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Civil Aviation Authority
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By email: economicregulation@caa.co.uk

27 September 2024

IAG response to the Civil Aviation Authority CAP 3012 - Second consultation on the extension of the current Commitments framework for the economic regulation of Gatwick Airport Ltd.

1 Introduction

- 1.1 Thank you for giving us the opportunity to respond to the second consultation on the proposed extension of the Commitments Framework for Gatwick Airport Limited (“GAL”) for the period 2025-2029.
- 1.2 We fully endorse the response submitted by British Airways to this same consultation. This response is submitted by the International Airlines Group (“IAG”) on behalf of our airlines British Airways, Iberia Express and Vueling which collectively carry over 9 million passengers to and from Gatwick every year, providing greater choice to consumers and enhancing the UK’s air connectivity.
- 1.3 Overall, we support the extension of the Commitments framework itself by another four years, as proposed by GAL and the CAA, on condition the Commitments be significantly improved and strengthened to tackle GAL’s excessive charges and profits, address shortcomings in core service standards (CSS) and on-time performance, and ensure investment is made where critically needed and on budget, to the ultimate benefit of consumers.
- 1.4 Given the CAA’s proposed approval is predicated on the Northern Runway expansion project (NRP) being approved, we would like to see a clear alternative route being defined by the CAA in mitigation, should this application be rejected or delayed, to prevent GAL from unduly accruing greater profits to the detriment of consumers.

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2 Background

- 2.1 In 2014 the CAA determined that GAL has significant market power (“SMP”) and that there was a risk the airport could abuse its position “through excessive pricing, inefficiency, inferior service quality or investment”.¹
- 2.2 A set of “commitments” was subsequently put in place as part of GAL’s licensing conditions which in parallel allowed for bilateral agreements to be negotiated between GAL and airlines. The initial regulatory period was extended in 2021 and, taking into account the impact of Covid-19, the commitments were amended and extended until 31 March 2025.
- 2.3 GAL has made another proposal to extend the commitments framework for another 4 years until March 2029, based on:
- i. a cap on published charges of CPI-1% for the first two years and CPI-0% for the final two years;
 - ii. an extension of the current commitment to investment a minimum of £120 million per annum; and
 - iii. an intention to introduce a CCS metrics on Air Traffic Control (“ATC”) and Special Assistance passengers.²
- 2.4 The CAA consulted stakeholders in March 2023. Following feedback by airlines that GAL’s proposal required a much deeper and thorough analysis, the CAA have launched a second consultation. In this second consultation the CAA confirm their initial assessment is to accept GAL’s proposals, emphasising GAL’s pursuit of expansion plans as being in the interest of consumers, and adding two caveats:
- i. that GAL obtains a Development Consent Order (“DCO”) under the Planning Act 2009 to further its Northern Runway Expansion project and make good progress with developing these plans over the new regulatory period; and
 - ii. bring forward credible plans to address the concerns on quality of service and special assistance services.

¹ CAP1134: Market Power Determination in relation to Gatwick Airport.

² CAP2554: Economic regulation of GAL: consultation on proposal to extend the current commitments

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3 IAG's response to the CAA's initial assessment of GAL's proposal

3.1 The proposed price cap will be applied on a significantly inflated base

- 3.1.1 While GAL's proposal of a CPI-1% cap for the first two years of the extension period and CPI+0% for the final two years is an improvement on the status quo, and may indeed appear reasonable in the first instance, it will result in compounding profits, estimated to exceed £1billion over the four year period and with operating margins reaching approximately 60%, when compared with the application of a market assessed WACC to the Gatwick asset base. This is because the baseline charge on which the cap will be applied is hugely inflated and has been for a number of years.
- 3.1.2 According to our analysis, we estimate costs to have deviated from a competitive cost base by approximately 30% and believe the price cap should be set at **CPI-20-30%** in 2025 (followed by a reasonable price path of CPI+0% thereafter) which would still deliver a fair return to shareholders, enable investment in current infrastructure while giving consumers a fair deal.
- 3.1.3 Given the disparity between GAL's proposal on the price cap and our calculations, we believe **further in-depth assessment is required by the CAA** in the interest of all stakeholders, not least consumers.

3.2 Excessive profits are not a prerequisite for investment in expansion

- 3.2.1 As part of its assessment of GAL's performance against the framework, the CAA opted to commission external consultants to benchmark GAL's prices and profitability against a number of non-regulated airports in the UK.
- 3.2.2 The CAA's benchmarking of GAL against other non-regulated UK airports oversimplifies the comparison required to address GAL's complex price structure and fails to fully account for GAL's SMP. Despite this, it is evident from this exercise that GAL is realising very high profits which are projected to increase further in future.
- 3.2.3 The CAA projects GAL's future EBITDA margin to rise to 57-65%, higher than the 47-55% recorded between 2014-2019, and notably higher than the 30-55% typical for the non-regulated UK airports. Similarly, the operating profit margin is expected to increase to 41-50%, well above the 27-34% range for the same earlier period.

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- 3.2.4 These rising profitability indicators all point to the risk that GAL could be exploiting its SMP. Yet the CAA is prepared to green light GAL's proposal on the basis this would attract investors to invest in the NRP which the CAA deems in the interest of consumers.
- 3.2.5 While such high operating margins and profits would undoubtedly attract investors, IAG and other partners in the aviation business have long demonstrated their ability to attract significant investment, and indeed invest in entities themselves which generate much lower profit margins. There is therefore no justification in needing to accrue excessive profits for this purpose.
- 3.2.6 Given the record levels of profit to date, we believe the NRP could be funded exclusively from the excessive profits made in the current regulatory period, rendering additional safeguards unnecessary. GAL would also be able to finance the NRP works earmarked for the extension period even after reducing its charges by at least 20%, as recommended above.
- 3.2.7 It is also worth noting that significant spend on this expansion project has already started in 2023 and that airlines are already pre-funding this project which may or may not proceed while GAL's profits continue to accumulate.

3.3 Bilateral agreements tip the balance in favour of GAL

- 3.3.1 The CAA views the commitments framework as a "proportionate and targeted approach to the economic regulation of GAL" in so far as it "encourages bilateral agreements between airport and airlines, fostering commercial decision-making rather than regulator-led intervention", which benefits consumers. However, given real competition is absent, airlines are left in a significantly weak bargaining position versus an airport holding SMP, unable to effectively push for better terms in the negotiation.
- 3.3.2 The lack of any true value for money for consumers is exacerbated by the fact that any modest discount negotiated in these asymmetric agreements is applicable on a significantly inflated published rate, as discussed under the 'price cap' section.
- 3.3.3 We therefore urge the CAA to require GAL to negotiate fair and equitable arrangements with airlines, removing the imbalance of power which currently favours GAL. We encourage the CAA to audit these commercial agreements, as per its previous undertaking, which has to date not taken place.
- 3.3.4 In addition to tracking excessive returns and inflated charges, the audit of bilateral agreements should help inform the CAA, as part of a wider review, whether a more prescriptive form of regulation is ultimately required for GAL, similar to the other UK major airport which has also been identified by the CAA as having significant market power, namely Heathrow Airport Limited.

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3.4 Deteriorating service standards are failing consumers

- 3.4.1 Despite the airport's growing profitability there has been insufficient investment in critical areas to support core service standards (CSS). As noted by the CAA in the consultation document, GAL continues to make significant returns, yet service quality has not kept pace with these gains.
- 3.4.2 We therefore share our concerns with the CAA at the level of service experienced by our customers at Gatwick. To this extent, IAG welcomes the CAA's requirement for GAL to bring forward credible plans to deal with these concerns.
- 3.4.3 The **average metrics used in the CSS mask critical issues** experienced on certain days or periods, creating a distorted view. The CSS relies on averages that fail to capture critical congestion periods such as the summer months and peak-times when security queues experience significant delays and PSL drop below target on a daily basis.
- 3.4.4 Through the Airline Consultative Committee (ACC) airlines having been striving for more suitable metrics and additional targets, however, there has been a degree of **reluctance on the part of GAL to amend current metrics**.
- 3.4.5 Our airlines continue to face daily operational issues at GAL which stem from a combination of poor infrastructure design, inadequate systems, and outdated technology which often leads to passenger dissatisfaction and boarding delays. We therefore need a more robust CCS framework which would allow all deficiencies including the above examples to be accurately measured and addressed, ensuring **GAL is held accountable for providing passenger service and satisfaction**.
- 3.4.6 Overall, we need the CAA to step in to become an active participant and provide stricter oversight to address long-standing issues experienced by consumers. We urge the CAA to consider a **complete redesign of the current CSS framework** to more accurately reflect the expectations of our customers and set in place a workable solution for the current impasse. The CAA needs to impose stricter targets, increase penalties for missed targets and link rebates to real-time performance to encourage GAL to actively manage and improve quality of service. The CAA should also incentivise GAL to direct investments where critically needed. Consumers are currently not receiving the service they deserve, and the CAA needs to impose real consequences for continued underperformance.

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3.4.7 **We welcome the introduction of a metric on ATC in the CSS framework.** While we acknowledge that certain operational issues are out of GAL's control, airlines are at the mercy of contracts agreed with third-party suppliers by GAL of which there is very limited visibility. Yet our customers bear the brunt of any failings in this area. Airlines would like to be more actively involved to ensure the contracts provide the right incentives to third party suppliers. Our airlines continue to experience operational disruptions and further resilience needs to be urgently built in and addressed as part of this metric.

3.5 Capital investment oversight at GAL is weak

3.5.1 While we welcome GAL's commitment to maintain a minimum level of investment, the **current capital oversight system lacks transparency** and fails to adequately involve airlines to help prioritise investments within the overall plan. Airlines should be given more opportunity to influence decisions on capital projects, making sure expansion ambitions do not proceed at the expense of smaller projects that could enhance existing operational performance, resilience and service quality, as outlined in the section above.

3.5.2 GAL sometimes defers or underinvests in key projects, such as infrastructure improvements, without proper consultation. On the other hand, GAL also misses key metrics on certain investments. The rationale for such deferrals, delays and overspends remain unclear, and there is insufficient transparency on how this affects service delivery in the interim.

3.5.3 **Airlines have raised concerns on overspending in certain projects and underinvesting in areas that directly affect operational efficiency** which GAL has not addressed in its CIP. GAL's decision to defer investment from CIP23 to CIP24, while extending the measurement period from 6 to 10 years, suggests a lack of urgency in resolving critical issues.

3.5.4 **We need the CAA to play a more active role in monitoring GAL's capital investments**, ensuring consumer interests are central to decision-making. The CAA should ensure GAL commits to investments that enhance operational performance and maintain infrastructure that benefit consumers directly. The CAA should also provide stricter oversight to prevent unnecessary delays in critical projects and ensure GAL's capex aligns with improving service quality.

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3.6 A rejection of the DCO expansion application could render the Commitments obsolete before they enter into force

- 3.6.1 Given the CAA's intention to support GAL's proposal is predicated on expansion moving ahead, a negative decision on the DCO application could render the Commitments outdated before the next regulatory period commences. On the other hand, if the decision is delayed, GAL could accrue additional excessive profits while investment in the project is not able to be made.
- 3.6.2 **We fully support the CAA's position that in the event the NRP is not approved the CAA would review the level of the pricing commitment** with a view to modifying the pricing structure and GAL's licence.
- 3.6.3 We are of the firm view that **a clawback provision should be included** in the CAA's caveat to capture any excess profits GAL may accrue during this period, preventing the airport from benefiting unfairly until critical decisions by the Regulator are made. We see the clawback provision being essential to reinforcing consumer interests and preventing overcharging airlines and in turn, consumers. The amount of provision included in GAL's contract and commitments relating to the NRP needs to be fully transparent and we would urge it is 'de-linked' from the price path for ease of measurement and assessment.

3.7 We call for greater monitoring and stricter oversight by the CAA

- 3.7.1 We call on the CAA to take a more active role in the economic regulation of GAL, specifically with regard to monitoring and providing greater oversight of bilateral arrangements and capex discussions and intervening in CSS deadlocks.
- 3.7.2 As the CAA's primary duty is to protect current and future consumers, and its secondary duty to promote efficiency on the part of licensees, it behoves the CAA to intervene when an airport with SMP risks making excessive returns while its service standards decline.

3.8 Conclusion

- 3.8.1 While we support in principle the concept of extending the commitment framework for another four years to 2029, we are gravely concerned at the continued level of excessive pricing by GAL and its deteriorating service standards. We cannot support the CAA's initial view that GAL's current proposal is likely to be in the interest of consumers. We therefore urge the CAA to improve GAL's proposition by introducing binding and meaningful changes to the proposed set of Commitments, as outlined in our response.

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3.8.2 The CAA's involvement is vital in safeguarding consumer interests, improving service standards, and ensuring GAL does not exploit its market power to prioritise profits over quality. Tighter regulation, intervention, and monitoring are needed to uphold the CAA's responsibilities.

On behalf of IAG and our airlines, we would like to reiterate our thanks for giving us the opportunity to outline our views and stand ready to answer any follow up queries the CAA may have.

Yours faithfully,



Matt Davies
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