Civil Aviation Authority
Westferry Circus
Canary Wharf
London EH14 4HD

cc: economicregulation@caa.co.uk

30th November 2020

IAG response to CAP1973: Economic regulation of Gatwick Airport

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Gatwick Airport. This submission is made by International Consolidated Airlines Group SA (IAG), which is the parent company of British Airways, Iberia, Vueling, Aer Lingus and LEVEL.

The IAG airlines have been operating under GAL's Commitments since their inception in April 2014. The Commitments are a significant change from the previous "RAB based" regulatory framework of the previous quinquenniums. Commitments regulation has removed some unnecessary regulatory administration and simplified some of the consultation processes that were previously undertaken between the airport and the airlines. However, there are still a number of issues with the existing commitments regulation which are outlined in this response. The proposed Commitments framework from GAL was published prior to the Covid-19 pandemic. Since then, traffic has declined significantly and there is a high level of uncertainty about future traffic forecasts. However, IAG had several concerns with the proposal at the time and several of these continue to be a concern in the new environment.

Our comments in response to GAL's proposals are outlined in this letter. We are disappointed that GAL have not recognised the majority of issues that we raised and instead pushed forward with their Commitments framework unilaterally.

It is important to recognise that Gatwick remains subject to regulatory price control as a result of its substantial market power. To ensure that incentives remain appropriate, the periodic review should therefore consider whether the building blocks that comprise the model within which Commitments framework sits remain appropriate. To allow users to validate if the price path remains appropriate, the CAA should continue to mandate GAL to calculate and publish the shadow RAB, as is the case today.

Price path

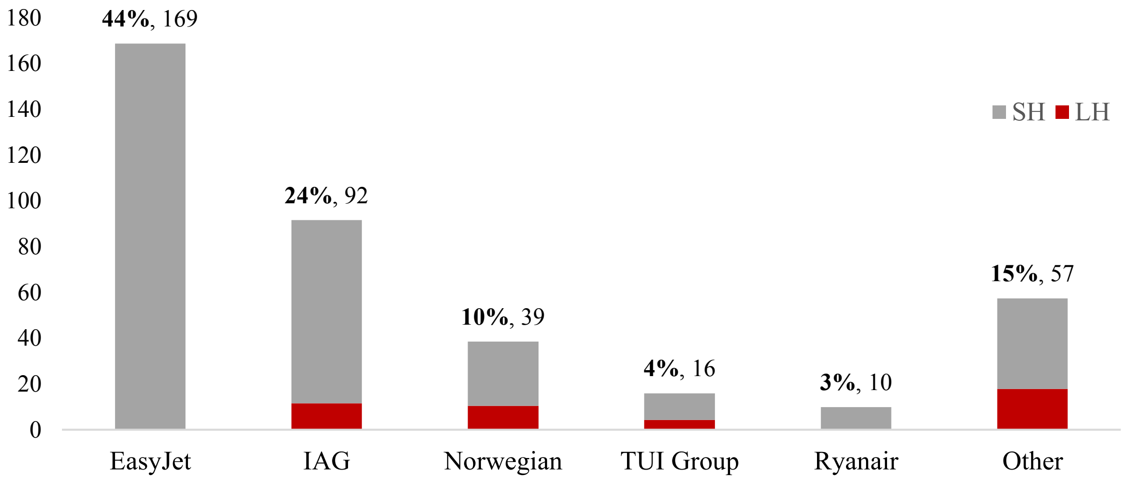
1. Market data and recent regulatory determinations have shown that the cost of capital has decreased significantly, primarily due to the low interest rate environment driving down the cost of debt. The cost of capital has a significant impact on the revenue requirements for GAL and the most recent data suggests a downward pressure on the required yield. A precedent has been set

in this area recently, with the NATS RP3 process determining a vanilla WACC of 2.68%[1].

2. Our modelling suggests that with a very conservative traffic forecast and adjustment to the WACC as detailed above, GAL's proposed gross yield of £10.29 is still almost 30% above a yield that would be permitted under price control regulation determined with 'building blocks'. For reference, GAL's 2018/19 achieved 'net yield' would also be 15% higher than a 'building block' yield. IAG request that the CAA share modelling of the building blocks at Gatwick Airport to provide evidence that the Commitments are in keeping with the intent of price control regulation, to ensure GAL are appropriately incentivised, and are not over-earning to the detriment of consumers at the outset of the next commitments period.

3. Whilst the outlook on passenger volumes is highly uncertain, we believe that Gatwick is well positioned to see a strong recovery in passenger numbers. Gatwick has a high proportion of both short-haul European traffic and low-cost carrier presence (**Figure 1**). Short-haul traffic has been significantly more resilient in the face of the Covid-19 pandemic and is expected to recover faster than long-haul traffic. Low-cost carriers have also weathered the pandemic better than full-service carriers and are expected to aggressively take market share in the recovery. For

Figure 1: Daily slot pairs at LGW by airline group (FY19)



Source: OAG, reflects slots scheduled and used

example, Wizz Air have recently announced that they want to target Gatwick as their primary focus for expansion in the UK[2].

4. IAG is concerned by GAL's proposal to remove the net yield price path and focus solely on gross yield. Removing net yield reduces transparency and removes the incentive for GAL to act commercially by negotiating discounts with airlines. Whilst GAL state that they do not see the difference between net and gross yield "narrowing systematically over the upcoming period", we do not believe that this provides adequate protection to consumers. Recent experience in contract negotiations with GAL is that the airlines must provide growth to prevent rate

[1] CMA final decision for NATS En-route Limited ("NERL") https://www.gov.uk/cma-cases/nats-en-route-limited-nerl-price-determination

[2] https://www.bloomberg.com/news/articles/2020-08-25/wizz-air-sets-sights-on-20-jet-gatwick-base-as-rivals-retreat

increases. GAL's commitment to repay over recoveries based upon gross yield and the CAA's proposal to 'monitor' the average level of discounts provided by GAL do not provide protection to consumers. The reinstatement of a 'fair price path' for net yield would provide guidance to GAL's pricing, a framework for CAA monitoring and protection to consumers.

5. IAG believes that the method of indexation used in GAL's price path should transition to CPI or CPI-H. In the UK, the robustness of the RPI has been called into question and since March 2013, it has no longer classified as an official government statistic. Since 2003, the Monetary Policy Committee has used CPI in place of RPI for the purpose of targeting inflation and setting interest rates. The UK Statistics Authority published a review of the production of consumer price statistics in 2015, concluding that "RPI is a flawed statistical measure of inflation…taxes, benefits and regulated prices should not be linked to the RPI". The Chancellor's announced on 25th November that the index would be adjusted in 2030 to CPI-H[3], with this change in indexation already implemented in other sectors. For example, the UK water industry will transition to CPI-H over the course of the next price review, and Ofgem has previously made the transition for gas and electric networks. We urge the CAA to conduct of review of and provide guidance of how indexation might evolve from RPI to an appropriate CPI based metric.

6. In conclusion, IAG believes that whilst there is still a high level of uncertainty in the market due to the Covid-19 pandemic, the price path GAL are proposing for the next Commitments term is not reflective of current market conditions. We urge the CAA to update the assumptions in their own modelling to reflect up-to-date trading conditions at Gatwick and the wider market to inform a starting position for the next Commitments period that is in the consumers interest. We strongly recommend that the CAA propose a **net** yield price path based on these new assumptions.

Core Service standards

7. This is the first significant review of the core service standards in over a decade between the airline community and GAL. This has led to improvements in a number of areas. Our views are detailed in the following section.

8. IAG considers passenger security at Gatwick to be efficient and provides a consistently high level of service. However, the current method of measuring outcomes using passenger segments and not individual passengers can misrepresent the service delivered and therefore IAG believes that an all passenger measurement is the most accurate and appropriate methodology. IAG accept that this may not currently be feasible and increasing the number of passengers measured and weighting the segment-based measure is an acceptable process until technology allows for an all passenger measurement. The current M-flow system used in Gatwick is not able to measure passengers wearing masks and therefore GAL need to commit to having measurements through a jointly agreed new system from 01st April 2021.

[3] HM Treasury, A consultation on the Reform to Retail Prices Index (RPI) Methodology, https://www.gov.uk/government/consultations/a-consultation-on-the-reform-to-retail-prices-index-rpi-methodology

9. IAG welcomes improvements in the metrics for staff search moving from 95% <5min to 97% <5mins, however as with passenger search, we believe basing the metric on segments rather than staff members does not provide an accurate representation of the service delivered.

10. Stands, Jetties & FEGP – IAG understand that discussions are on-going between the LGW ACC and GAL to move to a new measurement metric. In the event that this produces an agreement then IAG will support this on the basis that IAG airlines are represented on the ACC. If no agreement is reached then it is our belief that the existing measurement metric should be retained from April 2021. IAG does not support GAL's previous proposal to allow up to six units of each type to be removed for maintenance at any one time as this is excessive and represents a significant operational risk to airlines and customers.

11. Airfield Congestion Term – IAG is encouraged by the airline community and GAL's agreement to move towards a time-based measure of runway unavailability. GAL's agreement to increase rebates payable for periods of runway unavailability is welcomed as this should ensure there is suitable incentives to maintain runway availability. This new system also significantly reduces complexity in the measurement process.

12. Outbound baggage (OBP) – GAL's have improved their initial proposal to 98%, however this is critically important to our customers, and as such the target should be set higher. Allowing up to two percent of bags to not travel and still comply with a measure is counter to any definition of good service. OBP was introduced as a new measure within the original Commitments and as the outcomes were unknown at the time, the measure was set at a low base to reflect this. It has now been in operation for five years and consistently exceeds 99.5% per day; the measure should now be increased to reflect current levels of performance and ensure that GAL is incentivised to operate the baggage system effectively. IAG would recommend a floor level of a minimum 99%.

13. Airline Service Standards – IAG believe that the current practice of reducing airline rebates for failures to meet service targets can lead to unintended outcomes, including reducing airport infrastructure investment. As an example, not investing in enough arrivals baggage infrastructure may lead to slower baggage delivery times that then create a financial penalty that is passed on to airlines. In this situation the airport has avoided capital investment and reduced rebates to airlines.

Capital Investment and Consultation

14. The proposed GAL commitment for capital investment provides no certainty to airlines that projects that support either the customer experience or operational resilience will be delivered. A lack of timely investment in passenger infrastructure was a key theme of airlines feedback to the CAA during the first commitment period. Evidence of the negative impact this has had on customers was seen with domestic and common travel area arriving passengers requiring coaching for a period of three years, whilst GAL investigated solutions. Whilst IAG accept that this came about as a result of a change in policy by the UK Border Force, an acceptable solution could have been found much sooner. Other regulated airports require greater agreement on the

scope and timing of key projects to ensure better customer outcomes and IAG strongly encourages GAL to propose a mechanism to remedy this moving forward.

15. Whilst GAL and airlines have worked together to improve the capital consultation process this is still untested. The previous capital consultation and project prioritisation took little to no account of projects that reduce airline operating costs, yet driving economy and efficiency – both in airport and airline operations – is a key requirement of CAA12 to ensuring that services are provided to consumers at minimum cost[4]. There is evidence to suggest that some projects have had scope reduced without consultation with airlines, which has reduced GAL's capital spend whilst increasing airline operating costs and impacting the consumer as a result. Examples would include the lack of suitable infrastructure for the PRM operation in both Pier 1 and the descoping of parts of the proposed Pier 6 extension. These changes increase the operating costs of the PRM company that is then passed back to airlines.

16. IAG request that the CAA strengthen the governance and monitoring of capital consultation and investment for this commitment period. The CAA offering to monitor behaviours within a control period without specific indication of what that monitoring entails does not provide sufficient protection to the airport users and does not provide an adequate efficiency incentive on a regulated airport under CAA12. IAG propose that the CAA invoke a capital consultation review two years into the extended commitment period. This should be supported by a clear framework of requirements and what actions will be taken if the review finds that consultation is not working in the interests of consumers.

In summary, IAG recommends that the CAA carries out a detailed, evidence-based review GAL's proposals reflecting updated building blocks and current market conditions.

Yours sincerely

Alistair Hartley
Director of Strategy

[4] CAA12, Section 3(c) https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1