing designations.

On a semi-annual basis, management provides updates to the Audit Committee on CFHR and its assumptions.

(iii) Fair value of derivative financial instruments

The Group holds a substantial derivative financial instruments portfolio comprising interest rate swaps, cross currency swaps, and index-linked swaps which are accounted for at fair value. In determining the fair value, judgement is used to determine the recovery rate and associated reduction in credit risk of super senior ranking derivatives (interest rate and index-linked swaps). Due to the significance of the Group's derivative financial instruments and the related estimation uncertainty, there is a risk that derivative financial instruments are not valued based on appropriate assumptions and / or estimates.

The valuation of the Group's derivative financial instruments is determined through the application of a discounted cash flow approach and the use of inputs based on observable market data where these are available. The fair value of cross-currency, interest rate and index-linked swaps is calculated as the present value of the estimated future cash flows based on observable yield curves. The credit risk associated with the Group's derivative financial instruments is updated monthly based on current market data. The recovery rate and associated reduction in credit risk of super senior ranking derivatives (interest rate and index-linked swaps) is validated quarterly with a counterparty bank.

In 2017, management was successful in improving the automation of the Treasury Accounting System (Reval). Key benefit includes the automation of the credit risk adjustments which forms part of the monthly derivative valuation process. Minimal manual input is now required.

Strategic report *continued*

Internal controls and risk management *continued*
Risk management *continued*
Financial statements risk *continued*
(iv) Fair value of investment properties

The Group holds a variety of investment properties that are accounted for at fair value. In determining the fair value, judgement is required with regard to a number of valuation assumptions that include property rental growth rate, operating cost and expected yields.

Independent valuations are obtained for all investment properties. The valuations are prepared in accordance with the appraisal and valuation manual issued by the Royal Institution of Chartered Surveyors. Valuations are carried out having regard to comparable market evidence relevant to each specific property or class of properties.

In assessing fair value, current and potential future income (after deduction of non-recoverable outgoings) is capitalised using yields derived from market evidence. This market evidence also takes into account planned transactions and use of the property.

On behalf of the Board

Javier Echave
Director

21 February 2018

Directors' report

The directors present their annual report and the audited financial statements for the year ended 31 December 2017.

Principal activity
The principal activity of Heathrow Finance plc is as the holding company of Heathrow (SP) Limited. Heathrow (SP) Limited is the holding company for Heathrow (AH) Limited, owner of Heathrow Airport Limited, operator of the Heathrow Express rail service and owner of Heathrow Funding Limited, the bond issuer of the Group.

A review of the progress of the Group's business during the year, the key performance indicators, internal controls, principal business risks and likely future developments are contained in the Strategic report on pages 2 to 28.

Results and dividends
The profit after taxation for the financial year amounted to £503 million (2016: £127 million loss).

Dividends of £335 million (2016: £616 million) were paid to Heathrow (DSH) Limited during the year. The dividend payments were utilised primarily to fund dividends to the Group's ultimate shareholders and to repay and service external debt at the Group's holding companies.

The statutory results for the year are set out on page 39.

Directors
The directors who served during the year and since the year end, except where noted, were as follows:

Javier Echave	
Andrew Efiong	
Nicholas Golding	Appointed 17 January 2017
David Williamson	Resigned 9 January 2017

Employment policies
The Group's employment policies are regularly reviewed and updated to ensure they remain effective. The Group's overall aim is to create and sustain a high performing organisation by building on the commitment of its people.

The Group has defined a set of guiding principles to ensure fair recruitment and selection. The Group continues to aim to recruit, retain and develop high calibre people and has talent and succession management programmes for managerial roles.

The Group is committed to giving full and fair consideration to applicants for employment. Every applicant or employee will be treated equally whatever their race, nationality, ethnic or national origin, sex, marital status, sexual orientation, religious belief, disability, age or community background. The Group actively encourages a diverse range of applicants and commits to fair treatment of all applicants. The Group's investment in learning and development is guided by senior line managers who ensure that the Group provides the learning opportunities to support the competencies that are seen as key to the Group's success.

Disabled persons have equal opportunities when applying for vacancies, with due regard to their aptitudes and abilities. The Group has further procedures to ensure that disabled colleagues are fairly treated in line with the Equality Act (2010). Where employees have become disabled during the course of employment, the Group endeavours to ensure continuing employment through the arrangement of appropriate training.

Employee involvement and consultation is managed in a number of ways including employee surveys, team updates, briefings, road shows and an intranet. Collective bargaining takes place with the unions Unite, PCS and Prospect for those employee groups for which these unions are recognised. The Group is committed to managing people through change fairly.

Together these arrangements aim to provide a common awareness amongst employees of the financial and economic factors affecting the performance of their business. Bonuses paid to employees reflect the financial performance of the business. A Share In Success saver scheme in which eligible employees can save money which the company matches as a contribution in line with business performance has been in place since 2015. In addition, some senior management participate in long-term incentive plans which also rewards based on group performance.

The Group has no direct employees. The staff are employed by LHR Airports Limited, a fellow subsidiary entity of the Heathrow Airport Holdings group. The Group directly incurs the employment cost of services provided to the Group as stated in the Accounting policies on page 44.

Directors' report *continued*

Donations

The Group's charitable donations for the year amounted to £2 million (2016: £2 million). The beneficiaries of charitable donations, the relevant amounts donated and the activities of these beneficiaries are as follows:

Hillingdon Community Trust (charity number: 1098235)	£1,000,000	Heathrow Airport Limited made a 15 year commitment ending 2017 to make an annual grant of £1 million to the Hillingdon Community Trust. The deed of gift to the Trust carries a requirement that grants must benefit the community in the southern part of the Borough of Hillingdon including Hayes (the wards of Botwell, Townfield and Pinkwell, West Drayton, Yiewsley and the Heathrow Villages).
LHR Airport Communities Trust (charity number: 1058617)	£700,000	Heathrow Airport Limited made a donation to the charity LHR Airport Communities Trust, an independently run grant-making charity which operates the Heathrow Community Fund. The fund also received income from the proceeds of noise fines collected by Heathrow. Through the fund grant programme the charity supports significant and positive change for communities near the airport, with a priority on funding projects linked to education, the environment and economic regeneration. The charity also supports airport staff volunteering and fundraising to improve their community for a cause they believe in.

Directors' report *continued*

Donations *continued*
Heathrow continued fundraising for the benefit of Oxfam during the year, which represented the fifth year of the charity partnership with Oxfam. In April 2017, Heathrow passed the fantastic milestone of having raised £1 million for Oxfam since the beginning of the partnership and in 2017, a total of £363,423 was raised.

Internal controls and risk management
The Group actively manages all identified corporate risks and has in place a system of internal controls designed to mitigate these risks. Details of the Group's internal controls and risk management policies can be found on pages 22 to 28 in the internal controls and risk management section of the Strategic report.

Financial risk management objectives and policies
The Group's financial risk management objectives and policies, including hedging policies, along with the Group's exposure to risk can be found on pages 22 to 28 in the Internal controls and risk management section of the Strategic report.

Directors' indemnity
The Company's Articles of Association provide that, subject to the provisions of the Companies Act 2006, but without prejudice to any protection from liability which might otherwise apply, every director of the Company shall be indemnified out of the assets of the Company against any loss or liability incurred by him in defending any proceedings in which judgement is given in his favour, or in which he is acquitted or in connection with any application in which relief is granted to him by the court for any negligence, default, breach of duty or breach of trust by him in relation to the Company or otherwise in connection with his duties or powers or office.

Auditor
Pursuant to the provisions of section 485 of the Companies Act 2006, a resolution relating to the reappointment of the auditor Deloitte LLP will be proposed within the period set out in section 485 or, Deloitte LLP will be deemed re-appointed where no such resolution is proposed, following the period set out in section 485 in accordance with section 487.

Statement of disclosure of information to the Auditor
Each of the persons who is a director at the date of approval of this Annual report confirms that:
- so far as the director is aware, there is no relevant audit information of which the Company's auditor is unaware; and
- the director has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

On behalf of the Board

Javier Echave
Director

21 February 2018

Company registration number: 06458635

Heathrow Finance plc

Directors' responsibilities statement

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and the parent company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), including FRS 101 "Reduced Disclosure Framework". Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period.

In preparing the parent company financial statements, the directors are required to:
- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

In preparing the group financial statements, International Accounting Standard 1 requires that directors:
- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- make an assessment of the company's ability to continue as a going concern.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

On behalf of the Board

Javier Echave
Director

21 February 2018

Independent auditor's report to the members of Heathrow Finance plc for the year ended 31 December 2017

Opinion

In our opinion:

- The financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2017 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including FRS 101 "Reduced Disclosure Framework"; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS regulation.

We have audited the financial statements of Heathrow Finance Plc (the 'parent company') and its subsidiaries (the 'group') which comprise:

- the consolidated income statement;
- the consolidated statement of comprehensive income;
- the consolidated and parent company statements of financial position;
- the consolidated and parent statement of changes in equity;
- the consolidated cash flow statement;
- the group and parent company accounting policies; and
- the notes to the consolidated financial statements 1 to 28 and to the parent company financial statements 1 to 11.

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the group and the parent company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or parent company.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were in relation to the following balance sheet items: • Property, plant and equipment: classification of costs • Financial instruments: derivative valuations and appropriateness of hedge accounting; and • Valuation of investment properties: car parks
Materiality	£59.5m determined on the basis of 3.4% EBITDA.
Scoping	Full audit procedures were performed over 100% of the Group's total net assets and 100% of the Group's EBITDA.

Independent auditor's report to the members of Heathrow Finance plc for the year ended 31 December 2017 *continued*

Conclusions relating to going concern

We are required by ISAs (UK) to report in respect of the following matters where: • the directors' use of the going concern basis of accounting in preparation of the financial statements is not appropriate; or • the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the group's or the parent company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.	**We have nothing to report in respect of these matters.**

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Property, Plant and Equipment:	Classification of Costs
Key audit matter description	The Group is committed to a significant programme of enhancement and has recently launched a consultation around expansion. In 2017, the Group capitalised £683m of costs (2016: £666m) including £83m of expansion costs (2016: £9m). Determining whether expenditure should be capitalised in line with the appropriate criteria of IAS 16 can involve significant judgement. In addition, previously capitalised assets that are replaced or refurbished need to be appropriately removed from the fixed asset register. As noted on the Audit Committee section on page 27 of the annual report and page 56 of critical judgements, the Group considers that the project to expand the airport with the development of a third runway to be highly probable. There is judgement in regards to the appropriateness of capitalisation of expansion costs, both in respect of the risk of the project not proceeding and the appropriateness of the capitalisation of these costs under IAS 16. In order for costs to meet the capitalisation criteria, they need to be directly attributable to obtaining planning consent and relate to the development phase of expansion. We consider there to be a risk that capitalised costs do not meet the definition of capital expenditure and should be treated as operating costs. Due to the complexity of the classification of costs, and hence the level of management judgement involved, we deemed this a potential fraud risk for our audit.
How the scope of our audit responded to the key audit matter	• We tested a sample of capitalised costs to assess that they have been appropriately accounted for. This included testing the accounting for disposals when purchased additions replaced existing assets; • We tested a sample of transfers from assets in the course of construction to the main asset pools; • We reviewed management's revised capitalisation policy and calculations for capitalisation of directly attributable costs and assessed that it is consistent with the requirements set out by IAS 16, this policy also applied to expansion costs; • We reviewed management's assessment of the probability of the third runway project; and • We challenged the nature of costs as development costs and compared to other industry practice.

Independent auditor's report to the members of Heathrow Finance plc for the year ended 31 December 2017 *continued*

Key observations	The results of our procedures were satisfactory. We concur with the judgements made in regards to the classification of costs.

Financial Instruments: derivative valuation and appropriateness of hedge accounting	
Key audit matter description	As noted on the Audit Committee section on page 27 of the Annual Report and page 56 in key sources of estimation uncertainty the Group holds a substantial derivative portfolio comprising interest rate swaps, cross currency swaps and retail price index ("RPI") swaps, which are recorded at fair value. These are held to mitigate interest rate and foreign exchange risk arising on material levels of debt due to the capital programme, as well as inflation risk which arises in inflation linked revenue. At 31 December 2017, the Group has a net derivative liability of £852m (2016: £668m). IAS 39 "Financial Instruments: Recognition and Measurement" requires derivatives to be accounted for at fair value with movements recognised in profit or loss, unless designated in a hedge relationship. Where possible, management has elected to apply hedge accounting. We focused in particular on the following areas; • Judgements in the valuation of financial instruments, specifically in relation to new and restructured trades, and the associated accounting impact of swap restructures; • The eligibility of hedge relationships for new and restructured trades, which are complex; and • The impact on valuations for changes in credit risk.
How the scope of our audit responded to the key audit matter	We, with the involvement of our financial instrument specialists have: • Performed independent valuation testing on a sample of new and restructured trades, including the credit value adjustment and debit value adjustment in order to assess the appropriateness of the credit risk adjustments; • Performed independent hedge effectiveness testing for a sample of hedge relations- focusing on new and restructured detailed testing on a sample basis for whether the criteria for hedge accounting had been met and the hedges were effective; • Considered the appropriateness of accounting treatment arising from the restructuring of index-linked swaps; and • Tested the accounting entries for fair value calculations and hedge effectiveness, including the allocation between equity and the income statement.
Key observations	We are satisfied that the financial instrument valuations and hedge accounting have been accounted for appropriately.

Valuation of Investment Property: Car Parks	
Key audit matter description	The Group holds investment properties around Heathrow Airport including: rental properties (residential and commercial), car parks, fuel farms and advertising sites. The Group applies the fair value method in accounting for all investment properties as per IAS 40 "Investment Property" which also requires disclosure in respect of the valuation methodology applied and the significant assumptions applied in determining fair value. The Group engaged a valuation expert. We have focused the risk on the valuation of car parks which amount to 54% of investment properties (2016: 55%). As described on page 56 in key sources of estimation and uncertainty their valuation is subjective and inherently judgemental in nature, being based on a discounted cash flow which is sensitive to forecast passenger numbers and industry costs.

Independent auditor's report to the members of Heathrow Finance plc for the year ended 31 December 2017 *continued*

How the scope of our audit responded to the key audit matter	We, together with our Real Estate expert have: • Held discussions with management and their valuation expert to understand changes to valuations and key assumptions; • Reviewed the valuation approach used by management, including challenging their valuations, supporting information and market commentary; • Challenged the assumptions applied to the discounted cash flow calculations; • Tested the information provided to management's valuation expert on a sample basis to assess for accuracy; and • Assessed the financial statements against the disclosure requirements of IAS 40.
Key observations	We are satisfied that the assumptions and methodology applied in respect of the valuation of the car parks are appropriate.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Parent company financial statements
Materiality	£59.5m	£56m
Basis for determining materiality	3.4% of EBITDA.	0.9% of Net Assets.
Rationale for the benchmark applied	The Group operates stable trading business. We have used a profit adjusted measure of EBITDA as the benchmark, reflecting the Group's underlying trading performance, consistent with the Group's internal and external reporting.	The main purpose of the parent company is investment holding and we have therefore used net assets as the benchmark.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £3.1m as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

Our Group audit scope for the current and prior year included a full statutory audit of all five subsidiaries of the group plus the parent company, which covered 100% of the Group's total revenue, profit before tax and net assets. The materiality used for these subsidiaries ranged from £56m to £1.5m.

The Group team audits all of the subsidiaries directly.

At the Parent Company level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specific balances.

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

We have nothing to report in respect of these matters.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the group's and the parent company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the group or the parent company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Use of our report

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Companies Act 2006

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the directors' report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the group and of the parent company and their environment obtained in the course of the audit, we have not identified any material misstatements in the strategic report or the directors' report.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made.

We have nothing to report in respect of this matter.

Other matters

Auditor tenure

Following the recommendation of the audit committee, we were appointed by the Board of Directors on 14 July 2010 to audit the financial statements for the year ended 31 December 2010 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 8 years, covering the years ended 2010 to 2017.

Consistency of the audit report with the additional report to the audit committee

Our audit opinion is consistent with the additional report to the audit committee we are required to provide in accordance with ISAs (UK).

Jacqueline Holden FCA (Senior statutory auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom
21 February 2018

Heathrow Finance plc

Consolidated income statement for the year ended 31 December 2017

	Note	**Year ended 31 December 2017** Before certain re-measurements £m	Certain re-measurements [1] £m	Total £m	Year ended 31 December 2016 Before certain re-measurements £m	Certain re-measurements [1] £m	Total £m
Continuing operations							
Revenue	*1*	**2,884**	**-**	**2,884**	2,807	-	2,807
Operating costs	*2*	**(1,818)**	**-**	**(1,818)**	(1,798)	-	(1,798)
Other operating items							
Fair value gain on investment properties	*6*	**-**	**149**	**149**	-	44	44
Operating profit		**1,066**	**149**	**1,215**	1,009	44	1,053
Financing							
Finance income		**213**	**-**	**213**	221	-	221
Finance costs		**(1,038)**	**-**	**(1,038)**	(959)	-	(959)
Fair value gain/(loss) on financial instruments		**-**	**215**	**215**	-	(522)	(522)
	3	**(825)**	**215**	**(610)**	(738)	(522)	(1,260)
Profit/(loss) before tax		**241**	**364**	**605**	271	(478)	(207)
Tax (charge)/credit before change in tax rate		**(54)**	**(48)**	**(102)**	(60)	84	24
Change in tax rate		**-**	**-**	**-**	-	56	56
Taxation (charge)/credit	*4*	**(54)**	**(48)**	**(102)**	(60)	140	80
Profit/(loss) for the year[2]		**187**	**316**	**503**	211	(338)	(127)

[1] Certain re-measurements consist of: fair value gains on investment property revaluations and disposals, gains and losses arising on the re-measurement and disposal of financial instruments, together with the associated fair value gains and losses on any underlying hedged items that are part of a fair value hedging relationship, the effects of the changes in tax rate; and the associated tax impact of these.
[2] Attributable to owners of the parent.

Heathrow Finance plc

Consolidated statement of comprehensive income for the year ended 31 December 2017

	Note	**Year ended 31 December 2017 £m**	Year ended 31 December 2016 £m
Profit/(loss) for the year		**503**	(127)
Items that will not be subsequently reclassified to the consolidated income statement:			
Actuarial loss on pensions			
Gain on plan assets[1]	*21,22*	**62**	501
Increase in scheme liabilities[1]	*21,22*	**(116)**	(688)
Tax relating to indexation of operational land	*14,21,22*	**2**	1
Change in deferred tax due to tax rate change	*14,21,22*	**-**	6
Items that may be subsequently reclassified to the consolidated income statement:			
Cash flow hedges:			
(Losses)/gains taken to equity[1]	*21*	**(105)**	264
Transferred to income statement[1]	*21*	**121**	(241)
Change in deferred tax due to tax rate change	*14,20,21*	**-**	(7)
Other comprehensive loss for the year net of tax		**(36)**	(164)
Total comprehensive income/(loss) for the year		**467**	(291)
Attributable to owners of the parent		**467**	(291)

[1] Items in the statement above are disclosed net of tax. The tax relating to each component of other comprehensive income is disclosed in Note 21.

Heathrow Finance plc

Consolidated statement of financial position as at 31 December 2017

	Note	**31 December 2017 £m**	31 December 2016 £m
Assets			
Non-current assets			
Property, plant and equipment	*5*	**11,481**	11,483
Investment properties	*6*	**2,350**	2,200
Intangible assets	*7*	**175**	122
Derivative financial instruments	*12*	**444**	676
Trade and other receivables	*9*	**601**	102
		15,051	14,583
Current assets			
Inventories	*8*	**11**	11
Trade and other receivables	*9*	**320**	322
Derivative financial instruments	*12*	**170**	78
Term deposits	*10*	**12**	380
Cash and cash equivalents	*10*	**523**	286
		1,036	1,077
Total assets		**16,087**	15,660
Liabilities			
Non-current liabilities			
Borrowings	*11*	**(13,035)**	(12,717)
Derivative financial instruments	*12*	**(1,459)**	(1,419)
Deferred income tax liabilities	*14*	**(905)**	(884)
Retirement benefit obligations	*15*	**(158)**	(114)
Provisions	*16*	**(8)**	(9)
Trade and other payables	*17*	**(7)**	(8)
		(15,572)	(15,151)
Current liabilities			
Borrowings	*11*	**(1,355)**	(1,501)
Derivative financial instruments	*12*	**(7)**	(3)
Provisions	*16*	**(6)**	(12)
Current income tax liabilities		**(37)**	(25)
Trade and other payables	*17*	**(418)**	(408)
		(1,823)	(1,949)
Total liabilities		**(17,395)**	(17,100)
Net liabilities		**(1,308)**	(1,440)
Equity			
Capital and reserves			
Share capital	*18*	**3,109**	3,109
Merger reserve	*19*	**(994)**	(994)
Cash flow hedge reserve	*20*	**(252)**	(268)
Retained earnings	*22*	**(3,171)**	(3,287)
Total equity		**(1,308)**	(1,440)

These financial statements of Heathrow Finance plc (Company registration number: 06458635) were approved by the Board of Directors and authorised for issue on 21 February 2018. They were signed on its behalf by:

Javier Echave
Director

Nicholas Golding
Director

Heathrow Finance plc

Consolidated statement of changes in equity for the year ended 31 December 2017

		Attributable to owners of the Company				
	Note	Share capital £m	Merger reserve £m	Cash flow hedge reserve £m	Retained earnings £m	Total equity £m
1 January 2016		3,109	(994)	(284)	(2,364)	(533)
Comprehensive income:						
Loss for the year					(127)	(127)
Other comprehensive income:						
Fair value gains on cash flow hedges net of tax	*21*			23		23
Actuarial loss on pensions net of tax						
Gain on plan assets	*21,22*				501	501
Increase in scheme liabilities	*21,22*				(688)	(688)
Tax relating to indexation of operational land	*14, 21,22*				1	1
Change in deferred tax due to rate change	*20,21,22*			(7)	6	(1)
Total comprehensive loss				16	(307)	(291)
Transaction with owners:						
Dividends paid to Heathrow (DSH) Limited	*22*				(616)	(616)
Total transaction with owners					(616)	(616)
31 December 2016		**3,109**	**(994)**	**(268)**	**(3,287)**	**(1,440)**
Comprehensive income:						
Profit for the year					**503**	**503**
Other comprehensive income:						
Fair value gains on cash flow hedges net of tax	*21*			**16**		**16**
Actuarial loss on pensions net of tax						
Gain on plan assets	*21,22*				**62**	**62**
Increase in scheme liabilities	*21,22*				**(116)**	**(116)**
Tax relating to indexation of operational land	*14,21,22*				**2**	**2**
Total comprehensive income				**16**	**451**	**467**
Transaction with owners:						
Dividends paid to Heathrow (DSH) Limited	*22*				**(335)**	**(335)**
Total transaction with owners					**(335)**	**(335)**
31 December 2017		**3,109**	**(994)**	**(252)**	**(3,171)**	**(1,308)**

Heathrow Finance plc

Consolidated statement of cash flows for the year ended 31 December 2017

	Note	**Year ended 31 December 2017 £m**	Year ended 31 December 2016 £m
Cash flows from operating activities			
Cash generated from operations	*24*	**1,732**	1,654
Taxation:			
Corporation tax paid		**(53)**	(45)
Group relief paid		**(7)**	(12)
Net cash from operating activities		**1,672**	1,597
Cash flows from investing activities			
Purchase of:			
Property, plant and equipment		**(669)**	(660)
Investment properties		**(1)**	-
Intangible assets		**(17)**	(14)
Decrease in term deposits[1]		**368**	170
(Increase)/decrease in group deposits[2]		**(495)**	65
Interest received		**3**	7
Net cash used in investing activities		**(811)**	(432)
Cash flows from financing activities			
Dividends paid to Heathrow (DSH) Limited	*22*	**(335)**	(616)
Proceeds from issuance of bonds		**718**	829
Repayment of bonds		**(1,122)**	(761)
Drawdown of subordinated facilities		**200**	200
Issuance of term note		**518**	90
Repayment of facilities and other financing items		**(41)**	(46)
Swap restructuring		**-**	20
Settlement of accretion on index-linked swaps		**(10)**	(188)
Interest paid		**(552)**	(585)
Net cash used in financing activities		**(624)**	(1,057)
Net increase in cash and cash equivalents		**237**	108
Cash and cash equivalents at beginning of year		**286**	178
Cash and cash equivalents at end of year	*10*	**523**	286

[1] Term deposits with an original maturity of over three months are invested at Heathrow Airport Limited and Heathrow (AH) Limited.
[2] Group deposits are amounts settled with LHR Airports Limited during the year under the terms of the Shared Service Agreement.

Accounting policies for the year ended 31 December 2017

The principal accounting policies applied in the preparation of these consolidated financial statements of Heathrow Finance plc (the 'Company') and its subsidiaries (together the 'Group') are set out below. These policies have been consistently applied to all the years presented, unless stated otherwise.

Statement of compliance
The financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as adopted by the European Union ('EU').

The Group
The Company is the holding company of a group of companies that owns Heathrow Airport ('Heathrow') and operates Heathrow Express ('HEX'), the express rail service between Heathrow and central London. Heathrow Finance plc is a limited liability company incorporated in Great Britain and registered in England and Wales, and domiciled in the UK. Its registered office is The Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW.

Basis of accounting
The Group financial statements are prepared in accordance with IFRSs as issued by the IASB and as adopted by the EU and prepared under the historic cost convention, except for investment properties, available-for-sale assets, derivative financial instruments and financial liabilities that qualify as hedged items under fair value hedge accounting. These exceptions to the historic cost convention have been measured at fair value in accordance with IFRS and as permitted by the Fair Value Directive as implemented in the Companies Act 2006.

The Group financial statements are presented in Sterling and are rounded to the nearest million pounds (£m), except when otherwise noted.

Primary financial statements format
The primary financial statements are prepared in accordance with IFRS as adopted by the EU as they apply to the financial statements of the Group for the year ended 31 December 2017.

A columnar approach has been adopted in the income statement and the impact of certain items is shown in a separate column. This column includes certain re-measurements as listed in (i) and (ii) below, which management now separates from the underlying operations of the Group. Also, this column includes exceptional items as listed in (iii) and the effect on taxation of changes in tax rates in (iv) and (v) below. By isolating certain re-measurements and exceptional items,management believes the underlying results provides the reader with a more meaningful understanding of the performance of the Group, by concentrating on the matters over which it exerts influence, whilst recognising that information on these additional items is available within the financial statements, should the reader wish to refer to them.

The column 'certain re-measurements and exceptional items' in the consolidated income statement contains the following items:

i. fair value gains and losses on investment property revaluations and disposals;
ii. derivative financial instruments and the fair value gains and losses on any underlying hedged items that are part of a fair value hedging relationship;
iii. exceptional items;
iv. the associated tax impacts of the items in (i), (ii) and (iii) above; and
v. the impact on deferred tax balances of known future changes in tax rates.

Going concern
The directors have prepared the financial statements on a going concern basis which requires the directors to have a reasonable expectation that the Group, as part of the Heathrow Airport Holdings Limited group (the 'Heathrow Airport Holdings Group'), has adequate resources to continue in operational existence for the foreseeable future. The Company forms part of the Heathrow Airport Holdings Group, the level at which financial risks are managed for the Company.

Consequently the directors have reviewed the cash flow projections of the Group taking into account:

- the forecast revenue and operating cash flows from the underlying operations;
- the forecast level of capital expenditure; and
- the overall Heathrow Airport Holdings Group/ Group liquidity position, including cash resources, the remaining committed and uncommitted facilities available to it, its scheduled debt maturities, its forecast financial ratios and its ability to access the debt markets (refer to Recent financing activities in the Financial review).

Whilst the Group is in a net liability position, as a result of the review, and having made appropriate enquiries of management, the directors have a reasonable expectation that sufficient funds will be available to meet the Group's funding requirement for the twelve months following the date when the Statement of financial position was signed.

Accounting policies for the year ended 31 December 2017 *continued*

Changes in accounting policy and disclosures

(a) Amended standards adopted by the Group

During the year, the Group adopted a number of amendments to the IFRSs issued by the IASB that are mandatorily effective for accounting periods beginning on or after 1 January 2017. Their adoption has not had any material impact on the disclosures or on the amounts reported in these financial statements.

The following amendments, although relevant to the Group, have no impact on the Group's results for the reasons stated:

- Amendments to IAS 7: Disclosure initiative. The amendment requires to make disclosure of cash and non-cash changes in liabilities arising from financing activities. The Group already makes this disclosure. See note 24.
- Amendments to IAS 12: The amendments provide clarification around recognition of deferred tax on unrealised losses; no adjustments were required that has financial impact on the Group's results.

The following amendments are not applicable to the Group:

- Amendments to IFRS 12 (included in Annual improvements to IFRS Standards 2014-2016 Cycle): Disclosure of interest in Other Entities classified as held for sale. The amendment is not applicable as the Group does not have any interest in subsidiaries, associate or joint ventures that are classified (or included in the disposal group that are classified) as held for sale.

(b) Standards, amendments and interpretations to existing standards that are not yet effective and have not been adopted early by the Group

The following standards, amendments and interpretations, which have not been applied in these financial statements, were in issue but not yet effective (and in some cases had not yet been adopted by the EU):

- IFRS 9 Financial Instruments;
- IFRS 15 Revenue from Contracts with Customers;
- IFRS 16 Leases;
- IFRS 2 (amendments) Classification and Measurement of Share-based Payment Transactions;
- IFRS 10 and IAS 28 (amendments) Sale or Contribution of Assets between an Investor and its Associate or Joint Venture;
- IAS 40 (amendments) Transfer of Investment Property;
- Annual Improvements to IFRS Standards 2014-2016 Cycle; and
- IFRIC 22 Foreign Currency Transactions and Advance Consideration.

IFRS 9 *Financial Instruments*

IFRS 9 *Financial Instruments* is effective for periods beginning on or after 1 January 2018, with early adoption permitted. The standard addresses the classification, measurement and derecognition of financial assets and financial liabilities, introduces rules for hedge accounting and a new impairment model for financial assets.

The Group has reviewed its financial assets and liabilities and is expecting no material impact following adoption of the new standard on 1 January 2018 as noted below:

The Group's financial assets include cash and cash equivalents (including short term deposits), loans to third parties, trade and other receivable, intercompany loan receivables, and other debtor). These financial assets will continue to be measured at amortised cost as is currently adopted under IAS 39 as they will meet the condition for classification at amortised cost under IFRS 9. The Group's financial assets also include other investments that are currently classified as available-for-sale ("AFS") that will satisfy the conditions for classification at fair value through other comprehensive income ("FVOCI") and hence there will be no change to the accounting for these assets. Accordingly, the Group does not expect the new guidance to affect the classification and measurement of these financial assets.

There is no impact on the Group's accounting for financial liabilities, as the new requirements only affect the accounting for financial liabilities that are designated at fair value through income statement and the Group does not have any such liabilities. The derecognition rules have been transferred from IAS 39 and have not been changed.

The new hedge accounting rules will align the accounting for hedging instruments more closely with the Group's risk management practices. As a general rule, more hedge relationships might be eligible for hedge accounting, as the standard introduces a more principles-based approach. The Group has confirmed that its current hedge relationships will qualify as continuing hedges upon the adoption of IFRS 9. IFRS 9 introduces an optional treatment for cross currency swaps designated in hedge relationships, whereby the currency basis element can be bifurcated with changes in fair value recorded in other comprehensive income ("OCI"). In designating new fair value hedge relationships, the currency basis element shall be stripped out at inception and accounted for separately.

The new impairment model requires the recognition of impairment provisions based on expected credit losses (ECL) rather than only incurred credit losses as is the case under IAS 39. It applies to financial assets classified at amortised cost, debt instruments measured at FVOCI, contract assets under IFRS 15, lease receivables, loan commitments and certain financial guarantee contracts.

Accounting policies for the year ended 31 December 2017 *continued*

IFRS 9 *Financial Instruments continued*
Based on the assessment undertaken to date it is anticipated that the application of ECL IFRS 9 will result in an increase in the impairment recognition by £1.2 million in relation to the Group's intercompany receivables which is not material.

The new standard also introduces expanded disclosure requirements and changes in presentation. These are expected to change the nature and extent of the Group's disclosure about its financial instruments particularly in the year of adoption of the new standard.

IFRS 15 *Revenue from Contracts with Customers*
IFRS 15 is effective for periods beginning on or after 1 January 2018. This will replace IAS 18 which covers contracts for goods and services and IAS 11 which covers construction contracts. The Group intends to adopt the standard using modified retrospective approach which means that the cumulative impact of the adoption (not expected to be material) will be recognised in retained earnings as of 1 January 2018 and that comparatives will not be restated.

IFRS 15 establishes a single comprehensive model for accounting for revenue arising from contracts with customers. IFRS 15 identifies five steps in approaching revenue recognition, which are centred on the performance obligations in a contract and the timing of recognition of revenue when each individual performance obligation is satisfied.

The Group recognises revenue from the following major sources:

- Aeronautical income;
- Retail services;
- Other regulated charges;
- Car Parking; and
- Rail income.

The Group has considered each area of revenue and identified what are regarded to be the main performance obligations in each area, having reference to the underlying contracts. The results of the review, together with any potential impact on revenue recognition, are as follows:

- Aeronautical income: there are three separate performance obligations in respect of aeronautical charges, namely landing, parking and departing charges. These charges are separately identified in respect of any aircraft movement at the airport and the revenue is recognised on the day the movement takes place. Therefore, the Group does not consider there to be any impact on revenue recognition from the adoption of IFRS 15. In addition there are certain other regulated charges which are referred to below.
- Retail services: the performance obligation is the provision of retail unit space to a third party for the purposes of selling or providing services to the travelling public, in return for a fee, based either on a fixed rental fee, or a concession fee based on turnover. The retailer has the right to design and control the use of that space. As such, this concept suggests that retail contracts are aligned to a lease in nature, and therefore retail income from these sources will be treated as lease income. Therefore, retail services revenue is not impacted by IFRS 15.
- Other regulated charges (including those related to Aeronautical): this revenue is derived from the recovery of certain costs incurred by the Airport, for which IFRS 15 has no impact.
- Car parking: in the case of car parking greater than one day in length, currently the car parking revenue is recognised either:
  a). on the date of arrival at the car park, in the case of pre-booked parking; or
  b). on the date of departure from the car park, in the case of pay-on-exit.
  The Group considers the performance obligation is satisfied by the provision of a car park space for each day the car is parked, therefore the revenue should be divided equally for each day. This will result in a restatement of £0.6 million charged to retained earnings at 1 January 2018 and an expected timing difference to revenue of £0.1 million.
- Rail income: Heathrow Express derives its income from the sale of tickets to customers, which can be of many different types. Where tickets are booked in advance the revenue is recognised when the ticket is first used. Where tickets are bought at a rail station, the revenue is recognised immediately at the point of sale. In the case of 30-day return tickets the revenue in any accounting period will be overstated by half the value of the ticket if the return journey is not completed in the same accounting period. Similarly, revenue from Carnet tickets (12 journeys) is recognised at the point of sale, although the journeys can be taken up to 6 months from the date of sale. Adoption of IFRS 15 will result in a restatement of £1.2 million charged to retained earnings at 1 January 2018 and an expected timing difference to revenue of £0.2 million.

Apart from providing more extensive disclosures on the Group's revenue transactions, the Group does not anticipate that the application of IFRS 15 will have a significant impact on the financial position or financial performance of the Group.

Accounting policies for the year ended 31 December 2017 *continued*

IFRS 16 ***Leases***
IFRS 16 is effective for periods beginning on or after 1 January 2019. The standard requires a lessee to recognise an asset (the right to use the leased item) and corresponding financial liability for all leases (subject to certain exemptions). The standard is expected to affect primarily the accounting for the Group's operating leases. As at the reporting date, the Group has non-cancellable operating lease commitments of £717 million, see note 23. The Group is still assessing adjustments that are necessary for example because of the change in the definition of the lease, lease term and different treatment of variable lease payments. It is therefore not yet possible to estimate the amount of right-of-use assets and lease liabilities that will have to be recognised on adoption of the new standard and how this may affect the Group's profit or loss and classification of cash flows going forward and its opening reserves on transition. As part of its impact assessment, the Group will also be performing an assessment of its service contracts to determine whether they fall within the scope of IFRS 16 and their impact on the Group's financial results going forward.

Basis of consolidation
The Group financial statements consolidate the financial statements of Heathrow Finance plc and all the entities it controls (its subsidiaries) drawn up to 31 December each year, including the merger reserve which was created in 2008 upon reorganisation of the current Group structure.

The Group was formed in 2008 as part of a wider Heathrow Airport Holdings Group refinancing and group reconstruction. In 2008 the Company acquired Heathrow (SP) Limited, which owns the UK regulated airport Heathrow. The Group also operates the Heathrow Express rail service between Heathrow and Paddington, London.

Subsidiaries
Subsidiaries are consolidated from the date of their acquisition, being the date on which the Group obtains control, and continue to be consolidated until the date that such control ceases. Control is defined as where the Group is exposed or has rights to variable returns from its involvement with the subsidiary and the ability to affect those returns through its power over the subsidiary.

Intra-group balances and transactions are eliminated during the consolidation process.

Segment reporting
Information reported to the Board for the purposes of resource allocation and assessment of segment performance relates to the operations of Heathrow and Heathrow Express.

Revenue
Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured. Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods and services provided in the normal course of business, net of discounts, VAT and other sales-related taxes and consists primarily of:

Aeronautical
- Aircraft landing charges levied according to noise, emissions and weight recognised on landing.
- Aircraft parking charges based on time parked and whether aircraft are wide or narrow bodied as provided.
- Passenger charges based on the number of departing passengers on departure.
- Other charges levied for passenger and baggage operations when these services are rendered.

Retail
- Concession fees from retail and commercial concessionaires at the airport are based upon reported revenue by concessionaires, taking into account contracted minimum guarantees where appropriate, and are recognised in the period to which they relate.
- Car parking income is recognised on the date of arrival at the car park, in the case of pre-booked parking, or on the date of departure from the car park in the case of pay–on-exit, in accordance with operator management fee arrangements.

Other Regulated Charges ('ORCs')
- Usage charges made for operational systems (e.g. check-in desks), recognised as each service is provided.
- Charges related to passengers with restricted mobility and various other services recognised at the time of delivery.
- Other invoiced sales, recognised on the performance of the service.

Other
- Property letting rentals recognised on a straight-line basis over the term of the rental period.
- Proceeds from the sale of trading properties, recognised on the unconditional completion of the sale.
- Rail ticket sales; where tickets are booked in advance the revenue is recognised when the ticket is first used. Where tickets are bought at a rail station, the revenue is recognised immediately at the point of sale.

Accounting policies for the year ended 31 December 2017 *continued*

Contributions
On occasion, the Group may receive grants to improve airport infrastructure considered to be in the best interest of the public. These are recorded as reductions in the cost of the property, plant and equipment to which they relate.

Exceptional items
The Group separately presents certain items on the face of the income statement as exceptional. Exceptional items are material items of income or expense that, because of their size or incidence, merit separate presentation to allow an understanding of the Group's financial performance. They are not expected to be incurred on a recurring basis.

Such events may include gains or losses on the disposal of businesses or assets that do not qualify as discontinued operations, major reorganisation of businesses, closure or mothballing of terminals and costs incurred in bringing new airport terminal complexes and airfields to operational readiness that are not able to be capitalised as part of the project.

Finance income
Finance income is recognised when it is probable that the economic benefits will flow to the Group and the amount of revenue can be measured reliably. Finance income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to the asset's net carrying amount on initial recognition.

Borrowing costs
Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that take a substantial period of time to get ready for their intended use or sale, are capitalised as part of the cost of those assets, until the asset is complete and available for use. Such borrowing costs are capitalised whilst projects are in progress.

Where assets in the course of construction are financed by specific borrowing facilities the interest rate relating to those specific borrowing facilities is used to calculate the amount to capitalise, otherwise an interest rate based on the weighted average cost of debt is used. Capitalisation of interest ceases once the asset is complete and available for use. Interest is then charged to the income statement as a depreciation expense over the life of the relevant asset.

All other borrowing costs, including costs incurred in respect of the maintenance of the Group's credit ratings, are recognised in the income statement in the year in which they are incurred.

Property, plant and equipment
Operational assets
Terminal complexes, airfield assets, plant and equipment, rail assets and other land and buildings are stated at cost less accumulated depreciation and accumulated impairment losses. An item of property, plant and equipment is derecognised upon disposal or when no future economic benefits are expected. Any gain or loss arising on the derecognition of the asset is included in the income statement in the period of derecognition.

Assets in the course of construction are stated at cost less any impairment. Assets in the course of construction are transferred to completed assets when substantially all the activities necessary to get the asset ready for use are complete and the asset is available for use. Where appropriate, cost includes borrowing costs capitalised (see "Borrowing Costs" policy), own labour costs of construction-related project management and directly attributable overheads. Costs associated with projects that are in the early stages of planning are capitalised where the directors are satisfied that it is probable the necessary consents will be received and the projects will be developed to achieve a successful delivery of an asset such that future commercial returns will flow to the Group. The Group reviews these projects on a regular basis to determine whether events or circumstances have arisen that may indicate that the carrying amount of the asset may not be recoverable, at which point the asset would be assessed for impairment.

Heathrow expansion
Assets in the course of construction include qualifying costs in respect of Heathrow expansion following the Government decision in October 2016 in favour of Heathrow, and subsequent Board decision in October 2016 to apply for the Development Consent Order.

These two events were considered by management to be a trigger point for the expansion project to proceed. Management subsequently announced publicly that the Group would apply for planning permission, in the belief that it is highly probable that expansion at Heathrow will be realised. As a result, the Group has started to capitalise eligible costs as 'assets in the course of construction'.

The costs which are directly associated with, and solely for the purposes of, seeking planning consent for the delivery of new runway capacity through the Development Consent Order process are capitalised as they are directly attributable to the final design and construction of the expanded Heathrow assets. These costs include Environmental Impact Assessments, Statutory consultation, and Master plan options.

Accounting policies for the year ended 31 December 2017 *continued*

Property, plant and equipment *continued*
Heathrow expansion continued
In assessing expansion costs, the Group has regard to IAS 38 (see Accounting policy - 'Internally-generated intangible assets') and considers October 2016 to be the point at which Expansion moved from the Research phase to the Development phase, and therefore development expenditure is capitalised in line with the principles of IAS 38.

Expansion costs incurred during the research phase for the Airports Commission process and before Heathrow was named as the preferred location for new runway capacity in October 2016, were expensed in the period in which they were incurred.

Depreciation
Depreciation is provided on operational assets, other than land and assets in the course of construction, to write off the cost of the assets less estimated residual value, by equal instalments over their expected useful lives as set out below:

Terminal complexes	*Fixed asset lives*
Terminal building, pier and satellite structures	20–60 years
Terminal fixtures and fittings	5–20 years
Airport plant and equipment	
Baggage systems	15 years
Screening equipment	7 years
Lifts, escalators and travelators	20 years
Other plant and equipment, including runway lighting and building plant	5–20 years
Tunnels, bridges and subways	50–100 years
Airport transit systems	
Rolling stock	20 years
Track	50 years
Airfields	
Runway surfaces	10–15 years
Runway bases	100 years
Taxiways and aprons	50 years
Rail	
Rolling stock	8–40 years
Tunnels	100 years
Track metalwork	5–10 years
Track bases	50 years
Signals and electrification work	40 years
Plant and equipment	
Motor vehicles	4–8 years
Office equipment	5–10 years
Computer equipment	4–5 years
Other land and buildings	
Short leasehold properties	3-20 years
Leasehold improvements	Lower of useful economic life or period of lease

In certain circumstances, the asset life may fall outside of the boundaries disclosed above.

Asset residual values and useful lives are reviewed and adjusted, if appropriate, at each reporting date.

Impairment of assets
The Group assesses, at each reporting date, whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group estimates the asset's recoverable amount. Where the asset does not generate cash flows independent of other assets, the recoverable amount of the cash-generating unit to which the asset belongs is estimated. The recoverable amount is the higher of an asset's fair value less costs of disposal and its value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Where the carrying amount of a cash-generating unit exceeds its recoverable amount, the cash-generating unit is considered impaired and is written down to its recoverable amount.

As at 31 December 2017,the level of the fair value hierarchy within which the fair value measurement is categorised in its entirety is Level 3, as described in Note 13- *'Financial Instruments'*.

Accounting policies for the year ended 31 December 2017 *continued*

Investment properties
Investment property, which is property held to earn rentals and/or for capital appreciation, is initially measured at cost and subsequently stated at fair value at the reporting date, as determined by the directors and supported by external valuers every year. Gains or losses arising from changes in the fair value of investment property are recognised in the income statement in the period in which they arise.

Gains or losses on disposal of an investment property are recognised in the income statement on the unconditional completion of the sale.

Internally-generated intangible assets
Development expenditure incurred in respect of individual projects is capitalised when the future economic benefit of the project is probable and is recognised only if all of the following conditions are met:
- the Group can demonstrate the technical feasibility of completing the intangible asset so that it will be available for use or sale; and
- the Group can demonstrate how the intangible asset created will generate future economic benefits; and
- the Group has available the resources to complete the asset; and
- the Group intends to complete that asset and has the future ability to sell or use the asset; and
- the development cost of the intangible asset can be measured reliably.

Following initial recognition of the development expenditure as an asset, the cost model is applied requiring the asset to be held at cost less any accumulated amortisation and impairment. Amortisation begins when development is complete and the asset is ready for use.

This type of expenditure primarily relates to internally developed software and website projects and these are amortised on a straight-line basis over their useful lives of three to seven years. During the period of development, the asset is tested for impairment annually.

Where no internally-generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred.

Expenditure on research activities is recognised as an expense in the period in which it is incurred.

Purchased intangible assets (software costs)
Computer software costs principally relate to operating and financial software. These assets are amortised over a period of between four and fifteen years. Amortisation for the year is charged through operating costs. The assets are assessed for impairment whenever there is indication that the intangible asset may be impaired.

Leases
The determination of whether an arrangement is or contains a lease is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

Group as a lessee
Finance leases, which transfer to the Group substantially all the risks and benefits incidental to ownership of the leased item, are capitalised at the inception of the lease with a corresponding liability being recognised at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance costs are charged directly against income.

Capitalised leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term if there is no reasonable certainty that the Group will obtain ownership by the end of the lease term.

Leases where the lessor retains a significant portion of the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the income statement on a straight-line basis over the lease term.

In the event that lease incentives are received to enter into operating leases, such incentives are recognised as a liability. The aggregate benefit of incentives is recognised as a reduction of rental expense on a straight-line basis over the lease term, except where another systematic basis is more representative of the time pattern in which economic benefits from the leased asset are consumed.

Group as a lessor
Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases and with the exception of investment properties discussed above, the assets are included in property, plant and equipment and depreciated over their estimated useful lives. Rental income from operating leases is recognised on a straight-line basis over the term of the relevant lease. Initial direct costs incurred in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognised over the lease term on the same basis as the rental income.

Accounting policies for the year ended 31 December 2017 *continued*

Inventories
Inventories are stated at the lower of cost and net realisable value. Cost is calculated using the weighted average method.

Cash and cash equivalents
For the purposes of the Statement of financial position, cash and cash equivalents comprise cash at bank, cash in hand, repurchase agreements with an original maturity of three months or less and short-term deposits with an original maturity of three months or less. For the Consolidated statement of cash flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.
Term deposits
Term deposits, which include repurchase agreements, with an original maturity of over three months are shown separately on the Statement of financial position and Statement of cash flows.

Deferred income
Amounts received prior to the delivery of goods and services are recorded as deferred income and released to the income statement as they are provided.

Provisions
Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Provisions are measured at the best estimate of the expenditure required to settle the obligation at the reporting date and are discounted, where material, to present value using a current, pre-tax rate that reflects, where appropriate, the risks specific to the liability.

Restructuring
A restructuring provision is recognised when the Group has developed a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it. The measurement of a restructuring provision includes only the direct expenditures arising from the restructuring, which are those amounts that are both necessarily entailed by the restructuring and not associated with the ongoing activities of the entity.

Home loss payments
A home loss payments provision is recognised where, an obligation arises during the year, as a result of a past event. The home loss payment provision is in respect of historic property purchases and related expenditures created in 2016 specifically in respect of Heathrow Expansion, following the Government's decision in October 2016.

Financial instruments
Trade and other receivables
Trade receivables, which generally have 14 day terms, are recognised and carried at the lower of their original invoiced value and recoverable amount. Where the time value of money is material, receivables are carried at amortised cost. Provision is made when there is objective evidence that the Group will not be able to recover balances in full. Balances are written off when the probability of recovery is remote.

Investments
Financial assets within the scope of IAS 39 are classified as financial assets at fair value through the income statement, loans and receivables, held-to-maturity investments, available-for-sale financial assets, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The Group determines the classification of its financial assets at initial recognition.

On initial recognition, financial assets are measured at fair value, plus, in the case of investments not at fair value through the income statement, directly attributable transaction costs.

Assets classified as 'loans and receivables' or 'held-to-maturity' are recognised in the statement of financial position at their amortised cost, using the effective interest method, less any provision for impairment.

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market are classified as 'loans and receivables' and are carried at amortised cost using the effective interest method. Non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intent and ability to hold-to-maturity are classified as 'held-to-maturity' and are carried at amortised cost using the effective interest method. For investments carried at amortised cost, gains and losses are recognised in the income statement when the investments are de-recognised or impaired, as well as through the amortisation process.

For investments that are traded in an active market, fair value is determined by reference to quoted market bid prices at the reporting date. For investments where there is no quoted market price, fair value is determined by using valuation techniques, such as estimated discounted cash flows, or by reference to the current market value of similar investments.

Purchases and sales of investments are recognised on trade-date being the date on which the Group commits to purchase or sell the asset.

Financial Instruments *continued*

Investments continued

Investments are classified as held-for-sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable, the asset is available for immediate sale in its present condition, management are committed to the sale and the sale is expected to be completed within one year of the date of classification. Assets classified as held-for-sale cease to be depreciated and are measured at the lower of carrying amount and fair value less selling costs.

A financial asset is derecognised when i) the rights to receive cash flows from the asset have expired or ii) the Group has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party.
The Group assesses at each reporting date whether there is any objective evidence that a financial asset or group of financial assets is impaired.

Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that provides a residual interest in the assets of a business after deducting all other liabilities.

Borrowings

Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost unless part of a fair value hedge relationship. Any difference between the amount initially recognised (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method. Borrowings being novated or cancelled and re-issued, with a substantial modification of the terms, are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability, with any resulting gain or loss recognised in the income statement.

For index-linked borrowings, the nominal amount is adjusted for movements in the relevant price index. This accretion expense is recorded within finance costs in the income statement.

Debt issue costs

Prepaid fees in relation to the future issuance of debt are held on the statement of financial position on the basis that such issuance is considered probable. If issues do not occur, or are deemed not to be probable, such fees are recognised in the income statement.

Trade and other payables

Trade and other payables are non-interest bearing and are stated at their fair value and subsequently measured at amortised cost using the effective interest method.

Derivative financial instruments and hedging activities

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value.

The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged.

The Group designates certain derivatives as either:
- fair value hedges, where they hedge exposure to changes in the fair value of the hedged asset or liability; or
- cash flow hedges, where they hedge exposure to variability in cash flows that are attributable to a particular risk associated with any changes in the fair value of the hedged asset, liability or forecasted transaction.

The Group documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedging transactions. The Group also documents, both at hedge inception and on an ongoing basis, its assessment of whether the derivatives used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

The fair value of a derivative is classified as a non-current asset or liability when the remaining maturity is more than 12 months and as a current asset or liability where it is less than 12 months.

Novations of financial instruments

Derivative financial instruments novated from other companies within the Heathrow Airport Holdings Group are transferred at fair value prevailing on that date.

Accounting policies for the year ended 31 December 2017 *continued*

Financial Instruments *continued*
Fair value hedge
Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised in the income statement over the period to maturity.

Cash flow hedge
The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled in the income statement in the periods when the hedged item affects profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When or if a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Derivatives at fair value through the income statement
Certain derivative instruments do not qualify for hedge accounting. Changes in the fair value of these derivative instruments are recognised immediately in the income statement.

When derivatives are designated in a hedge relationship, the net interest payable or receivable on those derivatives is recorded net of the interest on the underlying hedged item in the income statement. When derivatives are not in a hedge relationship, the fair value changes on these derivatives are recognised within fair value gains/(losses) on financial instruments in the income statement. The interest payable and receivable on those derivatives are recorded at their gross amount in finance costs and finance income in the income statement.

Accounting for changes in credit risk
Accounting standards require that the fair value of financial instruments reflects their credit quality, and also changes in credit quality where there is evidence that this has occurred. The credit risk associated with the Group's derivatives is updated monthly based on current market data.

Shared Services Agreement ('SSA')
All employees of the Group are employed by LHR Airports Limited with the exception of non-senior management at Heathrow Express Operating Company Limited. LHR Airports Limited grants all employee benefits and sponsors the defined benefit pension schemes while Heathrow Airport Limited incurs any staff related costs.

On 18 August 2008, Heathrow Airport Limited and Heathrow Express Operating Company Limited entered into a SSA with LHR Airports Limited by which the latter became the shared services provider for the Group.

Following the disposal of Aberdeen, Glasgow and Southampton airports in December 2014 the directors reassessed the Group's relationship with LHR Airports Limited, given that the sole operating airport is now Heathrow and noted the following;

- The SSA states that the operating entities, being only Heathrow Airport Limited from 1 January 2015, are responsible for pension costs on LHR Airports Limited's retirement benefit schemes,
- The Group is responsible for funding the retirement benefit schemes, paying employer contributions directly to the pension scheme, and
- Although employees remain legally employed by LHR Airports Limited, the Group makes all employment decisions. LHR Airports Limited is no longer deemed to be providing a service, substantive or otherwise in relation to employees, to the Group.

Consequently, from 1 January 2015, all employment related costs and the disclosures pertaining to the defined benefit pension scheme are presented in the financial statements of Heathrow Airport Limited and therefore the Group.

Employment costs
The Group's airport incurs the cost of people which are contractually employed by LHR Airports Limited but provide services to the operation of the airport. Charges in relation to employment costs include wages and salaries, pension costs, medical costs and redundancy payments, as well as any other associated expenses properly incurred by the employees of LHR Airports Limited in providing the services.

Accounting policies for the year ended 31 December 2017 *continued*

Centralised services

LHR Airports Limited is considered to be acting as principal in relation to the services of the Heathrow Airport Holdings Limited ('HAHL') Group CEO, the HAHL Group CFO, the HAHL Chairman and HAHL non-executive board members and Ferrovial advisory services. These costs are recharged to Heathrow Airport Limited (the only remaining airport party to the SSA) with a mark-up of 7.5%. Other services are paid for and sourced directly by Heathrow Airport Limited, either without LHR Airports Limited's involvement or on a pass through fixed mark up only basis (agent).This judgement has been reached following consideration of whether LHR Airport Limited has been exposed to the majority of the significant benefits and risks associated with the exchange transaction.

Pension costs

Heathrow Airport Limited and Heathrow Express Operating Company Limited ('HEX') have an obligation to fund or benefit from their share of the LHR Airports Limited defined benefit pension scheme (or 'BAA Pension Scheme') deficit or surplus and Unfunded Unapproved Retirement Benefit Scheme and Post-Retirement Medical Benefits pension related liabilities under the SSA. Previously when part of a group with multiple operations, these provisions or assets were based on the relevant share of the scheme deficit or surplus and allocated on the basis of pensionable salaries. Movements in these provisions or assets arose due to current service costs, net finance costs or income, employer cash contributions and actuarial gains or losses. Heathrow Airport Limited and HEX recorded their share of the net actuarial gain or loss for the year as an exceptional item due to their size and nature.

Following the disposal of Aberdeen, Glasgow and Southampton airports (the 'NDH1' group) in December 2014, the directors reassessed the Group's relationship with the legal sponsor of the retirement benefit schemes (LHR Airports Limited) given that the HAH Group's sole operating airport is now Heathrow. The directors determined, after taking into account the Shared Service Agreement, employment relationships and the funding risk associated with the schemes, that Heathrow Airport Limited, and consequently the Group, now acts as principal in relation to these schemes. As a result, the Group now recognises an external asset or liability, in relation to the schemes, on its statement of financial position, as non-current under the caption of Retirement benefit surplus/obligations. Additionally, it is now considered appropriate for the Group to record actuarial gains and losses on the external scheme within other comprehensive income rather than the income statement.

The cost of providing benefits under the defined benefit pension scheme is determined using the projected unit method, which attributes entitlement to benefits to the current period (to determine current service cost) and to the current and prior periods (to determine the present value of the defined benefit obligation) and is based on actuarial advice. Past service costs are recognised in the income statement on a straight-line basis over the vesting period or immediately if the benefits have vested. When a settlement or curtailment occurs, the obligation and related plan asset are remeasured using current actuarial assumptions and the resultant gain or loss recognised in the income statement during the period in which the settlement or curtailment occurs.

The interest element of the defined benefit cost represents the change in present value of scheme obligations resulting from the passage of time, and is determined by applying the discount rate to the opening present value of the benefit obligation, taking into account material changes in the obligation during the year. The expected return on plan assets is based on an assessment made at the beginning of the year of long-term market returns on scheme assets, adjusted for the effect on the fair value of plan assets of contributions received and benefits paid during the year. The difference between the expected return on plan assets and the interest cost is recognised in the income statement as other finance income or cost.

The Group recognises actuarial gains and losses in full in other comprehensive income in the period in which they occur.

The defined benefit pension asset or liability in the statement of financial position comprises the total for each plan of the present value of the defined benefit plan obligation (using a discount rate based on high-quality corporate bonds), less any past service cost not yet recognised and less the fair value of plan assets out of which the obligations are to be settled directly. Fair value is based on market price information and in the case of quoted securities is the published bid price. The value of a net defined benefit pension asset is restricted to the sum of any unrecognised past service costs and the present value of any amount the Group expects to recover by way of refunds from the plan or reductions in future contributions.

Contributions to defined contribution pension schemes are recognised in the income statement in the period in which they become payable.

Current and deferred income tax

The tax expense for the year comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised directly in other comprehensive income. In this case, the tax is recognised in other comprehensive income.

Current tax liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted at the reporting date. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation.

Accounting policies for the year ended 31 December 2017 *continued*

Current and deferred income tax *continued*

Deferred income taxation is provided in full using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Group's financial statements, at rates expected to apply when they crystallise, based on current tax rates and law. Deferred income taxation is not provided on the initial recognition of an asset or liability in a transaction, other than a business combination, if at the time of the transaction there is no effect on either accounting or taxable profit or loss. Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax assets and liabilities are not discounted.

Deferred income taxation is determined using the tax rates and laws that have been enacted, or substantively enacted, during the year and are expected to apply in the periods in which the related deferred tax asset or liability is realised or settled.

Share capital

Ordinary shares are classified as equity and are recorded at the par value of proceeds received, net of direct issue costs, allowing for any reductions in the par value. Where shares are issued above par value, the proceeds in excess of par value are recorded in the share premium account.

Dividend distribution

A dividend distribution to the Company's shareholders is recognised as a liability in the Group's financial statements in the period in which the shareholders' right to receive payment of the dividend is established. Interim dividends are recognised when paid.

Foreign currency

The consolidated financial statements are presented in Sterling, which is the parent company's functional currency.

Transactions denominated in foreign currencies are initially recorded in the entity's functional currency using the exchange rates prevailing at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated into Sterling at the rates of exchange ruling at the reporting date. Differences arising on translation are charged or credited to the income statement.

Significant accounting judgements and estimates for the year ended 31 December 2017

In applying the Group's accounting policies, management have made judgements and estimates in a number of key areas. Actual results may, however, differ from the estimates calculated and management believes that the following areas present the greatest level of uncertainty.

Critical judgements in applying the Group's accounting policies

Hedge accounting
Certain interest rate swaps are designated in a cash flow hedge relationship to hedge the exposure to variability in cash flows of forecast transactions or existing liabilities. Management compares on a regular basis existing and historic hedging arrangements against expectations for future Sterling re-financing. If there were significant changes in the expected quantum of future Sterling re-financing, then levels may be insufficient to support components of the cash flow hedge reserve, requiring the recycling of the cash flow hedge reserve through the income statement. As at 31 December 2017, £291 million of fair value losses (2016: £333 million) on these derivatives have been deferred into the cash flow hedge reserve.

Capitalisation
Management are required to make judgements in relation to the capitalisation of costs. This relates to both when amounts may begin to be capitalised, where there may be doubt about planning consent or the ultimate completion of the asset, and in relation to the nature of costs incurred. Judgement has been exercised in the year including in relation to:

- capitalised interest, where judgement is exercised in relation to the applicable interest rate;
- the assessment of assets in the course of construction, including expansion costs;
- projects on hold and operational activities where judgement is exercised to determine costs that are directly attributable to the assets under construction; and
- when a project moves from the research phase (where costs must be expensed in the current period) to the development phase and hence may be capitalised as the future economic benefit of the project becomes probable and the principles of IAS 38 are considered and applied.

Agent versus principal
The presentation of certain costs including employment costs and pension costs which are a contractual obligation of LHR Airports Limited are presented as Operating costs of the Group in the 2017 financial statements as Heathrow Airport Limited (part of the Group) is deemed to be the principal in relation to these transactions. This judgement is described in the accounting policies and is based on the balance of risks and rewards between group companies.

Key sources of estimation uncertainty

Fair value of derivative financial instruments
The fair value of derivative financial instruments is calculated using a discounted cash flow approach and using inputs based on observable market data. Judgement is used to determine the recovery rate and associated reduction in credit risk of super senior ranking derivatives. Details of the carrying value and sensitivities are available in Note 12 and 13, respectively.

Investment properties
Investment properties are fair valued by CBRE Limited, Chartered Surveyors. The valuations are prepared in consideration of IFRS and in accordance with the appraisal and valuation manual issued by the Royal Institution of Chartered Surveyors. Valuations are carried out having regard to comparable market evidence relevant to each specific property or class of properties. In assessing fair value, current and potential future income (after deduction of non-recoverable outgoings) is capitalised using yields derived from market evidence. This market evidence also takes into account planned transactions and use of the property (for example the future expansion of Heathrow). Independent valuations are obtained for all investment properties. Management have reviewed the main assumptions underlying the valuation of Investment properties and the sensitivity analysis based on reasonable possible changes to relevant assumptions as set out in Note 6.

Pensions
Certain assumptions have been adopted for factors that determine the valuation of the Group's liability for pension obligations at period end and charges to the income statement. The factors have been determined in consultation with the Group's actuary taking into account market and economic conditions. Changes in assumptions can vary from period to period as a result of changing conditions and other determinants which may cause increases or decreases in the valuation of the Group's liability for pension obligations. The objective when setting pension scheme assumptions for future periods is to reflect the expected actual outcomes, other than the discount rate which must be set by reference to the yield on high quality corporate bonds with a term consistent with the obligations. The impact of the change in assumptions on the valuation of the net financial position of the Group pension scheme is recorded as a net actuarial gain or loss and is reflected in the statement of comprehensive income. Further details are available in Note 15.

Notes to the Group financial statements for the year ended 31 December 2017

1 Segment information

As described in the accounting policies on page 44, the Group is organised into business units according to the nature of the services and has two reportable operating segments as follows:
- Heathrow (aeronautical, retail, other regulated charges ('ORCs'))
- Heathrow Express (rail income)

The performance of the above segments is measured on a revenue and Adjusted EBITDA basis, before certain re-measurements.

The reportable segments derive their revenues from a number of sources including aeronautical, retail, other regulated charges ('ORCs') and other products and services (including rail income), and this information is also provided to the Board on a monthly basis.

Table (a) details total revenue from external customers for the year ended 31 December 2017 and is broken down into aeronautical, retail, ORCs and other in respect of the reportable segments. No information in relation to inter-segmental revenue is disclosed as it is not considered material. Also detailed within table (a) is Adjusted EBITDA which is earnings before interest, tax, depreciation, amortisation and certain re-measurements.

Table (b) details comparative information to table (a) for the year ended 31 December 2016.

Table (c) details depreciation, amortisation and fair value adjustments.

Table (d) details asset, liability and capital expenditure information by reportable segment. The assets and liabilities information by segment is not provided to the Board on a monthly basis, but is included in this note as additional information.

Section (e) details revenue and non-current asset information by geographical segment.

Table (a)	**Segment revenue**					
Year ended 31 December 2017	**Aeronautical £m**	**Retail £m**	**ORCs £m**	**Other £m**	**Total external revenue £m**	**Adjusted EBITDA £m**
Heathrow	1,716	659	240	142	2,757	1,688
Heathrow Express	-	-	-	127	127	72
Continuing operations	1,716	659	240	269	2,884	1,760
Reconciliation to statutory information:						
Unallocated income and expense						
Depreciation and amortisation (table (c))						(694)
Operating profit (before certain re-measurements)						1,066
Fair value gain on investment properties (certain re-measurements) (table (c))						149
Operating profit						1,215
Finance income						213
Finance costs						(1,038)
Fair value gain on financial instruments (certain re-measurements)						215
Profit before tax						605
Taxation before certain re-measurements						(54)
Taxation (certain re-measurements)						(48)
Taxation charge						(102)
Profit for the year						503

Revenue of £901 million was derived from a single external customer and has been included within the Heathrow segment.

1 Segment information *continued*

Table (b)

Year ended 31 December 2016	Segment revenue Aeronautical £m	Retail £m	ORCs £m	Other £m	Total external revenue £m	Adjusted EBITDA £m
Heathrow	1,699	612	232	144*	2,687	1,616
Heathrow Express				120*	120	66
Continuing operations	1,699	612	232	264	2,807	1,682
Reconciliation to statutory information:						
Unallocated income and expense						
Depreciation and amortisation (table (c))						(673)
Operating profit (before certain re-measurements)						1,009
Fair value gain on investment properties (certain re-measurements) (table (c))						44
Operating profit						1,053
Finance income						221
Finance costs						(959)
Fair value loss on financial instruments (certain re-measurements)						(522)
Loss before tax						(207)
Taxation before certain re-measurements						(60)
Taxation (certain re-measurements)						140
Taxation credit						80
Loss for the year						(127)

* Segment revenue for both Heathrow and Heathrow Express has been re-stated by £14 million as the revenue from Transport for London (allowing the Piccadilly line to run to Heathrow) was included in the Heathrow Express revenue. The restatement reflects a more accurate performance of the underlying Heathrow Express business and to present segmental revenue on a basis consistent with Adjusted EBITDA reported for Heathrow Express. There was no effect on total revenue as a result of this restatement.

Revenue of £908 million was derived from a single external customer and has been included within the Heathrow segment.

Table (c)

	Year ended 31 December 2017		Year ended 31 December 2016	
	Depreciation & amortisation[1] £m	**Fair value gain[2] £m**	Depreciation & amortisation[1] £m	Fair value gain[2] £m
Heathrow	**(652)**	**149**	(631)	44
Heathrow Express	**(42)**	**-**	(42)	-
Total	**(694)**	**149**	(673)	44

[1] Includes intangible amortisation charge of £40 million (2016: £36 million).
[2] Reflects fair value gain on investment properties only.

Heathrow Finance plc

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

1 Segment information *continued*

Table (d)	31 December 2017			31 December 2016		
	Assets[1]	Liabilities	Capital expenditure[2]	Assets[1]	Liabilities	Capital expenditure[2]
	£m	£m	£m	£m	£m	£m
Heathrow	**13,401**	**(536)**	**685**	13,169	(474)	669
Heathrow Express	**887**	**(4)**	**15**	913	(6)	11
Total operations	**14,288**	**(540)**	**700**	14,082	(480)	680
Unallocated assets and liabilities:						
Cash , term deposits and external borrowings	**535**	**(14,390)**	**-**	666	(14,218)	-
Derivative financial instruments	**614**	**(1,466)**	**-**	754	(1,422)	-
Taxation	**-**	**(942)**	**-**	-	(909)	-
Amounts owed from/(to) group undertakings	**650**	**(57)**	**-**	158	(71)	-
Total	**16,087**	**(17,395)**	**700**	15,660	(17,100)	680

1 Segment assets primarily include airport runways and facilities.
2 Capital expenditure excludes the impact of capital creditors.

(e) Revenue and non-current asset information by geographical segment
Heathrow Finance plc is domiciled in the UK. All revenue from external customers comes from the UK which for the year ended 31 December 2017 was £2,884 million (2016: £2,807 million). The breakdown of the major components of total revenue from external customers is shown in tables (a) and (b) above.

Non-current assets excluding derivative financial instruments were £14,607 million (2016: £13,907 million). There are no non-current assets held outside the UK (2016: £nil).

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

2 Operating costs

Operating costs comprise:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Employment		
Wages and salaries	**325**	322
Social security	**35**	32
Pension	**40**	37
Other staff related costs	**24**	21
Own staff costs capitalised	**(50)**	(39)
	374	373
Operational	**252**	265
Maintenance	**176**	176
Rates	**126**	128
Utilities	**86**	74
Other	**110**	109
Operating costs before depreciation and amortisation	**1,124**	1,125
Depreciation and amortisation		
Property, plant and equipment	**654**	637
Intangible assets	**40**	36
	694	673
Total operating costs	**1,818**	1,798

Rentals under operating leases

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Operating costs include:		
Land and buildings[1,2]	**29**	17
Others[3]	**16**	15
Total rentals under operating leases	**45**	32
Property lease and sub lease charges – minimum lease payments	**15**	14

[1] The Group leases various offices and warehouses under non-cancellable operating lease agreements. The leases have various terms, escalation clauses and renewal rights. The amounts above are stated net of discounts.
[2] A significant portion of the operating rental costs relates to electricity supply equipment at the airport leased on agreement with UK Power Networks Services Limited 'UKPNS'.
[3] Others mainly comprises of wayleaves and easements.

Auditor's remuneration

Audit fees and non-audit fees for the current and preceding financial years were borne by Heathrow Airport Limited. The audit fees of FGP Topco Group are also borne by Heathrow Airport Limited.

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Fees payable to the Company's auditor for the annual audit of the:		
Company's ultimate parent	**0.1**	0.1
Company's subsidiaries [1]	**0.4**	0.3
Total audit fees	**0.5**	0.4
Fees payable to the Company's auditor and their associates for other services specific to the Group		
Audit related assurance services	**0.1**	0.1
Other services	**0.1**	-
Other assurance services	**0.1**	0.1
Total non-audit fees	**0.3**	0.2
Total fees	**0.8**	0.6

[1] Fees payable to the Company's auditors for the audit of the Company's annual accounts were £82,000 (2016: £62,000)

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

2 Operating costs *continued*

Employee numbers

The Group has 6,605 employees (2016: 6,419) of which 484 (2016: 481) are employees of HEX and the rest are legally employed by LHR Airports Limited. The Group makes all employment decisions; consequently, employee numbers for providing services to the operation of the airport are reported in the financial statement of the Group and not in the financial statements of LHR Airports Limited.

Directors' remuneration

Javier Echave was a director of a number of companies within the Heathrow Airport Holdings Group during the year. His remuneration for the year ended 31 December 2017 was disclosed in the financial statements of Heathrow Airport Holdings Limited. Andrew Efiong, Nicholas Golding and David Williamson were directors of a number of companies within the Heathrow Airport Holdings Group. They were paid by, but are not directors of, Heathrow Airport Limited. The directors do not believe it is possible to accurately apportion their remuneration to individual companies within the Group based on services provided.

During the year, one of the directors (2016: none) had retirement benefits accruing to them under a defined benefit scheme and three of the directors (2016: four) had retirement benefits accruing to them under a defined contribution scheme.

None of the directors (2016: none) exercised share options during the year in respect of their services to the HAH Group and no shares (2016: none) were received or became receivable under long-term incentive plans.

3 Financing

(a) Net finance costs before certain re-measurements

	Note	**Year ended 31 December 2017 £m**	Year ended 31 December 2016 £m
Finance income			
Interest receivable on external derivatives not in hedge relationship		**198**	209
Interest on deposits		**3**	5
Net pension finance income		**-**	4
Interest receivable from group undertakings		**12**	3
		213	221
Finance costs			
Interest on borrowings:			
Bonds and related hedging instruments[1]		**(615)**	(644)
Bank loans and overdrafts and related hedging instruments		**(74)**	(63)
Interest payable on external derivatives not in hedge relationship[2]		**(384)**	(277)
Facility fees and other charges		**(7)**	(9)
Net pension finance costs		**(3)**	-
Unwinding of credit discount		**(1)**	(1)
		(1,084)	(994)
Less: capitalised borrowing costs[3]	*6*	**46**	35
		(1,038)	(959)
Net finance costs before certain re-measurements		**(825)**	(738)

1 Includes accretion of £48 million (2016: £26 million) on index-linked bonds.
2 Includes accretion of £222 million (2016: £113 million) on index-linked swaps.
3 Capitalised interest included in the cost of qualifying assets arose on the general borrowing pool and is calculated by applying an average capitalisation rate of 5.37% (2016: 4.89%) to expenditure incurred on such assets.

(b) Fair value gain/(loss) on financial instruments

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Interest rate swaps: not in hedge relationship	**63**	(120)
Index-linked swaps: not in hedge relationship	**134**	(436)
Cross-currency swaps: ineffective portion of cash flow hedges	**4**	10
Cross-currency swaps: ineffective portion of fair value hedges	**14**	24
Fair value gain/ (loss) on financial instruments	**215**	(522)
Net finance costs	**(610)**	(1,260)

4 Taxation

	Year ended 31 December 2017			Year ended 31 December 2016		
	Before certain re-measurements £m	**Certain re-measurements £m**	**Total £m**	Before certain re-measurements £m	Certain re-measurements £m	Total £m
UK corporation tax						
Current tax charge at 19.25% (2016: 20%)	**(70)**	**(2)**	**(72)**	(50)	(2)	(52)
Under provision in respect of prior years	**-**	**-**	**-**	(1)	-	(1)
Deferred tax						
Current year (charge)/credit	**3**	**(54)**	**(51)**	(7)	88	81
Prior year credit/(charge)[1]	**13**	**8**	**21**	(2)	(2)	(4)
Change in UK corporation tax rate - impact on deferred tax assets and liabilities	**-**	**-**	**-**	-	56	56
Taxation (charge)/credit for the year	**(54)**	**(48)**	**(102)**	(60)	140	80

[1] Prior year credit for 2017 includes a £9 million adjustment in relation to investment properties and a £12 million adjustment primarily for accelerated capital allowances.

The tax (charge)/credit on the Group's profit before tax differs from the theoretical amount that would arise by applying the UK statutory tax rate to the accounting profits of the Group for the reasons as set out in the following reconciliation:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Profit before tax (before certain re-measurements)	**241**	271
Reconciliation of the tax charge		
Tax calculated at the UK statutory rate of 19.25% (2016: 20%)	**(46)**	(54)
Adjustments in respect of current income tax of previous years	**-**	(1)
Net non-deductible expenses	**(21)**	(3)
Adjustments in respect of deferred income tax of previous years[1]	**13**	(2)
Total tax charge before certain re-measurements excluding change in UK corporation tax rate	**(54)**	(60)
Change in UK corporation tax rate - impact on deferred tax assets and liabilities	**-**	56
Tax (charge)/credit on certain re-measurements[2]	**(48)**	84
Taxation charge/(credit) for the year	**(102)**	80

[1] Prior year adjustment in 2017 relates primarily to accelerated capital allowances.
[2] This consists of the tax impact arising from fair value gains on investment property revaluations and fair value gains/losses on financial instruments, along with prior year adjustments for investment properties.

The total tax charge recognised for the year ended 31 December 2017 was £102 million (2016: £80 million credit). Based on a profit before tax for the year of £605 million (2016: £207 million loss), this results in an effective tax rate of 16.9% (2016: 38.6%).

The total tax charge before certain re-measurements for the year ended 31 December 2017 was £54 million (2016: £60 million), which includes a £13 million prior year deferred tax credit adjustment (2016: £2 million prior year deferred tax debit adjustment) relating primarily to accelerated capital allowances. Based on a profit before tax and certain re-measurements of £241 million (2016: £271 million) this results in an effective tax rate of 22.4% (2016: 22.1%). The tax charge in 2017 is more (2016: more) than implied by the statutory rate of 19.25% (2016: 20%) primarily due to non-deductible expenses and because a substantial proportion of Heathrow's capital expenditure does not qualify for tax relief.

In addition, there was a £48 million tax charge (2016: £84 million tax credit) reflecting the tax impact arising from fair value gains on investment property revaluations and fair value gains/losses on financial instruments, along with any associated prior year adjustments.

The Finance (No 2) Act 2015 enacted reductions in the main rate of UK corporation tax from 20% to 19% from 1 April 2017 and from 19% to 18% from 1 April 2020. The Finance Act 2016 enacted a further reduction in the main rate of corporation tax to 17% from 1 April 2020. The effects of these rate reductions were reflected in the deferred tax balances in the 2016 financial statements.

4 Taxation *continued*

In November 2017 the Finance (No.2) Act 2017 received Royal Assent, giving effect to a new interest deductibility regime. This regime is in response to the Organisation for Economic Co-operation and Development (OECD) reports on base erosion and profit shifting (BEPS). As a result of the new legislation, from 1 April 2017, interest deductions are limited to 30% of tax based EBITDA, with the ability to apply a group ratio rule (GRR) and a public infrastructure exemption (PIE). Heathrow will be protected from the 30% of tax based EBITDA cap as a result of applying either the PIE or GRR therefore no interest disallowance has been reflected in the 2017 tax charge (2016: nil).

Other than these changes, there are no items which would materially affect the future tax charge.

5 Property, plant and equipment

	Note	Terminal complexes £m	Airfields £m	Plant and equipment £m	Other land and buildings £m	Rail £m	Assets in the course of construction £m	Total £m
Cost								
1 January 2016		11,793	1,378	855	187	1,463	645	16,321
Additions		-	-	-	-	-	666	666
Borrowing costs capitalised	3	-	-	-	-	-	35	35
Disposals		(479)	(13)	(56)	(1)	-	-	(549)
Transfer to intangible assets	7	-	-	-	-	-	(13)	(13)
Reclassification		36	-	-	-	(36)	-	-
Transfer to completed assets		104	20	28	24	-	(176)	-
31 December 2016		**11,454**	**1,385**	**827**	**210**	**1,427**	**1,157**	**16,460**
Additions		**-**	**-**	**-**	**-**	**-**	**683**	**683**
Borrowing costs capitalised	3	**-**	**-**	**-**	**-**	**-**	**46**	**46**
Disposals		**(78)**	**(10)**	**(25)**	**(5)**	**(7)**	**-**	**(125)**
Reclassfication		**-**	**-**	**-**	**-**	**-**	**(1)**	**(1)**
Transfer to intangible assets	7	**-**	**-**	**-**	**-**	**-**	**(76)**	**(76)**
Transfer to completed assets		**495**	**331**	**89**	**-**	**1**	**(916)**	**-**
31 December 2017		**11,871**	**1,706**	**891**	**205**	**1,421**	**893**	**16,987**
Depreciation								
1 January 2016		(3,593)	(387)	(369)	(55)	(487)	-	(4,891)
Depreciation charge		(468)	(47)	(70)	(10)	(42)	-	(637)
Disposals		479	13	56	1	-	-	549
Transfer to intangible assets		(1)	-	3	-	-	-	2
31 December 2016		**(3,583)**	**(421)**	**(380)**	**(64)**	**(529)**	**-**	**(4,977)**
Depreciation charge		**(472)**	**(53)**	**(78)**	**(9)**	**(42)**	**-**	**(654)**
Disposals		**78**	**10**	**25**	**5**	**7**	**-**	**125**
31 December 2017		**(3,977)**	**(464)**	**(433)**	**(68)**	**(564)**	**-**	**(5,506)**
Net book value								
31 December 2017		**7,894**	**1,242**	**458**	**137**	**857**	**893**	**11,481**
31 December 2016		7,871	964	447	146	898	1,157	11,483

Other land and buildings

Other land and buildings are freehold except for certain short leasehold properties with a net book value at 31 December 2017 of £11 million (2016: £12 million).

Assets in the course of construction

The major balances in assets in the course of construction include Baggage programme projects to install the latest generation of Baggage screening machines, the Asset Management programme to replace assets at the end of their useful life, and the Airport resilience programme including tunnels and airfield improvements.

Borrowing costs capitalised

During the year ended 31 December 2017, borrowing costs of £46 million were capitalised (2016: £35 million). Capitalised borrowing costs were calculated by applying an average interest rate of 5.37% (2016: 4.89%) to expenditure incurred on qualifying assets.

5 Property, plant and equipment *continued*
Borrowing costs capitalised *continued*
A tax deduction of £46 million (2016: £35 million) for capitalised borrowing costs was taken in the year. Subsequent depreciation of the capitalised borrowing costs is disallowed for tax purposes. Consequently, the capitalised borrowing costs give rise to a deferred tax liability, which is released each year in line with the depreciation charged on the relevant assets.

Leased assets
The Group had assets rented to third parties under operating leases as follows:

	31 December 2017	31 December 2016
	£m	£m
Cost or valuation	**594**	689
Accumulated depreciation	**(251)**	(259)
Net book value	**343**	430

Security granted by the Group over its assets, including property, plant and equipment, is disclosed in Note 11.

6 Investment properties

	Airport investment properties £m
Valuation	
1 January 2016	2,156
Revaluation	44
31 December 2016	**2,200**
Additions	**1**
Revaluation	**149**
31 December 2017	**2,350**

Investment properties were valued at fair value at 31 December 2017 by CBRE Limited, Chartered Surveyors (2016: CBRE Limited, Chartered Surveyors).

All valuations were prepared in consideration of IFRS and in accordance with the appraisal and valuation manual issued by the Royal Institution of Chartered Surveyors. Valuations were carried out having regard to comparable market evidence relevant to each specific property or class of properties. In assessing fair value, current and potential future income (after deduction of non-recoverable outgoings) has been capitalised using yields derived from market evidence. The fair value measurement hierarchy used in calculating fair value (refer to Note 13) has been classified as level 3. The higher the discount rate and expected vacancy rate, the lower the fair value. The higher the current and potential future income or rental growth rate, the higher the fair value.

The Investment Property portfolio includes Car Parks (for travellers and employees) and Maintenance Hangars, which together account for 67% of the total investment property portfolio at 31 December 2017. As stated above, the valuations are based on assumptions relevant to the type of property being valued. Management have reviewed the assumptions, as described in the sensitivity analysis below, as prepared by CBRE Limited:

	Increase/(decrease) in asset valuation
Car parks	
Revenue growth rate	
+0.5% pa	**84**
-0.5% pa	**(80)**
Operating costs	
+0.5% pa	**(21)**
-0.5% pa	**19**
Maintenance Hangars	
Net initial yield	
+0.1% pa	**(9)**
-0.1% pa	**10**

The methodology used in arriving at the incremental changes shown above is consistent with that used for the valuation of car parks and maintenance hangars within the Investment Property portfolio at the year end.

The Group has historically had a low level of void properties.

6 Investment properties *continued*

Investment properties are let on either full repair and insuring leases, under which all outgoings are the responsibility of the lessee, or under tenancies, where costs are recovered through a service charge levied on tenants during their period of occupation. This service charge amounted to less than £1 million (2016: £1 million) for which a similar amount is included within operating costs.

The property rental income earned by the Group from its investment property, all of which is leased out under operating leases, amounted to £74 million (2016: £66 million). Direct operating expenses arising on the investment property, all of which generated rental income in the period, amounted to £1 million (2016: £1 million). The Group has entered into contracts for the maintenance of its investment property, which will give rise to an annual charge of less than £1 million (2016: £1 million).

Security granted by the Group over its assets, including investment properties, is disclosed in Note 11.

7 Intangible assets

	£m
Cost	
1 January 2016	227
Additions	14
Transfers from property, plant and equipment	13
Disposals	(2)
31 December 2016	**252**
Additions	**17**
Transfers from property, plant and equipment	**76**
Disposals	**(16)**
31 December 2017	**329**
Amortisation	
1 January 2016	(94)
Charge for the year	(36)
Disposals	2
Transfers from property, plant and equipment	(2)
31 December 2016	**(130)**
Charge for the year	**(40)**
Disposals	**16**
31 December 2017	**(154)**
Net book value	
31 December 2017	**175**
31 December 2016	122

All intangible assets relate to capitalised computer software costs. These software costs principally relate to operating and financial software. These assets are being amortised over a period of between four and fifteen years. Amortisation for the year has been charged through operating costs.

8 Inventories

	31 December 2017 £m	31 December 2016 £m
Consumables	**11**	11

The total amount of inventories consumed in the year was £6 million (2016: £6 million). There is no material difference between the statement of financial position value of inventories and their replacement cost.

9 Trade and other receivables

	31 December 2017 £m	31 December 2016 £m
Non-current		
Prepaid debt fees[1]	**4**	6
Prepayments	**15**	16
Amounts owed by group undertakings	**582**	75
Other receivables	**-**	5
	601	102
Current		
Trade receivables	**210**	212
Less: provision for impairment	**(2)**	(1)
Trade receivables – net	**208**	211
Prepayments	**27**	25
Amounts owed by group undertakings[2]	**68**	83
Other receivables	**17**	3
	320	322

1 Prepaid debt fees largely relate to financing fees paid on facilities not yet drawn and are amortised over the term of the facility.
2 Amounts owed by group undertakings relate to a loan of £50 million loan due from LHR Airports Limited on an interest free basis and external payments received by LHR Airports Limited under the Shared Services Agreement on behalf of Heathrow that will be remitted to Heathrow in due course. This amount is payable on demand and accrues interest at Bank of England base rate +1.5%.

The fair value of trade and other receivables are not materially different from the carrying value.

Unless otherwise stated, trade and other receivables do not contain impaired assets.

Trade receivables are non-interest bearing and are generally on 14 day terms. No collateral is held as security.

As at 31 December 2017, trade receivables of £196 million (2016: £164 million) were fully performing. Trade receivables of £7 million (2016: £35 million) were past due but not impaired. These relate to a number of independent customers for whom there is no recent history of default. The ageing analysis of these trade receivables is as follows:

	31 December 2017 £m	31 December 2016 £m
Fully performing	**196**	164
Past due but not impaired:		
Not impaired but overdue by less than 30 days	**4**	25
Not impaired but overdue by between 30 and 60 days	**-**	-
Not impaired but overdue by more than 60 days	**3**	10
	7	35
Overdue by more than 90 days	**7**	13

Movements in the provision for impairment of trade receivables are as follows:

	2017 £m	2016 £m
1 January	**1**	1
Provision for receivables impairment	**1**	-
31 December	**2**	1

As at 31 December 2017, trade receivables were considered for impairment of which £2 million (2016: £1 million) was provided for, with the remaining amount expected to be fully recovered. The individual impaired receivables mainly relate to customers who are in difficult economic situations. The creation and release of any provisions for impaired receivables have been included in 'general expenses' within 'operating costs' in the consolidated income statement. Amounts charged to the provision account are generally written off when there is no expectation of recovery.

The Group is not exposed to significant foreign currency exchange risk as the majority of trade and other receivables are denominated in Sterling. Additional disclosure on credit risk management is included in Note 13.

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

10 Cash and cash equivalents and term deposits

	31 December 2017	31 December 2016
	£m	£m
Cash at bank and in hand	**54**	10
Short-term deposits	**469**	276
Cash and cash equivalents	**523**	286
Term deposits	**12**	380
Cash and cash equivalents and term deposits	**535**	666

Cash at bank and in hand earns interest at floating rates based on daily bank deposit rates and is subject to interest rate risk. The fair value of cash and cash equivalents approximates to their book value.

Heathrow Airport Limited and Heathrow (AH) Limited hold investments in term deposits, which have an original maturity of more than three months.

For the purposes of the Consolidated statement of cash flows, cash and cash equivalents comprise cash at bank, cash in hand, repurchase agreements with an original maturity of three months or less and short-term deposits with an original maturity of three months or less, held for the purpose of meeting short-term cash commitments, restricted cash and bank overdrafts.

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

11 Borrowings

	31 December 2017 £m	31 December 2016 £m
Current		
Secured		
Heathrow Funding Limited bonds:		
4.375% €700 million due 2017	-	598
2.500% CHF400 million due 2017	-	318
4.600% €750 million due 2018	665	-
6.250% £400 million due 2018	399	-
	1,064	916
Heathrow Finance plc bonds:		
7.125% £325 million due 2017	-	265
Total bonds	1,064	1,181
Heathrow Airport Limited loans	33	36
Total current (excluding interest payable)	1,097	1,217
Interest payable	258	284
Total current	1,355	1,501
Non-current		
Secured		
Heathrow Funding Limited bonds:		
4.600% €750 million due 2018	-	627
6.250% £400 million due 2018	-	398
4.000% C$400 million due 2019	235	240
6.000% £400 million due 2020	398	398
9.200% £250 million due 2021	266	272
3.000% C$450 million due 2021	260	274
4.875% US$1,000 million due 2021	746	831
1.650%+RPI £180 million due 2022	206	199
1.875% €600 million due 2022	545	534
5.225% £750 million due 2023	683	669
7.125% £600 million due 2024	592	591
0.500% CHF400 million due 2024	293	314
3.250% C$500 million due 2025	286	303
4.221% £155 million due 2026	155	155
6.750% £700 million due 2026	689	688
2.650% NOK1,000 million due 2027	90	93
7.075% £200 million due 2028	198	198
2.500% NOK1,000 million due 2029	81	85
1.500% €750 million due 2030	624	614
6.450% £900 million due 2031	851	850
Zero-coupon €50 million due January 2032	57	52
1.366%+RPI £75 million due 2032	82	79
Zero-coupon €50 million due April 2032	56	52
1.875% €500 million due 2032	442	-
4.171% £50 million due 2034	50	50
Zero-coupon €50 million due 2034	49	46
1.061%+RPI £180 million due 2036	191	183
1.382%+RPI £50 million due 2039	55	53
3.334%+RPI £460 million due 2039	606	585
1.238%+RPI £100 million due 2040	107	103
5.875% £750 million due 2041	735	734
4.625% £750 million due 2046	742	742
1.372%+RPI £75 million due 2049	82	79
2.750% £400 million due 2049	392	392
	10,844	11,483
Heathrow Finance plc bonds:		
5.375% £275 million due 2019	262	261
5.750% £250 million due 2025	248	248
3.875% £275 million due 2027	273	-
	783	509
Total bonds	11,627	11,992

11 Borrowings *continued*

	31 December 2017 £m	31 December 2016 £m
Heathrow Airport Limited debt:		
Class A1 term loan due 2020	**416**	-
Term notes due 2026-2037	**439**	339
Loans	**29**	62
Heathrow Finance plc facilities	**524**	324
Total other debt	**1,408**	725
Total non-current	**13,035**	12,717
Total borrowings (excluding interest payable)	**14,132**	13,934

Heathrow Funding Limited bonds

The maturity dates of the Heathrow Funding Limited bonds listed above reflect their scheduled redemption dates that correspond to the maturity dates of the loans between Heathrow Airport Limited and Heathrow Funding Limited. The bonds are not callable in nature and are expected to be repaid on their scheduled redemption date. However, to meet rating agency requirements the bonds have a legal maturity that is two years later, except for the 6.250% £400 million due 2018, 6.000% £400 million due 2020, 7.125% £600 million due 2024, 4.221% £155 million due 2026 and 1.061%+RPI £180 million due 2036 bonds wherein the redemption dates coincide with their legal maturity dates.

Fair value of borrowings

	31 December 2017		31 December 2016	
	Book value £m	**Fair value[1] £m**	Book value £m	Fair value[1] £m
Current				
Short-term debt	**1,097**	**1,084**	1,217	1,223
Non-current				
Long-term debt	**13,035**	**15,783**	12,717	15,631
	14,132	**16,867**	13,934	16,854

[1] Fair value of borrowings are for disclosure purposes only.

Accrued interest is included as a current borrowings balance and not in the carrying amount of non-current borrowings. The fair value of listed borrowings are based on quoted prices at balance sheet date. For unlisted borrowings, the Group establishes fair value by using discounted cash flow analysis utilising yield curves derived from observable market data (Level 2). The fair value of non-current borrowings which have floating rate interest are assumed to equate to their nominal value. At 31 December 2017, the fair value of debt classified as Level 1 and Level 2 was £15,006 million and £1,861 million respectively (2016: £15,456 million and £1,398 million respectively).

The average cost of the Group's external nominal gross debt at 31 December 2017 was 3.96% (2016: 4.19%). Taking into account the impact of interest rate, cross-currency and index-linked hedges but excluding index-linked swap accretion. Including index-linked swap accretion, the average cost of debt for Group's debt portfolio at 31 December 2017 was 5.62% (2016: 5.24%). The reduction in the average cost of debt excluding index-linked swap accretion since the end of 2015 is mainly due to the replacement in 2017 of relatively high cost maturing legacy debt with new lower cost debt. The increased cost of debt including index-linked swap accretion since the end of 2016 has been driven by recent increases in RPI inflation.

Securities and guarantees

Heathrow Airport Limited, Heathrow Express Operating Company Limited, Heathrow (SP) Limited and Heathrow (AH) Limited (together, the 'Obligors') have granted security to Deutsche Trustee Company Limited (in its capacity as the 'Borrower Security Trustee', for itself and as trustee for the Borrower Secured Creditors) over their property, assets and undertakings to secure their obligations under various financing agreements. Each Obligor has also guaranteed the obligations of each other Obligor under such financing agreements.

Heathrow (DSH) Limited and Heathrow Finance plc have also granted security over substantially all of their assets, which includes first priority security interests in the share capital of Heathrow Finance plc and its wholly-owned subsidiary, Heathrow (SP) Limited, to secure their obligations under their financing agreements.

BAA Pension Trust Company Limited, as a trustee from time to time of the BAA Pension Scheme, is a Borrower Secured Creditor and ranks equally in an amount up to £284 million with senior (Class A) debt.

11 Borrowings *continued*

Securities and guarantees *continued*

Heathrow Funding Limited has given Deutsche Trustee Company Limited (the 'Bond Trustee') a covenant to pay and discharge, when due, to each of the Issuer Secured Creditors (including Bondholders) all Issuer Secured Liabilities (including all amounts due under the Bonds). The Bond Trustee holds the benefit of that covenant on trust for itself and the Issuer Secured Creditors. Heathrow Funding Limited has also granted security to the Bond Trustee (for itself and as trustee for the Issuer Secured Creditors) over its property, assets, undertakings and rights to secure the covenant to pay and discharge the Issuer Secured Liabilities.

Heathrow Airport Limited and Heathrow Express Operating Company Limited have provided a guarantee and indemnity in favour of Lloyds Bank plc (in its capacity as the Borrower Account Bank) in respect of each other's obligations under the Borrower Account Bank Agreement and associated financing agreements.

Additional disclosures on risk management and hedging of borrowings are included in Notes 12 and 13.

12 Derivative financial instruments

31 December 2017	Notional £m	Assets £m	Liabilities £m	Total £m
Current				
Foreign exchange contracts	5	-	-	-
Interest rate swaps	400	-	(3)	(3)
Cross-currency swaps	510	170	-	170
Index-linked swaps	97	-	(4)	(4)
	1,012	170	(7)	163
Non-current				
Foreign exchange contracts	3	-	-	-
Interest rate swaps	2,513	-	(466)	(466)
Cross-currency swaps	3,374	408	(29)	379
Index-linked swaps	5,119	36	(964)	(928)
	11,009	444	(1,459)	(1,015)
Total	12,021	614	(1,466)	(852)

31 December 2016	Notional £m	Assets £m	Liabilities £m	Total £m
Current				
Interest rate swaps	50	-	(3)	(3)
Cross-currency swaps	856	78	-	78
	906	78	(3)	75
Non-current				
Interest rate swaps	2,913	-	(531)	(531)
Cross-currency swaps	3,442	658	(9)	649
Index-linked swaps	5,116	18	(879)	(861)
	11,471	676	(1,419)	(743)
Total	12,377	754	(1,422)	(668)

Interest rate swaps

Interest rate swaps are maintained by the Group and designated as hedges, where they qualify against variability in interest cash flows on current and future floating or fixed rate borrowings. The gains and losses deferred in equity on the cash flow hedges will be continuously released to the income statement over the period of the hedged risk. The losses deferred of £34 million expected to be released in less than one year, £34 million between one and two years, £46 million between two and five years and £177 million over five years.

Cross-currency swaps

Cross-currency swaps have been entered into by the Group to hedge currency risk on interest and principal payments on its foreign currency-denominated bond issues. The gains and losses deferred in equity on certain swaps in cash flow hedge relationships will be continuously released to the income statement over the period to maturity of the hedged bonds. The gains deferred of £1 million are expected to be released in less than one year, £nil between one and two years, losses of £3 million between two and five years and losses of £10 million over five years.

Index-linked swaps

Index-linked swaps have been entered into in order to economically hedge RPI linked revenue and the Regulatory Asset Base but are not designated in a hedge relationship.

Foreign exchange contracts

Foreign exchange contracts are used to manage exposures relating to future capital expenditure. Hedge accounting is not sought for these derivatives.

13 Financial instruments

Financial risk management objectives and policies

The Group's principal financial instruments (other than derivatives) comprise loans, term notes, listed bonds, cash and short-term deposits. The main purpose of these instruments is to raise finance for the Group's operations.

The Group also enters into derivative transactions, principally interest rate swaps, index-linked swaps, cross-currency swaps and foreign exchange contracts. The purpose of these transactions is to manage the interest rate and currency risks arising from the Group's operations and its sources of finance.

The Group mitigates the risk of mismatch between Heathrow's aeronautical income and its regulatory asset base, which are directly linked to changes in the retail prices index, and nominal debt and interest payments by the use of index-linked instruments.

The Group does not use financial instruments for speculative purposes. The treasury function operates on a centralised non-speculative risk basis. Its purpose is to identify, mitigate and hedge treasury-related financial risks inherent in the Group's business operations and funding.

The main risks arising from the Group's financial instruments are market risk (including fair value interest rate, foreign currency, cash flow interest rate and price risks), credit risk and liquidity risk. The Board approves prudent treasury policies for managing each of the risks which are summarised below.

Foreign exchange risk

For debt raised in foreign currencies, the Group uses cross-currency swaps to hedge the interest and principal payments. The Group uses foreign exchange contracts to hedge material capital expenditure in foreign currencies once a project is certain to proceed.

The Group is not exposed to foreign exchange risk on borrowings after hedging. The Group is not materially exposed to foreign exchange risk on an economic basis.

Price risk

The Group is exposed to RPI risk on its index-linked bonds and derivatives held to economically hedge cash flows on debt instruments and RPI linked revenue. As at 31 December 2017, with all other variables remaining constant, if the RPI had increased or decreased by a factor of 10%, annual pre-tax profit would have decreased or increased by £235 million and £228 million respectively (2016: £274 million and £264 million respectively). During 2017, the highest month-on-month RPI curve movement averaged 5% and the highest month-on-month movement for a given term (1-year) was 11%. Therefore 10% is considered to be reasonable and provides an appropriate stress test.

Cash flow and fair value interest rate risk

The Group's interest rate risk arises primarily from its borrowings. Borrowings issued at variable interest rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed rates expose the Group to fair value interest rate risk. The Group's policy is to maintain a mix of fixed and floating rate debt within Board approved parameters such that a minimum of 75% of existing and forecast debt is at a fixed rate. To manage this mix, the Group enters into interest rate swaps. These swaps may be designated to hedge underlying debt obligations. The Group also uses floating rate interest bearing financial assets as a natural hedge of the exposure to fair value interest rate risk.

As at 31 December 2017, the Group's fixed floating interest rate profile, after hedging, on gross debt was 97:03 (2016: 98:02).

Each 0.50% change in interest rates would have resulted in the following gain/(loss) to pre-tax profit and equity, due to movements in the finance income, finance cost and mark-to-market valuation of derivatives:

	31 December 2017		31 December 2016	
	Income statement impact £m	**Equity impact £m**	Income statement impact £m	Equity impact £m
0.50% increase	**191**	**37**	192	10
0.50% decrease	**(201)**	**(36)**	(203)	(11)

During 2017, the highest month-on-month 6 month GBP LIBOR curve movement was 0.30%; therefore 0.50% is considered to be reasonable and provides an appropriate stress test.

Credit risk

Credit risk arises from cash and cash equivalents, term deposits, derivative financial instruments and accounts receivable. The Group has no significant concentrations of credit risk. The Group's exposure to credit related losses, in the event of non-performance by counterparties to financial instruments, is mitigated by limiting exposure to any one party or instrument and ensuring only counterparties within defined credit risk parameters are used.

13 Financial instruments *continued*

Credit risk *continued*

The Group maintains a prudent split of cash and cash equivalents and term deposits across a range of market counterparties in order to mitigate counterparty credit risk. Board approved investment policies and relevant debt facility agreements provide counterparty investment limits, based on short and long-term credit ratings. Investment activity is reviewed on a regular basis and no cash or cash equivalents are placed with counterparties with short-term credit ratings lower than A-2 (S&P)/F1 (Fitch). The Group monitors the credit rating of derivative counterparties on a daily basis and ensures no positions are entered into with counterparties with long-term credit ratings below BBB+ (S&P)/BBB+ (Fitch).

As at 31 December 2017, the Group had credit risk on derivatives with asset mark to market of £614 million (2016: £754 million).

Financial assets past due but not impaired are disclosed in Note 9 'Trade and other receivables'. The maximum exposure to credit risk as at 31 December 2017 was £1,357 million (2016: £1,631 million) as disclosed in Note 13 'Financial instruments by category'.

Liquidity risk

Although there can be no certainty that financing markets will remain open for issuance at all times, debt maturities are spread over a range of dates, thereby ensuring that the Group is not exposed to excessive refinancing risk in any one year. Further details of the risk management objectives and policies are disclosed in the internal controls and risk management section of the Strategic report in the statutory annual report and financial statements.

The Group has the following undrawn committed borrowing facilities available in respect of which all conditions precedent had been met at the relevant date:

	31 December 2017 £m	31 December 2016 £m
Floating rate facilities		
Expiring in more than two years and less than five years	**1,150**	1,500
Expiring in more than five years	**100**	200
	1,250	1,700

As at 31 December 2017, overdraft facilities of £10 million were available (2016: £10 million).

The tables below analyse the gross undiscounted contractual cash flows as at 31 December of the Group's financial liabilities and net settled derivative financial instruments to the contractual maturity date.

	31 December 2017			
	Less than one year £m	**One to two years £m**	**Two to five years £m**	**Greater than five years £m**
Borrowing principal payments	**943**	**529**	**2,770**	**9,736**
Borrowing interest payments	**608**	**547**	**1,420**	**3,865**
Derivative financial instruments	**101**	**7**	**103**	**(281)**
Trade payables	**175**	**-**	**-**	**-**
Capital payables	**134**	**-**	**-**	**-**

	31 December 2016			
	Less than one year £m	One to two years £m	Two to five years £m	Greater than five years £m
Borrowing principal payments	1,157	943	2,130	9,409
Borrowing interest payments	618	575	1,467	4,050
Derivative financial instruments	(25)	45	(22)	(296)
Trade payables	169	-	-	-
Capital payables	121	-	-	-

The tables below analyse the expected gross undiscounted contractual cash flows as at 31 December of the Group's derivative financial instruments which will be settled on a gross basis based on the remaining period to the contractual maturity date. The table should be viewed in conjunction with the table presenting undiscounted cash flows on the Group's financial liabilities and net settled derivative financial instruments.

13 Financial instruments *continued*
Liquidity risk *continued*

	31 December 2017			
	Less than one year £m	**One to two years £m**	**Two to five years £m**	**Greater than five years £m**
Cross-currency derivative payments	**86**	**71**	**169**	**245**
Cross-currency derivative receipts	**(123)**	**(92)**	**(206)**	**(500)**

	31 December 2016			
	Less than one year £m	One to two years £m	Two to five years £m	Greater than five years £m
Cross-currency derivative payments	111	77	165	147
Cross-currency derivative receipts	(151)	(117)	(241)	(438)

Capital risk management
The Group's objectives when managing capital are to safeguard the Group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure. The Group regularly reviews and maintains or adjusts the capital structure as appropriate in order to achieve these objectives.

The Group monitors capital on the basis of its gearing ratio. Like other regulated utilities in the UK, gearing is measured by reference to the ratio of net debt to the Regulatory Asset Base ('RAB'). Net debt is the external consolidated nominal net debt at the entity within the Group that the relevant debt facility sits.

There are gearing covenants in financing agreements held by the Group. Gearing ratios achieved by the Group are set out below:

	31 December 2017	31 December 2016
Net debt to RAB at Heathrow Finance group	**0.87**	0.85
Total net debt to RAB at Heathrow (SP) Limited	**0.78**	0.78
Senior net debt to RAB at Heathrow (SP) Limited	**0.67**	0.67

At 31 December 2017, the Group's senior (Class A) and junior (Class B) trigger levels were 70.0% and 85.0% under its financing agreements. Note that the Group's senior gearing trigger level increases from 70.0% to 72.5% with effect from 1 April 2018. At 31 December 2017, Heathrow Finance's gearing covenant level were 90.0% abd 92.5% respectively under their financing agreements. Heathrow Finance's gearing covenant will increase to 92.5% from 1 September 2019.

Financial instruments by category
The Group's financial instruments as classified in the financial statements as at 31 December can be analysed under the following categories:

	31 December 2017			
	Loans and receivables £m	**Assets at fair value through income statement £m**	**Derivatives qualifying for hedge accounting £m**	**Total £m**
Derivative financial instruments	**-**	**36**	**578**	**614**
Cash and cash equivalents	**523**	**-**	**-**	**523**
Trade receivables	**208**	**-**	**-**	**208**
Term deposits	**12**	**-**	**-**	**12**
Total financial assets	**743**	**36**	**578**	**1,357**

	31 December 2017			
	Liabilities at fair value through income statement £m	**Derivatives qualifying for hedge accounting £m**	**Other financial liabilities at amortised cost £m**	**Total £m**
Borrowings	**-**	**-**	**(14,132)**	**(14,132)**
Derivative financial instruments	**(1,414)**	**(52)**	**-**	**(1,466)**
Trade payables	**-**	**-**	**(175)**	**(175)**
Capital payables	**-**	**-**	**(134)**	**(134)**
Total financial liabilities	**(1,414)**	**(52)**	**(14,441)**	**(15,907)**

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

13 Financial instruments *continued*
Financial instruments by category continued

	31 December 2016			
	Loans and receivables £m	Assets at fair value through income statement £m	Derivatives qualifying for hedge accounting £m	Total £m
Derivative financial instruments	-	18	736	754
Cash and cash equivalents	286	-	-	286
Trade receivables	211	-	-	211
Term deposits	380	-	-	380
Total financial assets	877	18	736	1,631

	31 December 2016			
	Liabilities at fair value through income statement £m	Derivatives qualifying for hedge accounting £m	Other financial liabilities at amortised cost £m	Total £m
Borrowings	-	-	(13,934)	(13,934)
Derivative financial instruments	(1,192)	(230)	-	(1,422)
Trade payables	-	-	(169)	(169)
Capital payables	-	-	(121)	(121)
Total financial liabilities	(1,192)	(230)	(14,224)	(15,646)

At 31 December 2017, the only financial assets and financial liabilities at fair value through the income statement are derivatives that do not qualify for hedge accounting.

Fair value estimation
Financial instruments that are measured in the statement of financial position at fair value are classified by the following fair value measurement hierarchy:

- Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 - inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices); and
- Level 3 - inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs).

At 31 December 2017 and 2016, all the resulting fair value estimates on derivative financial instruments are included in level 2.

The fair value of financial instruments traded in active markets is based on quoted market prices at the reporting date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the Group is the current bid price. These instruments are included in level 1.

The fair value of financial instruments that are not traded in an active market (such as derivatives) is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available. If all significant inputs required to fair value an instrument are observable, the instrument is included in level 2.

If one or more of the significant inputs is not based on observable market data, the instrument is included in level 3.

Specific valuation techniques used to value financial instruments include:
- quoted market prices or dealer quotes for similar instruments;
- market prices for credit spreads based on counterparty's credit default swap prices and company's bond spread;
- the fair value of cross-currency and interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves; and
- other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

On a semi-annual basis, the Group reviews any material changes to the valuation techniques and market data inputs used. The potential impact to the fair value hierarchy is assessed if it is deemed a transfer. Significant transfers between levels are considered effective at the end of the reporting period. During the year there were no transfers between the levels in the fair value hierarchy.

Heathrow Finance plc

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

13 Financial instruments *continued*
Fair value estimation *continued*

The tables below present the Group's assets (other than investment properties) and liabilities that are measured at fair value as at 31 December:

	31 December 2017			
	Level 1 £m	**Level 2 £m**	**Level 3 £m**	**Total £m**
Assets				
Assets at fair value through income statement	-	36	-	36
Derivatives qualifying for hedge accounting	-	578	-	578
Total assets	-	614	-	614
Liabilities				
Liabilities at fair value through income statement	-	(1,414)	-	(1,414)
Derivatives qualifying for hedge accounting	-	(52)	-	(52)
Total liabilities	-	(1,466)	-	(1,466)

	31 December 2016			
	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Assets				
Assets at fair value through income statement	-	18	-	18
Derivatives qualifying for hedge accounting	-	736	-	736
Total assets	-	754	-	754
Liabilities				
Liabilities at fair value through income statement	-	(1,192)	-	(1,192)
Derivatives qualifying for hedge accounting	-	(230)	-	(230)
Total liabilities	-	(1,422)	-	(1,422)

On a semi-annual basis, the Group reviews any material changes to the valuation techniques and market data inputs used. The potential impact to the fair value hierarchy is assessed if it is deemed a transfer. Significant transfers between levels are considered effective at the end of the reporting period. During the year there were no transfers between the levels in the fair value hierarchy.

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

14 Deferred income tax

The net movement on the deferred income tax account is as follows:

	2017 £m	2016 £m
1 January	**(884)**	(1,056)
(Charged)/credited to income statement	**(30)**	77
Credited to income statement – change in tax rate	**-**	56
Credited to other comprehensive income	**9**	40
Charged to other comprehensive income – change in tax rate	**-**	(1)
31 December	**(905)**	(884)

Deferred tax is analysed as follows:

	2017 £m	2016 £m
Deferred income tax liabilities	**(1,073)**	(1,070)
Deferred income tax assets	**168**	186
31 December	**(905)**	(884)

The amounts of deferred income tax provided are detailed below:

Deferred income tax liabilities

	Excess of capital allowances over depreciation £m	Revaluations of investment property to fair value £m	Revaluations of property, plant and equipment £m	Tax on rolled over gains £m	Post employment benefits £m	Others £m	Total £m
1 January 2016	(842)	(194)	(51)	(7)	(19)	(14)	(1,127)
(Charged)/credited to income statement	(11)	(4)	(1)	(1)	(6)	1	(22)
Credited to income statement- change in tax rate	42	7	4	-	-	1	54
Credited to other comprehensive income	-	-	1	-	38	-	39
Credited/(charged) to other comprehensive income - change in tax rate	-	4	-	-	2	-	6
Re-allocation from deferred income tax assets	(5)	-	-	-	(15)	-	(20)
31 December 2016	**(816)**	**(187)**	**(47)**	**(8)**	**-**	**(12)**	**(1,070)**
Credited/(charged) to income statement	**5**	**(10)**	**-**	**-**	**-**	**-**	**(5)**
Credited to other comprehensive income		**-**	**2**	**-**	**-**	**-**	**2**
31 December 2017	**(811)**	**(197)**	**(45)**	**(8)**	**-**	**(12)**	**(1,073)**

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

14 Deferred income tax *continued*

Deferred income tax assets

	Financial instruments £m	Short-term timing differences £m	Post employment benefits £m	Total £m
1 January 2016	66	-	5	71
Credited to income statement	99	-	-	99
Credited to income statement – change in tax rate	2	-	-	2
Credited to other comprehensive income	-	-	1	1
Charged to other comprehensive income – change in tax rate	(7)	-	-	(7)
Re-allocation to deferred income tax liabilities	-	5	15	20
31 December 2016	**160**	**5**	**21**	**186**
(Charged)/credited to income statement	**(24)**	**2**	**(3)**	**(25)**
(Charged)/credited to other comprehensive income	**(3)**	**-**	**10**	**7**
31 December 2017	**133**	**7**	**28**	**168**

Deferred income tax credited to other comprehensive income during the year is as follows:

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Cash flow hedge reserve	**(3)**	-
Cash flow hedge reserve – change in tax rate	**-**	(7)
Tax relating to indexation of operational land	**2**	1
Tax credit on actuarial loss	**10**	39
Retained earnings – change in tax rate	**-**	6
	9	39

The Finance (No 2) Act 2015 enacted reductions in the main rate of UK corporation tax from 20% to 19% from 1 April 2017 and from 19% to 18% from 1 April 2020. The Finance Act 2016 enacted a further 1% reduction in the main rate of corporation tax to 17% from 1 April 2020. The effects of these rate reductions were reflected in the deferred tax balances in the 2016 financial statements.

Deferred income tax assets have been recognised in respect of all temporary differences giving rise to deferred income tax assets where it is considered probable that there will be sufficient future taxable profit against which these assets will be recovered.

15 Retirement benefit obligations

The Group has applied the requirements of the standard IAS 19 'Employee Benefits (Revised 2011)' ('IAS 19R') for the year ended 31 December 2017. The total cost of defined contribution pension arrangements are fully expensed as employment costs.

Characteristics of the LHR Airports Limited related liabilities

LHR Airports Limited operates a defined contribution pension scheme for all employees who joined the Group after 15 June 2008. The HAH Group has no further payment obligations once the contributions have been paid.

The HAH Group's primary UK defined benefit pension fund is a self-administered defined benefit scheme (the 'BAA Pension Scheme' or the 'Scheme') now closed to new employees. As required by UK pension law, there is a Pension Trustee Board that, together with LHR Airports Limited, is responsible for governance of the Scheme. The employer's contributions are determined based on triennial valuations conducted on assumptions determined by the Trustee and agreed by LHR Airports Limited. The defined benefit obligation or surplus is calculated quarterly by independent actuaries.

In July 2016, the trustee of the BAA Pension Scheme concluded a formal actuarial valuation of the Scheme. The valuation was carried out as at 30 September 2015 and took into account changes implemented to reduce the Scheme's liabilities. These were the introduction of an annual cap on future increases in pensionable pay for active members and a reduction

15 Retirement benefit obligations *continued*

Characteristics of the LHR Airports Limited related liabilities continued

in both the accrual rate for future service and inflationary increases for those service pensions whilst in payment. The valuation indicated a scheme deficit of £228 million calculated using the agreed actuarial assumptions. As part of the process, LHR Airports Limited agreed a reduction to its annual deficit repair contribution from £27 million to £23 million that is intended to eliminate the deficit by 2022. The process also resulted in a reduction in ongoing cash contributions from 33% to 23% of pensionable salary, consistent with the efficiency targets under the current regulatory settlement. The reduction in cash contributions into the Scheme applied from 1 July 2016 and is estimated at £12 million per annum.

LHR Airports Limited also provides unfunded pensions in respect of a limited number of former directors and senior employees whose benefits are restricted by the rules of the Scheme. In addition, LHR Airports Limited provides post-retirement medical benefits to certain pensioners.

Amounts arising from pensions related liabilities in the Group's financial statements

The following tables identify the amounts in the Group's financial statements arising from its pension related liabilities. Further details of each scheme (except defined contribution schemes) are within sections a) and b).

Income statement - pension and other pension related liabilities costs

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
Employment costs:		
Defined contribution schemes	**10**	10
BAA Pension Scheme	**29**	27
	39	37
Finance charge/(income) - BAA Pension Scheme	**1**	(5)
Total pension costs	**40**	32

Other comprehensive income – (loss)/gain on pension and other pension related liabilities

	Year ended 31 December 2017 £m	Year ended 31 December 2016 £m
BAA Pension Scheme	**(65)**	(219)
Unfunded schemes	**1**	(7)
Actuarial loss recognised before tax	**(64)**	(226)
Tax credit on actuarial loss	**10**	39
Actuarial loss recognised after tax	**(54)**	(187)

Statement of financial position – net defined benefit pension (deficit)/surplus and other pension related liabilities

The net deficit or surplus of the LHR Airports Limited retirement benefit schemes, being the BAA Pension Scheme, Unfunded Unapproved Retirement Benefit Scheme and Post-Retirement Medical Benefit Scheme, are recognised within non-current assets or non-current liabilities if the pension schemes are in a surplus or deficit position respectively. The net surplus or deficit is presented below for the current and previous four financial years.

	31 December				
	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m
Fair value of plan assets	**4,085**	3,975	3,288	3,274	2,867
Benefit obligation	**(4,209)**	(4,054)	(3,184)	(3,473)	(2,960)
(Deficit)/surplus in BAA Pension Scheme	**(124)**	(79)	104	(199)	(93)
Unfunded pension obligations	**(29)**	(29)	(22)	(24)	(22)
Post-retirement medical benefits	**(5)**	(6)	(6)	(6)	(6)
Deficit in other pension related liabilities	**(34)**	(35)	(28)	(30)	(28)
Net (deficit)/surplus in pension schemes	**(158)**	(114)	76	(229)	(121)
Group share of net (deficit)/surplus in pension schemes	**(158)**	(114)	76	(229)	(106)

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

15 Retirement benefit obligations *continued*
(a) BAA Pension Scheme
The Heathrow Airport Holdings ("HAH") Group operates one main defined benefit pension scheme for its UK employees, the BAA Pension Scheme, which is a funded defined benefit scheme with both open and closed sections. The Scheme closed to employees joining the Group after 15 June 2008. The Scheme's assets are held separately from the assets of the HAH Group and are administered by the trustee.

The value placed on the Scheme's obligations as at 31 December 2017 is based on the full actuarial valuation carried out at 30 September 2015. This has been updated at 31 December 2017 by KPMG LLP to take account of changes in economic and demographic assumptions, in accordance with IAS 19R. The Scheme assets are stated at their bid value at 31 December 2017. As required by IAS 19R, the Group recognises re-measurements as they occur in the statement of comprehensive income.

Analysis of movements in plan assets and defined benefit obligations

	2017 **£m**	2016 £m
Fair value of plan assets at 1 January	**3,975**	3,288
Income statement:		
Interest income on plan assets	**108**	124
Administration costs	**(3)**	(2)
Other comprehensive income:		
Remeasurement gain/(loss) (return on assets in excess of interest income on plan assets)	**75**	603
Cash flows:		
Employer contributions (including benefits paid and reimbursed)	**50**	59
Members' contributions	**5**	5
Benefits paid (by fund and Group)	**(125)**	(102)
Fair value of plan assets at 31 December	**4,085**	3,975
Defined benefit obligation at 1 January	**(4,054)**	(3,184)
Income statement:		
Current service cost	**(26)**	(25)
Interest cost	**(109)**	(120)
Other comprehensive income:		
Experience gains	**-**	53
Re-measurements of defined benefit obligation:		
arising from changes in demographic assumptions	**-**	2
arising from changes in financial assumptions	**(140)**	(877)
Cash flows:		
Members' contributions	**(5)**	(5)
Benefits paid (by fund and Group)	**125**	102
Defined benefit obligation at 31 December	**(4,209)**	(4,054)

For the year ended 31 December 2017 there were experience gains of £nil million (2016: £53 million).

The net actuarial loss before tax of £65 million (2016: £219 million net loss) resulted from a loss on change in assumptions of £140 million (2016: £875 million loss), partially offset by the actual return on assets being £75 million in excess (2016: £603 million in excess) of the income statement credit.

15 Retirement benefit obligations continued

(a) BAA Pension Scheme *continued*

The actuarial loss on change in financial assumptions is mainly attributable to a decrease in the net yield of 0.15% over the year, based on a single equivalent discount rate assumption of 2.55% and an RPI inflation assumption of 3.40%. The discount rate used has decreased from 2.75% in 2016 to 2.55% in 2017. IAS 19 requires that this discount rate should be derived from the yield on 'high quality corporate bonds' of duration consistent with liabilities of the scheme. The discount rate is based on a full yield curve approach, a 'single agency' approach where the yield curve is constructed from the Merrill Lynch corporate bond universe with at least one AA rating from the main ratings agencies.

Analysis of fair value of plan assets

	31 December 2017 £m	31 December 2016 £m
Fair value of plan assets		
Equity	**540**	476
Property	**172**	118
Bonds	**1,405**	1,095
Cash	**59**	153
LDI	**1,579**	1,583
Other	**330**	550
Total fair value of plan assets	**4,085**	3,975

At 31 December 2017, the largest single category of investment is a liability driven investment mandate, with a value of £1,579 million (39% of the asset holding at 31 December 2017). The purpose of the Scheme entering into this mandate is to reduce asset/liability mismatch risk. At 31 December 2016, the largest single category of investment is an interest rate and inflation hedging mandate, with a value of £1,583 million (40% of the asset holding at 31 December 2016).

LDI holdings are portfolios of interest rate and inflation derivatives which are intended to protect the Scheme from movements in interest rates and inflation, so that the fair value of this element of the portfolio moves in the same way as the fair value of Scheme's obligations.

Analysis of financial assumptions

The financial assumptions used to calculate Scheme assets and liabilities under IAS 19R were:

	31 December 2017 %	31 December 2016 %
Rate of increase in pensionable salaries	**1.90**	1.90
Increase to deferred benefits during deferment	**2.65**	2.70
Increase to pensions in payment:		
Open section	**3.30**	3.35
Closed section	**3.40**	3.45
Discount rate	**2.55**	2.75
Inflation assumption	**3.40**	3.45

The assumptions relating to longevity underlying the pension liabilities at the reporting date are in line with those adopted for the 2015 actuarial funding valuation, and are based on standard actuarial mortality tables with an allowance for future improvements in longevity. The assumptions are equivalent to a life expectancy for a 60 year old male pensioner of 27.1years (2016: 27.0 years) and 29.4 years (2016: 29.3 years) from age 60 for a 40 year old male non-pensioner.

The expected rate of inflation is an important assumption for the salary growth and pension increase assumptions. A rate of inflation is 'implied' by the difference between the yields on fixed and index-linked government bonds.

As required under IAS 19R, interest income on the plan assets is calculated by multiplying the fair value of the plan assets by the discount rate discussed above.

15 Retirement benefit obligations *continued*
(a) BAA Pension Scheme *continued*
Sensitivity analysis of significant assumptions
The following tables present a sensitivity analysis for each significant actuarial assumption showing how the defined benefit obligation would have been affected, before and after tax, by changes in the relevant actuarial assumptions that were reasonably possible at the reporting date.

The standard market practice is to include sensitivity to a change of between 0.1% and 1%. Therefore 0.5% is considered to be reasonable and in line with market practice.

The range of long term inflation and long dated AA bonds over 2017 were c.0.4% and 0.5% respectively, so the choice of 0.5% is deemed to be acceptable as pension sensitivities are aligned to historical trends.

	31 December 2017 (Decrease)/increase in defined benefit obligation	
	Before tax £m	After tax £m
Discount rate		
+0.50% discount rate	(416)	(345)
-0.50% discount rate	483	401
Inflation rate		
+0.50% inflation rate	392	325
-0.50% inflation rate	(348)	(289)
Mortality		
Increase in life expectancy by one year	157	130

The sensitivity analysis is based on a change in one assumption while holding all other assumptions constant, therefore interdependencies between assumptions are excluded, with the exception of the inflation rate sensitivity which also impacts salary and pension increase assumptions. The analysis also makes no allowance for the impact of changes in gilt and corporate bond yields on asset values. The methodology applied is consistent to that used to determine the recognised pension liability.

The total contributions to the defined benefit pension scheme in 2018 are expected to be £51 million for the Group. The levels of contributions are based on the current service costs and the expected cash flows of the defined benefit pension scheme. The Group estimates the present value of the duration of the Scheme liabilities on average fall due over 21 years (2016: 19 years).

(b) Other pension and post-retirement liabilities
LHR Airports Limited also provides unfunded pensions in respect of a limited number of former directors and senior employees whose benefits are restricted by the Scheme rules. The unfunded pension obligations amount to £29 million (2016: £29 million) and are included in the statement of financial position.

In addition LHR Airports Limited provides post-retirement medical benefits to certain pensioners. The present value of the future liabilities under this arrangement is £5 million (2016: £6 million) and this is also included in the statement of financial position. The value of these unfunded pensions has been assessed by the actuary using the same assumptions as those used to calculate the Scheme's liabilities.

16 Provisions

	Reorganisation costs £m	Home loss payments £m	Other £m	Total £m
Current	12	-	-	12
Non-current	-	7	2	9
1 January 2017	**12**	**7**	**2**	**21**
Charged to income statement	**8**	**-**	**-**	**8**
Utilised	**(10)**	**-**	**-**	**(10)**
Released to the income statement	**(4)**	**-**	**(1)**	**(5)**
31 December 2017	**6**	**7**	**1**	**14**
Current	**6**	**-**	**-**	**6**
Non-current	**-**	**7**	**1**	**8**
31 December 2017	**6**	**7**	**1**	**14**

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

16 Provisions *continued*

Reorganisation costs

These are costs associated with the Company's reorganisation programmes primarily relating to restructuring processes designed to reduce the size and costs of overhead functions. The utilisation and release of the provision relates to severance and pension payments associated with the reorganisation programme carried out during 2016 and continuing into 2017. The charge relates to a provision established in 2017 for voluntary severance in engineering and baggage operational areas. The provision will be fully utilised in 2018.

Home loss payments

Between 2005 and 2011, the Company entered into a number of agreements to buy residential properties in the original third runway blight area. The purchase price for these properties included a deferred 10% payment ("deferred payment") which will be settled in cash when planning consent is obtained, expected to be around 2021. In October 2016, the Government announced its decision in favour of expansion at Heathrow and following board approval, a public statement was issued by the Company stating its intention to apply for planning consent, making it probable that the Company will be required to pay the deferred payment in the future. As a result, in the year ended 31 December 2016, the Company created a provision for the deferred payment equal to the amount it expects to pay of £7 million.

Other

These provisions relate to insurance claims liability from incidents which occurred at Heathrow airport.

17 Trade and other payables

	31 December 2017 £m	31 December 2016 £m
Non-current		
Other payables	**7**	8
	7	8
Current		
Deferred income	**33**	30
Trade payables[1]	**175**	169
Other tax and social security	**9**	8
Other payables	**10**	9
Capital payables	**134**	121
Amount owed to group undertakings – operating[2]	**57**	71
	418	408

1 Trade payables are non-interest bearing and are generally on 30-day terms.
2 Amounts owed to group undertakings largely relate to external payments made by LHR Airports Limited under the Shared Services Agreement on behalf of Heathrow.

18 Share capital

	£m
Authorised	
At 1 January and 31 December 2017	
9,500,000,000 ordinary shares of £1 each	**9,500**
Called up, allotted and fully paid	
At 1 January and 31 December 2017	
3,109,350,689 ordinary shares of £1 each	**3,109**

19 Merger reserve

	£m
1 January 2017 and 31 December 2017	**(994)**

20 Cash flow hedge reserve

	2017 £m	2016 £m
1 January	**(268)**	(284)
Cash flow hedges		
Fair value (losses)/gains	**(127)**	317
Transferred to income statement	**146**	(294)
Deferred tax on fair value gains	**(3)**	-
Change in tax rate	**-**	(7)
31 December	**(252)**	(268)

21 Tax relating to components of other comprehensive income

The tax credit relating to components of other comprehensive income is as follows:

	Year ended 31 December 2017			Year ended 31 December 2016		
	Before tax £m	**Tax (charge)/ credit £m**	**After tax £m**	Before tax £m	Tax (charge)/ credit £m	After tax £m
Cash flow hedges						
(Losses)/gains taken to equity	**(127)**	**22**	**(105)**	317	(53)	264
Transferred to income statement	**146**	**(25)**	**121**	(294)	53	(241)
Change in tax rate	**-**	**-**	**-**	-	(7)	(7)
Actuarial loss on pensions	**(64)**	**10**	**(54)**	(226)	39	(187)
Change in tax rate	**-**	**-**	**-**	-	6	6
Tax relating to indexation of operational land	**-**	**2**	**2**	-	1	1
Other comprehensive (loss)/ income	**(45)**	**9**	**(36)**	(203)	39	(164)
Deferred tax	**-**	**9**	**-**	-	39	-

22 Retained earnings

	2017 £m	2016 £m
1 January	**(3,287)**	(2,364)
Consolidated profit/(loss) for the year	**503**	(127)
Dividends paid to Heathrow (DSH) Limited[1]	**(335)**	(616)
Tax relating to indexation of operational land	**2**	1
Change in tax rate	**-**	6
Actuarial loss on pensions (Note 15)	**(64)**	(226)
Tax credit on actuarial loss	**10**	39
31 December	**(3,171)**	(3,287)

1 During the year ended 31 December 2017, the Company paid dividends of £335 million to Heathrow (DSH) Limited comprising £85 million on 23 February 2017 and £250 million on 20 December 2017. (2016: £615 million comprising £78 million on 22 February 2016, £177 million on 23 June 2016 and £135 million on 22 July 2016, £1.3 million on 16 September 2016, £114 million on 6 October 2016 and £110 million on 21 December 2016.)

During the year, the Board has become aware of certain instances of technical breaches of Companies Act 2006 (and before that, the Companies Act 1985 (the "Acts") that have arisen with regard to dividends paid (between 2013 and 2016) by the Company. The instances relate to where reliance was placed on accounts where the reserves shown in the balance sheet had been fully utilised by dividends paid between the balance sheet date and the date of distribution in question or reliance was placed on interim or annual accounts which had not been filed at Companies House prior to the payment of the dividend. The Company at all times had sufficient profit and other distributable reserves to justify the payments of dividends. Since the breaches were discovered, the Company has undertaken rectification steps to regularise the position. The rectification did not require any adjustments to the accounts and did not have any effect on the Company's financial position.

23 Commitments and contingent liabilities

Non-cancellable operating lease commitments – Group as a lessee

Total future minimum rentals payable as at the year end are as follows:

	31 December 2017		31 December 2016	
	Land and buildings £m	**Other £m**	Land and buildings £m	Other £m
Within one year	**13**	**36**	14	35
Within two to five years	**44**	**138**	26	134
After five years	**5**	**481**	8	450
	62	**655**	48	619

The Group leases various offices and warehouses under non-cancellable operating lease agreements. The leases have various terms, escalation clauses and renewal rights. The Group also leases plant and machinery under non-cancellable operating leases.

23 Commitments and contingent liabilities *continued*

Non-cancellable operating lease commitments – Group as a lessee *continued*

A significant portion of the commitments classified as 'other' relates to electricity supply equipment at Heathrow leased on agreement with UK Power Networks Services Limited ('UKPNS'). The lease expires in 2083. The amounts disclosed are the total estimated charges under the agreement including both the actual lease commitment and the significant maintenance element of the fee payable to UKPNS as neither the Group nor UKPNS are able to split the base fee between a 'capital' and 'maintenance' charge. The commitment has been discounted at the Group's incremental borrowing rate.

Other commitments in total have increased from £619 million in 2016 to £655 million in 2017, based on current information available from contracts held with third parties. The increase in other commitments is due mainly to the change in assumptions used to calculate the net present value of the commitments under the UKPNS contract.

Non-cancellable operating lease commitments – Group as a lessor

Total future minimum rentals receivable as at the year end are as follows:

	31 December 2017	31 December 2016
	Land and buildings	Land and buildings
	£m	£m
Within one year	**95**	92
Within two to five years	**243**	205
After five years	**1,711**	1,709
	2,049	2,006

The Group uses a number of different leasing and contractual structures depending on the type and location of the investment property. Typically in multi-let offices and industrial premises a standard indefinite tenancy is used, which is terminable by the tenant on three months' notice at any time. However, it is common for the accommodation to remain let or be quickly re-let should it be vacated. For larger, stand alone premises, e.g. cargo sheds, longer leases of multiples of three years are used.

Car rental facilities are operated under concession agreements subject to minimum guaranteed payments and the amounts are included above. Public car parks are covered by a single management contract.

Group commitments for property, plant and equipment

	31 December 2017	31 December 2016
	£m	£m
Contracted for, but not accrued:		
Baggage systems	**155**	157
Terminal restoration and modernisation	**101**	173
Capacity optimisation	**23**	33
IT projects	**21**	28
Other projects	**23**	24
	323	415

The figures in the above table are contractual commitments to purchase goods and services at the reporting date. Capital expenditure for the Q6 regulatory period from 1 April 2014 to 31 December 2018 is currently forecast to be £3.0 billion (excluding expansion related costs). The Q6 capital programme may increase to up to £3.3 billion, in line with the regulatory settlement. This is subject to further scoping of the remaining individual projects and approval of the corresponding business cases. The capital programme is primarily focussed on maintenance and compliance related projects, together with sustaining and improving the passenger experience.

The capital plan for the period includes a £1 billion programme of asset management projects and a project to implement the latest generation of hold baggage screening equipment to comply with EU directives. Capital spend in 2018 is forecast to be in the region of £700 million (excluding expansion related costs).

Other commitments

Heathrow Airport Limited has a commitment to pay £87 million in 2018 to the Department for Transport in relation to the Crossrail project in return for a service commitment for Crossrail to operate services to Heathrow for 15 years. It is expected that the amount will be included in the RAB.

Following the Government decision in October 2016 for Heathrow as preferred option for expansion, the Company recognises that up to 64 residential property owners could exercise their right under the previous scheme for which bonds were issued, to redeem those bonds at some point in the future. At this time it is not possible to state how many of those owners will exercise their right, or at what point in time. If all 64 owners exercised their option to sell, the Company's best estimate of the total payment is £21 million based on a valuation in accordance with the terms set out in the bond contract.

Notes to the Group financial statements for the year ended 31 December 2017 *continued*

23 Contingent liabilities *continued*

The Group has external contingent liabilities, comprising letters of credit, performance/surety bonds, performance guarantees and other items arising in the normal course of business amounting to £1 million at 31 December 2017 (2016: £1 million).

24 Notes to the consolidated cash flow statement

Reconciliation of net profit/(loss) before tax to cash generated from continuing operations

	Note	**Year ended 31 December 2017 £m**	Year ended 31 December 2016 £m
Operating activities			
Profit/(loss) before tax		**605**	(207)
Adjustments for:			
Fair value (gain)/loss on financial instruments	*3(b)*	**(215)**	522
Finance costs	*3(a)*	**1,038**	959
Finance income	*3(a)*	**(213)**	(221)
Fair value gain on investment properties	*1(c)*	**(149)**	(44)
Depreciation	*2*	**654**	637
Amortisation	*2*	**40**	36
Increase in trade and other receivables		**(7)**	(18)
Increase in trade and other payables		**8**	14
(Decrease)/increase in provisions		**(7)**	7
Difference between pension charge and cash contributions		**(22)**	(31)
Cash generated from continuing operations		**1,732**	1,654

Reconciliation in net debt

Net debt comprised the Group's consolidated borrowings, excluding interest accruals, net of cash and cash equivalents and term deposits.

	1 January 2017 £m	**Cashflow £m**	**Transfers from non-current to current £m**	**Other non-cash changes[1] £m**	**31 December 2017 £m**
Cash and cash equivalents	**286**	**237**	**-**	**-**	**523**
Term deposits	**380**	**(368)**	**-**	**-**	**12**
Current debt	**(1,217)**	**1,157**	**(1,059)**	**22**	**(1,097)**
Non-current debt	**(12,717)**	**(1,429)**	**1,059**	**52**	**(13,035)**
Net debt	**(13,268)**	**(403)**	**-**	**74**	**(13,597)**

	1 January 2016 £m	Cashflow £m	Transfers from non-current to current £m	Other non-cash changes[1] £m	31 December 2016 £m
Cash and cash equivalents	178	108	-	-	286
Term deposits	550	(170)	-	-	380
Current debt	(708)	800	(1,162)	(147)	(1,217)
Non-current debt	(12,038)	(1,114)	1,162	(727)	(12,717)
Net debt	(12,018)	(376)	-	(874)	(13,268)

[1] Relates to amortisation of issue costs, premiums and discounts, foreign exchange translations of foreign debt, fair value adjustments on hedged bonds and accretion accruals.

25 Related party transactions

During the year the Group entered into the following transactions with related parties:

	Year ended 31 December 2017 Purchase of goods and services £m	Year ended 31 December 2016 Purchase of goods and services £m
Ferrovial Agroman	**61**	62
HETCo[1]	**-**	7
	61	69

[1]A joint venture between Ferrovial Agroman and Laing O'Rourke.

	Year ended 31 December 2017 Sales to related party £m	Year ended 31 December 2016 Sales to related party £m
Harrods International Limited	**23**	22
Qatar Airways	**35**	32
	58	54

The related parties outlined above are related through ownership by the same parties. The transactions relate primarily to construction projects, loans and interest payable and are conducted on an arm's length basis.

The Group enters into transactions with LHR Airports Limited in accordance with the SSA, as described in the Accounting policies note. The amount expensed in the Group's income statement in relation to these charges is shown within Notes 2 and 3. Where the repayment terms and nature of settlement of the related statement of financial position amounts are known they are disclosed in the relevant statement of financial position caption, see Notes 9 and 17. The Group also has other balances with other entities owned by FGP Topco Limited that are not eliminated on consolidation and that relate to previous group reconstructions and financing arrangements. Where known, the nature, settlement and terms of the arrangements are disclosed in Notes 9 and 17.

26 Ultimate parent undertaking and controlling party

The immediate parent undertaking of the Group is Heathrow (DSH) Limited, a company registered in England and Wales.

The ultimate parent entity is FGP Topco Limited, which is the parent undertaking of the smallest and largest group to consolidate these financial statements. The shareholders of FGP Topco Limited are Hubco Netherlands B.V. (25.00%) (an indirect subsidiary of Ferrovial, S.A., Spain), Qatar Holding Aviation (20.00%) (a wholly-owned subsidiary of Qatar Holding LLC), Caisse de dépôt et placement du Québec (12.62%), Baker Street Investment Pte Ltd (11.20%) (an investment vehicle of GIC), Alinda Airports UK L.P. (11.18%) (an investment vehicle managed by Alinda Capital Partners), Stable Investment Corporation (10.00%) (an investment vehicle of the China Investment Corporation) and USS Buzzard Limited (10.00%) (wholly-owned by the Universities Superannuation Scheme).

The Group's results are also included in the audited consolidated financial statements of Heathrow Airport Holdings Limited for the year ended 31 December 2017, which is the parent undertaking of the smallest group to consolidate these financial statements. They are also included in the audited consolidated financial statements of FGP Topco Limited for the year ended 31 December 2017.

Copies of the financial statements of FGP Topco Limited and Heathrow Airport Holdings Limited may be obtained by writing to the Company Secretarial Department at The Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW.

27 Subsidiaries
The subsidiaries of the Group are as follows:

Holding companies
Heathrow (SP) Limited
Heathrow (AH) Limited †

Airport owner and operator
Heathrow Airport Limited†

Other
Heathrow Funding Limited †#
Heathrow Express Operating Company Limited †

† Held by a subsidiary undertaking
# Incorporated in Jersey, but UK tax resident

Unless otherwise indicated, all subsidiaries are wholly owned, incorporated in Great Britain and registered in England and Wales.

The registered office of the Company's subsidiaries is the same as Heathrow Finance plc as set up below, with the exception of Heathrow Funding Limited whose registered office is 13 Castle Street, St Helier, Jersey, JE4 5UT, Channel Islands.

28 Subsequent events
On 21 February 2018, the Board approved the payment of a £113.25 million dividend to the Company's parent, Heathrow (DSH) Limited. A £113.25 million dividend receipt from the Company's subsidiary, Heathrow SP Limited, was also approved on 21 February 2018.

Registered office
Heathrow Finance plc, The Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW
Registered in England Number: 06458635

Heathrow Finance plc

Company statement of financial position as at 31 December 2017

	Note	31 December 2017 £m	31 December 2016 £m
Assets			
Non-current assets			
Investment in subsidiary	*2*	**5,006**	5,006
Trade and other receivables	*3*	**2,410**	1,418
		7,416	6,424
Current assets			
Trade and other receivables	*3*	**91**	79
Cash at bank and in hand		**10**	6
		101	85
Total assets		**7,517**	6,509
Liabilities			
Non-current liabilities			
Trade and other payables	*4*	**(1,307)**	(833)
Current liabilities			
Trade and other payables	*4*	**(26)**	(286)
Total liabilities		**(1,333)**	(1,119)
Net assets		**6,184**	5,390
Capital and reserves			
Called up share capital	*5*	**3,109**	3,109
Revaluation reserve	*6*	**1,997**	1,997
Profit and loss reserve	*6*	**1,078**	284
Total shareholder's funds		**6,184**	5,390

The profit of the Company for the year attributable to shareholders was £1,129 million (2016: £615 million).

The financial statements of Heathrow Finance plc (Company registration number: 06458635) were approved by the Board of Directors and authorised for issue on 21 February 2018. They were signed on its behalf by:

Javier Echave
Director

Nicholas Golding
Director

Heathrow Finance plc

Accounting policies for the year ended 31 December 2017

The principal accounting policies applied in the preparation of the financial statements: of Heathrow Finance plc (the 'Company') are set out below. These policies have been applied consistently to all the years presented, unless otherwise stated.

Basis of preparation
These financial statements have been prepared under the historical cost convention, as modified by the revaluation of investment in subsidiary in accordance with the Companies Act 2006 and applicable accounting standards. They have been prepared by the directors in accordance with FRS 101.

Under FRS 101, the Company has chosen to apply the recognition and measurement provisions of International Accounting Standard ('IAS') 27 'Separate Financial Statements', as endorsed by the European Union ('EU').

The Company has taken advantage of certain disclosure exemptions in FRS 101 as its financial statements are included in the publicly available consolidated financial statements of the Group. As such, the Company is exempt from presenting the Statement of cashflows and from the disclosures requirement to show related party transactions with entities that are wholly owned subsidiaries of the Company. In addition, the Company has also taken advantage of disclosure exemption of the income statement as allowed by the Companies Act. Copies of those consolidated financial statements may be obtained by writing to the Company Secretarial Department at the Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW.

The Company is not a financial institution and is therefore able to take advantage of exemption from all requirements of, IFRS 7 'Financial Instruments: Disclosures' and from the disclosure requirements of IFRS 13 'Fair Value Measurement' and IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

We consider that the disclosures required in the statement of changes in equity are satisfied by reference to Notes 1,5 and 6.

Going concern
The Directors have prepared the financial statements on a going concern basis which requires the Directors to have a reasonable expectation that the Company, as part of the Heathrow Airport Holdings Limited group (the 'HAH Group'), has adequate resources to continue in operational existence for the foreseeable future. The Company forms part of the HAH Group, the level at which financial risks are managed for the Company.

Consequently the Directors have reviewed the cash flow projections of the HAH Group taking into account:
- the forecast turnover and operating cash flows from the underlying operations;
- the forecast level of capital expenditure; and
- the overall HAH Group liquidity position, including cash resources, the remaining committed and uncommitted facilities available to it, its scheduled debt maturities, its forecast financial ratios and its ability to access the debt markets.

Whilst the Company is in a net current liability position, as a result of the review, and having made appropriate enquiries of management, the Directors have a reasonable expectation that sufficient funds will be available to meet the Company's funding requirement for the next twelve months from the balance sheet signing date.

Interest
Interest payable and interest receivable are recognised in the income statement in the period in which they are incurred.

Investments in subsidiaries
Investments in subsidiaries are stated at cost and reviewed for impairment if there are any indications that the carrying value may not be recoverable. Reversals are recognised where there is a favourable change in the economic assumptions in the period since the provision was made.

Trade and other receivables
Trade and other receivables are recognised initially at cost less any provision for impairment.

Cash
Cash comprises cash in hand and deposits repayable on demand, less overdrafts payable on demand when a right to offset exists.

Trade and other payables
Amounts owed to group undertakings are recognised initially at fair value, net of transaction costs incurred. Any difference between the amount initially recognised (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

Accounting policies for the year ended 31 December 2017 *continued*

Current and deferred taxation
The tax expense for the year comprises current and deferred tax. Tax is recognised in the income statement.

Current tax liabilities are measured at the amount expected to be paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted at the reporting date. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation.

Deferred income taxation is provided in full, using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the Company's financial statements. Deferred income taxation is not provided on the initial recognition of an asset or liability in a transaction, other than a business combination, if at the time of the transaction there is no effect on either accounting or taxable profit or loss.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised. Deferred tax assets and liabilities are not discounted.

Deferred income taxation is determined using the tax rates and laws that have been enacted, or substantively enacted, during the year and are expected to apply in the periods in which the related deferred tax asset or liability is realised or settled.

Dividend distribution
A dividend distribution to the Company's shareholder is recognised as a liability in the Company's financial statements in the period in which the shareholder's right to receive payment of the dividend is established.

Share capital
Ordinary shares are classified as equity and are recorded at the par value of proceeds received, net of direct issue costs allowing for any reductions in the par value. Where shares are issued above par value, the proceeds in excess of par value are recorded in the share premium reserve.

Heathrow Finance plc

Significant accounting judgements and estimates for the year ended 31 December 2017

In applying the Company's accounting policies, management have made judgements and estimates in a number of key areas. Actual results may, however, differ from the estimates calculated and management believes that the following areas present the greatest level of uncertainty.

Critical judgements in applying the Company's accounting policies

There are no critical judgements for the Company.

Key sources of estimation uncertainty

Investment impairment review
The Company reviews investment in subsidiary for impairment if there are any indications that the carrying value may not be recoverable. The carrying value of the investment is compared to the recoverable amount of the subsidiary and where a deficiency exists, an impairment charge is considered by management. The recoverable amount has been calculated using the fair value less cost to sell methodology. Fair value less cost to sell has been calculated based on discounted cash flow projections of the business.

Notes to the Company financial statements for the year ended 31 December 2017

1 Company result for the year

As permitted by section 408 of the Companies Act 2006, the income statement of the Company is not presented as part of these financial statements. The profit of the Company for the year attributable to shareholders was £1,129 million (2016: £615 million).

2 Investment in subsidiaries

	£m
1 January 2017 and 31 December 2017	5,006

The Company's subsidiary undertaking is Heathrow (SP) Limited, which is incorporated in Great Britain and registered in England and Wales. Details of the principal subsidiary undertakings of the Group are provided in Note 28 of the Heathrow Finance plc group financial statements.

3 Trade and other receivables

	31 December 2017 £m	31 December 2016 £m
Current:		
Interest receivable from group undertakings	**40**	23
Amounts owed by group undertakings - interest free	**51**	51
Group relief receivable	**-**	5
	91	79
Non-current		
Amounts owed by group undertakings - interest free[1]	**74**	74
Amounts owed by group undertakings - interest bearing[2]	**2,336**	1,343
Prepaid debt fees	**-**	1
	2,410	1,418
Total debtors	**2,501**	1,497

[1] Amount owed by group undertakings – interest free relates to the loan receivable from Heathrow (DSH) Limited.

[2] Amounts owed by group undertakings - interest bearing relates to the debenture payable by Heathrow (SP) Limited which is used to fund interest on the Company's bond and loan facilities. As at 31 December 2017, the rate on the debenture was 5.13% (2016: 5.54%). Also included is a loan advanced to Heathrow (DSH) Limited amounting to £508 million (31 December 2016: nil). As at 31 December 2017, the rate on the loan was 5.20%.

4 Trade and other payables

	31 December 2017 £m	31 December 2016 £m
Non-current		
Bonds	**783**	509
Loan facilities	**524**	324
	1,307	833
Current		
Bonds	**-**	265
Interest payable	**19**	18
Derivative financial instruments	**-**	3
Group relief payable	**7**	-
	26	286

5 Share capital

	£m
Authorised	
At 1 January and 31 December 2017	
9,500,000,000 ordinary shares of £1 each	**9,500**
Called up, allotted and fully paid	
At 1 January and 31 December 2017	
3,109,350,689 ordinary shares of £1 each	**3,109**

6 Reserves

	Revaluation reserve £m	Profit and loss reserve £m	Total £m
1 January 2016	1,997	285	2,282
Profit for the financial year		615	615
Dividends paid[1]		(616)	(616)
31 December 2016	**1,997**	**284**	**2,281**
Profit for the financial year		**1,129**	**1,129**
Dividends paid[1]		**(335)**	**(335)**
31 December 2017	**1,997**	**1,078**	**3,075**

[1] During the year ended 31 December 2017, the Company paid dividends of £335 million to Heathrow (DSH) Limited comprising £85 million on 23 February 2017 and £250 million on 20 December 2017. (2016: £615 million comprising £78 million on 22 February 2016, £177 million on 23 June 2016 and £135 million on 22 July 2016, £1 million on 16 September 2016 , £114 million on 6 October 2016 and £110 million on 21 December 2016.)

During the year, the Board has become aware of certain instances of technical breaches of Companies Act 2006 (and before that, the Companies Act 1985 (the "Acts") that have arisen with regard to the dividends paid (between 2013 and 2016) by the company. The instances relate to where reliance was placed on accounts where the reserves shown in the balance sheet had been fully utilised by dividends paid between the balance sheet date and the date of distribution in question or reliance was placed on interim or annual accounts which had not been filed at Companies House prior to the payment of the dividend. The company at all times had sufficient profit and other distributable reserves to justify the payments of dividends. Since the time the breaches were discovered, the company have undertaken rectifications steps to regularise the position. The rectification did not require any adjustments to the accounts and did not have any effect on the company's financial position.

7 Auditor's remuneration

Audit fees are recharged in accordance with the group Shared Service Agreements ('SSAs') into the operating entities. This entity is not an operating entity and is therefore not party to the SSAs and receives no recharge of the audit cost. However, the Company's auditor received £40,000 (2016: £22,000) as remuneration for the audit of the Company's financial statements, the cost of which was borne by LHR Airports Limited.

Details of fees for other services are provided in Note 2 of the Heathrow Finance plc group financial statements.

8 Employee information and directors' remuneration

Employee numbers

The Company has no employees (2016: none).

Directors' remuneration

Details of directors' remuneration for the year are provided in Note 2 of the Heathrow Finance plc group financial statements.

9 Guarantees

Securities and guarantees

The Company and Heathrow (DSH) Limited have granted security over substantially all of their assets, which includes first priority security interests in the share capital of the Company and its wholly-owned subsidiary, Heathrow (SP) Limited, to secure their obligations under their financing agreements.

10 Subsequent events

On 21 February 2018, the Board approved the payment of a £113.25 million dividend to the Company's parent, Heathrow (DSH) Limited. A £113.25 million dividend receipt from the Company's subsidiary, Heathrow SP Limited, was also approved on 21 February 2018.

11 Ultimate parent undertaking

The immediate parent undertaking is Heathrow (DSH) Limited, a company registered in England and Wales.

The ultimate parent entity is FGP Topco Limited, which is the parent undertaking of the smallest and largest group to consolidate these financial statements. The shareholders of FGP Topco Limited are Hubco Netherlands B.V. (25.00%) (an indirect subsidiary of Ferrovial, S.A., Spain), Qatar Holding Aviation (20.00%) (a wholly-owned subsidiary of Qatar Holding LLC), Caisse de dépôt et placement du Québec (12.62%), Baker Street Investment Pte Ltd (11.20%) (an investment vehicle of GIC), Alinda Airports UK L.P. (11.18%) (an investment vehicle managed by Alinda Capital Partners), Stable Investment Corporation (10.00%) (an investment vehicle of the China Investment Corporation) and USS Buzzard Limited (10.00%) (wholly-owned by the Universities Superannuation Scheme).

Notes to the Company financial statements for the year ended 31 December 2017 *continued*

11 Ultimate parent undertaking *continued*

The Company's results are also included in the audited consolidated financial statements of Heathrow Finance plc for the year ended 31 December 2017, which is the smallest group to consolidate these financial statements. They are also included in the audited consolidated financial statements of Heathrow Airport Holdings Limited and FGP Topco Limited for the year ended 31 December 2017.

Copies of the financial statements of FGP Topco Limited and Heathrow Airport Holdings Limited may be obtained by writing to the Company Secretarial Department at The Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW.

Registered office

Heathrow Finance plc, The Compass Centre, Nelson Road, Hounslow, Middlesex TW6 2GW.
Registered in England Number: 06458635